

January 7, 2004

NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500
Attention: Barbara Z. Sweeney

Re: Request for Comment on the Proposed Rule Governing Allocations and Distributions of Shares in Initial Public Offerings

Ladies and Gentlemen:

W.R. Hambrecht + Co., LLC (“WR Hambrecht + Co.”)¹ welcomes the opportunity to provide the National Association of Securities Dealers, Inc. (“NASD”) with its comments on Notice to Members 03-72, dated November 2003 (the “Notice”), in which NASD requested comments concerning (i) a proposal by the NASD to amend proposed Rule 2712 (the “Amendment”), and (ii) certain additional regulatory steps, mentioned in the Notice, that might be adopted to “promote transparency in IPO pricing.”

WR Hambrecht + Co commends the NASD on targeting an issue of substantial magnitude and critical importance to the US economy. The emerging growth sector of the US economy has and continues to be a primary engine of economic growth. A study commissioned by the National Venture Capital Association (“NVCA”) in the summer of 2002 found that venture capital-funded companies contributed nearly \$1.1 trillion to GDP and directly accounted for 12.5 million jobs in 2000. If supporting businesses that deliver goods and services to these venture-backed companies were also included in the total, the jobs number increases by a multiplier of 2.2, translating to 27 million jobs². A critical factor for the success and continued growth of the venture-capital community is the ability to access equity capital, which requires a vibrant IPO market. As Mark Heesen, President of NVCA commented recently, “strong exit markets are essential to the long-term health of the venture capital industry³.” In order for the IPO markets to be fully functional and efficient, they need to be trusted, fair and transparent.

Sadly, in recent years, the IPO process has lost substantial credibility as the recent enforcement actions and attendant publicity surrounding underpricing and preferential

¹ Founded in 1998 by William R. Hambrecht, WR Hambrecht + Co is a private financial services firm committed to using the Internet and auction process to level the playing field for investors and issuers.

² DRI-WEFA study released June 26, 2002. In the study, DRI-WEFA constructed two databases consisting of 16,278 venture capital financed companies to estimate the annual contribution of the venture capital industry to the US standard of living over the last 30 years.

³ NVCA. “Venture-backed IPO Market Shows Signs of Life in the Third Quarter.” October 1, 2003.

allocation of IPO shares to favored customers have made it increasingly obvious that the IPO market was indeed an “insiders game.” In the class action suit pending in the Southern District Court of New York on behalf of investors in 312 companies that went public between 1998 and 2000, \$49.7 billion of “guaranteed profit” was allocated by underwriters and \$91.2 billion was lost by investors who bought in the aftermarket⁴. Given that there were over 2,000 IPOs during the most recent IPO bubble, the combination of underwriter giveaways and investor aftermarket losses stretches into the hundreds of billions of dollars. These numbers, and a long list of well-publicized instances of questionable behavior, were enabled by the systemic failure of the traditional IPO pricing mechanism and regulatory framework to prevent underwriters from acting in their narrow self-interest at the expense of investors and issuing companies. The abuses were not confined to a subset of underwriters –many of the most reputable investment firms were the most active players during the period and their track records are consistent with the general pattern. The obligation of regulators must be to ensure that such a pattern does not occur again. Without substantial action on the part of NASD and other regulatory agencies, we feel that the return of such behavior is inevitable during the next “hot” IPO cycle.

The fundamental flaw in the current IPO process is the incentive for underwriters to underprice IPOs in order to create “guaranteed profits” for select clients. Traditional underwriters’ judgment is understandably guided in large part by their economic self-interest, specifically the steady commission flow generated by their relationships with institutional investors and potential future investment banking assignments. In “hot” IPO markets, this trend is exacerbated, and some institutions (such as hedge funds) have actually bid for allocations with promises to the underwriter of above-market commission flow. One public investigation found that a leading underwriter received back in above market commissions from a hedge fund client an amount equal to 50% of the first day profits realized by the hedge fund on the sale of its IPO shares. Our general estimate is that 20% to 30% of the gains generated by underpricing were paid to underwriters as compensation for other transactions or services. Given the tens of billions of dollars of allocated “guaranteed profit”, in many cases the scale of these de facto rebates to underwriters may have overwhelmed the money that underwriters received from fees from the issuing companies.

Underwriters have attempted to justify this underpricing by categorizing their pricing as “conservative” and in the best interests of the issuing company. In reality, this systemic guaranteed profit attracts trading-oriented accounts including some major institutional investors, who are not interested in holding shares of the issuing company as a long-term investment, but seek a quick profit and invariably “flip” their shares after the initial run-up in the price of those shares. Moreover, the issuer raises significantly fewer proceeds than the demand would allow, resulting in money left on the table. In a typical underpriced IPO, the price tends to have an immediate run-up on the first day of trading. The run-up generates positive publicity for the issuer and attracts uninformed retail investors, who purchase shares in the aftermarket thinking that the run-up implies a special investment opportunity. Hence, the public ends up buying the shares at the highest price.

⁴ As of December 11, 2003.

It is not surprising that most underwriters have been reluctant to change the traditional IPO system as they benefit extensively from the current process. Nonetheless, in order to make a meaningful attempt to restore the credibility of the US IPO process, regulators must bravely target the two fundamental areas in which the traditional IPO process fails to hold underwriters accountable – arbitrary pricing and preferential allocation. Both of these issues deserve detailed attention.

Arbitrary Pricing

The necessity for NASD action on IPO reform arose primarily from widespread broker-dealer abuses that developed from inherent conflicts of interest in the traditional IPO process. The offending broker-dealers were able to act in ways that were contrary to the best interests of issuing companies and investors. Their behavior was enabled by the closed and non-transparent nature of the traditional process, specifically the underwriter's lack of accountability for pricing an IPO appropriately. The recommendations in the Notice fail to establish an explicit fiduciary duty on the part of member firms that would make underwriters accountable for their IPO pricing decisions. In the equity secondary markets, the SROs have been quite successful at protecting investors by promoting the requirement of "best execution." The use of new technologies has made it easier to access these alternatives, and investors have benefited with significantly increased liquidity and substantial reductions in transaction costs.

In contrast, the IPO market pricing mechanism currently resides outside of the framework of rules and regulations that govern conduct to insure best execution. The notion that an underwriter is a principal given the "bought deal" nature of the underwriting transaction, and therefore not subject to typical agency regulation, is no longer compelling, as the vast majority of deals are fully sold immediately to new buyers. Underwriters will typically wait until an IPO is oversubscribed before they make their firm commitment to the issuer, which effectively makes an IPO resemble an agency transaction. The NASD should do everything it can to bring this concept of "best execution" to the IPO market, so that the IPO market can benefit from the same principles that have so effectively served the equity secondary markets.

Preferential Allocation

In our view, the incentive to take advantage of arbitrary pricing is most apparent in a system that allows underwriters to allocate shares to their best clients, regardless of whether they are the appropriate long-term investors from the issuing company's standpoint. The Final Report to the NASD/NYSE Advisory Committee details a wide range of abuses by underwriters and acknowledges a general trend of underwriters delivering "guaranteed profits" to preferred clients – yet its recommendations only cover the end results of these abuses. The Committee refused to target the fundamental cause of the abuses – the unchecked ability of underwriters to allocate shares to their best clients.

If an underwriter is permitted to limit the recorded demand for an offering to favored clients and to allocate shares at its whim, the underwriter will inevitably be tempted to underprice the offering. This underpricing creates an economic rent in the form of "guaranteed profit",

which fosters an environment in which favored investors will emerge to bid on the value created. Even if, as expected, the SROs limit excessive compensation in the form of inflated commissions, potential investors or other related parties are virtually certain to find other ways to compensate an underwriter for that value.

The Committee, in fact, chose to emphasize that the report “in no way is intended to restrict the underwriter’s lawful exercise of its allocation discretion.” That is a mistake in our view. The only way to fundamentally address the abuses in the system is to utilize every available distribution channel to gather demand from all pre-qualified investors and to distribute in a non-preferential manner. The Amendment’s requirement that the lead managing underwriter disclose indications of interest would add some transparency to the process. However, the Amendment does not address the obligation of the underwriter to record full suitable demand or to disclose its prior economic relationship with the investors to whom it allocates.

Specific Comments on the Amendment

The undersigned served as an active participant on the NYSE/NASD IPO Advisory Committee referenced in the Notice. The Committee recommended the proposed amendments to Rule 2712 in the Notice and we feel that they will add some transparency to the IPO process and eliminate certain limited instances of abuse. In our view, however, the proposed Amendment, as written, fails to promote reforms that would fundamentally target the issues of arbitrary pricing and preferential allocation. The Amendment would not create a regulatory framework that would require firms to price IPOs on a more objective basis and more appropriately allocate IPO shares. With that in mind, we focus our comments on the potential strength of the three additional regulatory steps mentioned in the Notice.

- 1. Retain an independent broker-dealer to opine that the initial IPO price range at which the offering is marketed and the final offering price are reasonable and require that the independent broker-dealer’s opinion is disclosed in the prospectus**

While incrementally improving the accountability of the lead underwriter, this proposal offers an incomplete solution to the reality of arbitrary pricing. First, an independent broker-dealer would not have an efficient mechanism to separately canvas the demand for an IPO, leaving the broker-dealer largely beholden to the lead underwriter for information. Second, in the absence of an explicit fiduciary duty on the part of the lead underwriter, there is no specific standard for a third party to determine whether the underwriter chose an appropriate initial price. Another consideration is the question of which party would pay for such an opinion. In addition, if the managing underwriters were involved in the selection of the third party reviewer, it would be unlikely that party would be truly independent, which might in fact have the perverse effect of allowing friendly parties to act in ways which actually reduce the accountability of lead underwriters. A preferable standard in our view would be an explicit requirement that the lead underwriter itself commit to a fairness opinion, similar to the opinions delivered in merger and acquisition transactions, in which the underwriter would justify the valuation based on actual demand. More specific additional pricing requirements using traditional metrics could also be instituted.

The board of directors of the issuing company should be reminded of its fiduciary responsibility to seek and obtain a reasonable final offering price and should certify and support the fairness opinion of the lead underwriter. Information required to set the price range for an IPO ultimately must come from the company, and the company must take joint responsibility for determining the appropriate price range based on that information. Requiring the board of directors to sign off on the opinion letter provides an additional check on the IPO process and makes explicit that obtaining a reasonable price is a shared responsibility of the underwriter and issuing company.

We encourage the NASD to consider revising the Amendment to incorporate the foregoing concepts.

2. Use an auction or other system to collect indications of interest to help establish the final IPO price

The goal of any new IPO regulation, as discussed above, should be to eliminate arbitrary pricing and preferential allocation. The goal should be to find an objective mechanism to judge whether a lead underwriter has approached the “best market” for an IPO. The traditional IPO process does not enable such a judgment, as potential IPO investors are not required to place hard orders for demand or to specify a specific price level – instead they suggest a non-binding price range within which they would be willing to participate.

In a similar vein to the SRO regulation of the secondary market, there are clear principles that should be mandated in determining the “best execution” of an IPO. First, that the underwriter address and record all potential markets of demand for an offering. Second, that the final allocation reflect the true demand and not a subjectively determined subset. Third, that the process be completely transparent between the issuer and the underwriter. We recognize that such a “best market” does not necessarily imply the highest price, but involves the quality of the buyers, their intended holding period, the timing of the offering and other considerations.

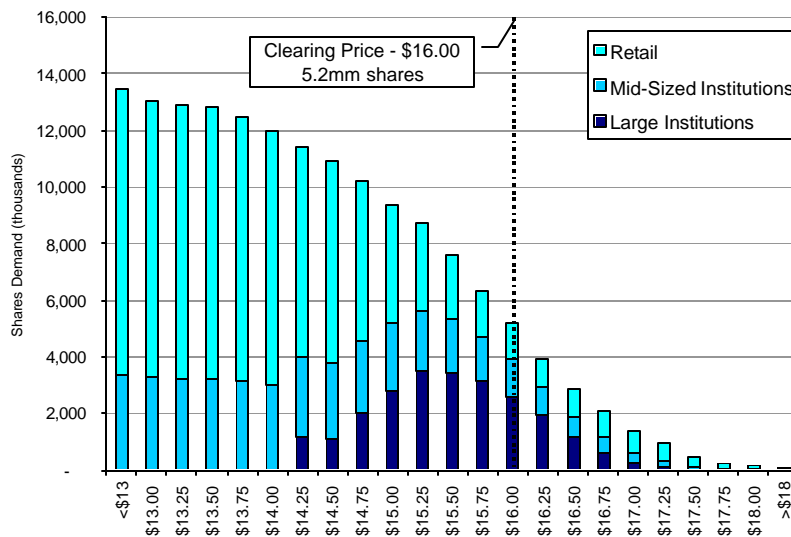
WR Hambrecht + Co was founded with the goal of finding a mechanism that would accomplish those objectives. Among other things, we studied the various approaches used by other countries. India offers a lottery, while Japan used a modified auction exclusively until 1997. Several authors have pointed out that the overwhelming use of a book-building process indicates its superiority over other methods such as the auction. We interpret the preference for book-building as a reflection of the political strength and economic self-interest of the underwriting firms. We also believe that prior attempts at alternative IPO pricing mechanisms were tested at a time when it was far more expensive to gather indications of interest from all investors than it is today. It was also more challenging for investors to gain access to relevant information about issuing companies and their markets. The increased use of the Internet has enabled broader and more efficient collection of demand and distribution of information.

After a thorough analysis of the alternatives, we settled on a Dutch auction, based on the Vickrey algorithm, for our IPO system called OpenIPOSM. To date, we have completed nine

OpenIPOs⁵. We designed the auction system to eliminate the fundamental conflicts addressed above – replacing arbitrary pricing and preferential allocation with a system that objectively establishes the full demand curve for an IPO and allocates to those investors willing to pay the highest price. The empirical evidence, which we detail below, suggests that this process discovers a better price, enhances the distribution of the offering by finding long-term holders and levels the playing field for retail and other smaller investors, while limiting volatility and eliminating the appearance of impropriety.

OpenIPO was designed to realign the incentives in the underwriting process in favor of long-term investors and issuing companies. The goal was to eliminate the influence of economic self-interest on the part of an underwriter in pricing and allocating an IPO. Specifically, we wanted to avoid the incentive to underprice IPOs and allocate the “guaranteed profit” to customers that would reciprocate with greater commission flow or related compensation.

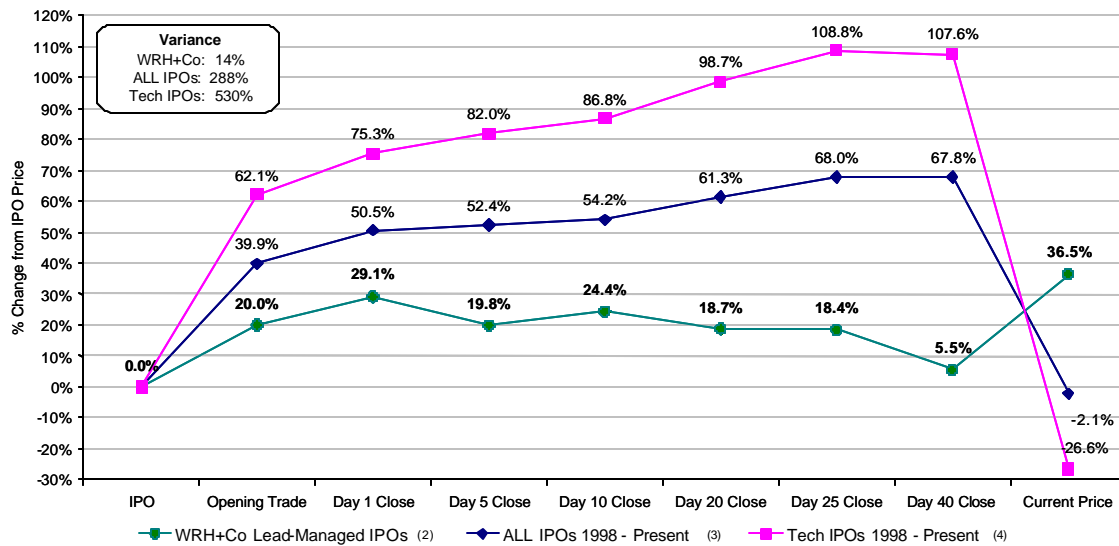
The implementation of an auction mechanism does not require a fundamental change to the IPO process. The underwriter performs due diligence and determines the appropriate positioning of the company relative to its peers. A marketing effort, including a prospectus and road show, is conducted for potential investors. The difference in an auction pricing involves the method in which the demand curve is generated. In OpenIPO, each pre-qualified investor indicates both the price they are willing to pay and their desired number of shares. The investor bids are stacked from highest to lowest and we cumulatively count down from the top of the stack, aggregating shares at each price. A Clearing Price is reached when the cumulative shares equal the quantity of shares offered. The Offering Price may either be equal or at a slight discount to the Clearing Price – a decision by the issuing company and determined by whatever price would optimize the demand curve. Investors that bid below the Offering Price receive no stock. This process is demonstrated in the following chart of a representative auction:



⁵ The specific OpenIPO offerings are Ravenswood Winery, Inc., Salon Media Group, Inc., Andover.Net, Nogatech Inc., Peet’s Coffee & Tea, Inc., Briazz Inc., Overstock.com, Inc., RedEnvelope, Inc. and Genitope Corporation.

WR Hambrecht + Co believes that an auction is superior for both the issuing company and the investor. From the issuer’s perspective, OpenIPO has three principal advantages:

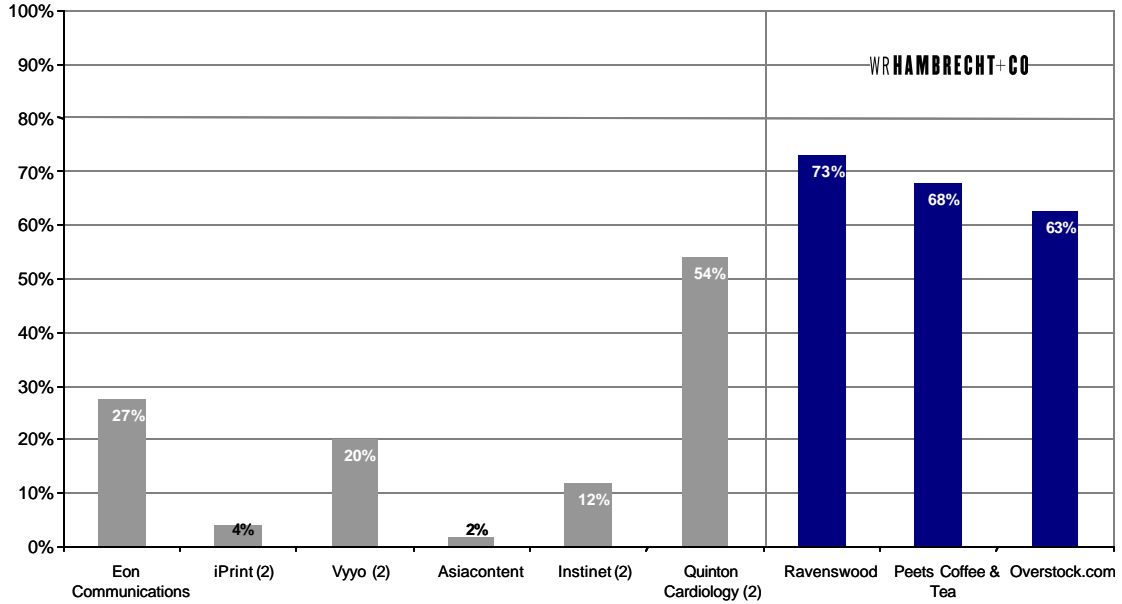
- (i) OpenIPO generates better pricing and reduced volatility. By reaching out to broader demand and pricing an IPO more successfully, we feel that the OpenIPO process more accurately finds the appropriate issue price and builds a steady, long-term investor base that limits future volatility. The following chart reflects the immediate and long-term performance of the nine OpenIPOs to date relative to the aggregate of other IPOs over the same period and validates this theory. In general, OpenIPOs had initial offering prices that correlated closely with the opening trade prices and held up better over the long term with reduced volatility.



Sources: Equidestk and FactSet

1. Data represents mean averages for January 1, 1998 to December 11, 2003.
2. Calculates share price at acquisition for WR Hambrecht + Co IPOs that were acquired.
3. Data includes 1,139 IPOs for which price data was available on FactSet.
4. Data includes 542 IPOs for which price data was available on FactSet.

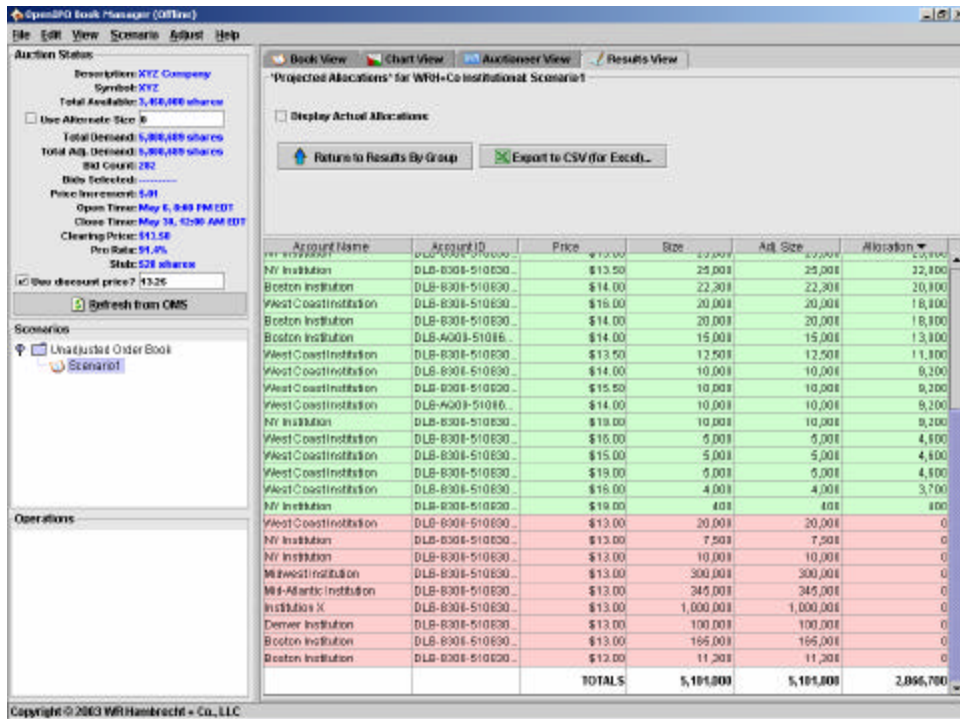
- (ii) Open IPO was designed and has proven to allocate shares to likely long-term shareholders. The auction process ensures that those investors that are most inclined to invest in an IPO are allocated shares. Those investors signal through their higher bids that they are willing to pay more for the long-term prospects of an offering. Since an auction tends to reduce the first day “pop” generated by underpricing, those investors looking for a quick profit are less likely to participate. By reducing speculative behavior, OpenIPO works in the favor of both the issuing company and investors. Our experience to date has validated this behavior as a greater percentage of the initial institutional shareholders in WR Hambrecht + Co IPOs have tended to hold on to their shares.



Sources: WR Hambrecht+ Co data, co-managed institutional pot lists and 13F filings

- 13F filings occur every calendar quarter. Data represents time periods of 1-3 months depending on when each IPO was priced relative to the next 13F occurrence (Asiacontent – 11 weeks, Eon Communications – 8 weeks, iPrint– 3 weeks, Vyvo– 12 weeks, Instinet – 6 weeks, Quinton – 8 weeks, Ravenswood – 12 weeks, Peet’s – 9 weeks, Overstock – 5 weeks).
- Actual pot list share counts are not available. The percentage of initial institutional investors remaining as shareholders after the IPO was used as a proxy for the percentage of IPO shares still held by initial institutional investors in the aftermarket.

(iii) OpenIPO offers complete transparency to the issuer. The entire order book and process are accessible and open to the issuing company. The chart below offers a snapshot of the demand for an actual recent offering and displays the view that was shared with the issuing company (the names of investors have been shielded):



From the investor's perspective, OpenIPO has three principal advantages:

- (i) The OpenIPO system records bids from each pre-qualified retail or institutional investor that is deemed suitable and who maintains a bona fide brokerage relationship with a participating broker-dealer. In order to avoid any gaming or questionable bidding activity, WR Hambrecht + Co screens all potential bids to determine whether the investor is legitimate and a proper holder of the stock of the issuing company. The experience to date is that our auctions have heavy participation from all investor segments, with institutional bids typically representing a substantial majority of the issued shares.
- (ii) OpenIPO is predicated on a formula-based allocation process that avoids the subjective allocation decisions that often limit the access of individual and smaller institutional investors and thereby discourages them from even showing their interest.
- (iii) OpenIPO allows investors to determine the maximum price they are willing to pay for stock and more precisely control their individual allocation. In the traditional book-building process, investors give a general indication and often resort to order padding and other games to ultimately acquire the desired number of shares.

As a strong believer that the marketplace ultimately determines the best process, we don't believe that the NASD should mandate a specific IPO pricing mechanism. However, we strongly support an NASD initiative to create a rule that brings the Best Execution principle to IPO pricing and allocation akin to the equity secondary market. In promulgating such a rule, the NASD should acknowledge that a Dutch auction satisfies the Best Execution requirement.

3. Include a "valuation disclosure" section in the prospectus with information about how the managing underwriter and issuer arrived at the initial price range and final IPO price, such as the issuer's one-year projected earnings or P/E ratios and share price information of comparable companies

The SEC has properly focused recent attention on the concept of equal access to information. For our markets to function most effectively, all investors must be able to make decisions with reference to all available information. Regulation FD has been successful in putting individual investors on the same level as institutions in the equity secondary markets. The legacy IPO process is conspicuously exempted from that requirement. Currently, valuation rationales and earnings estimates are generally made available to only the institutional market and solely through the book-running underwriter's research analyst, creating a de facto information monopoly that is inaccessible to smaller institutions and retail investors.

The inclusion of a valuation rationale for the IPO price – if accompanied by an explicit fiduciary duty for the underwriter – would lessen abuse and foster confidence in the IPO process. It is critical that all potential investors receive equal access to IPO pricing information in order for the lead underwriter to develop a complete and accurate demand curve. The specific inclusion of an earnings estimate in the prospectus is a very important

step. The current Global Settlement that separates research analysts from the distribution process, except for responding to inquiries, will eliminate the ability of investors that lack direct access to the book-running analyst to get any access to this information. Given that the market will continue to demand forward estimates and make valuation decisions based on them, the requirement that they be included in the prospectus is the best alternative to the current reality of selective and non-accountable disclosure. The NASD should encourage the SEC to extend the Section 27A safe harbor to IPOs so that underwriters feel more confident that they are protected in doing so.

We encourage the NASD to formally recommend adoption of Proposal Three and, moreover, to recommend the extension of the Section 27A safe harbor to IPOs.

Conclusion

As firms have grown in market power and as new technology has allowed almost instant real time communication, the SROs have developed sound rules of practice for the secondary markets that have allowed tremendous growth in liquidity, dramatic reductions in transaction cost, and a re-affirmation that a fiduciary has a duty to deal in the most appropriate and effective market to gain the best price for his customer, irrespective of his own self-interest. NASD has an important opportunity and responsibility to take similar regulatory action on the IPO process. By implementing rules that eliminate the systemic flaws with the traditional IPO process, the NASD can take an important step to avoid the otherwise inevitable return of underwriter abuses in the next "hot" IPO market. The IPO segment of our capital markets is critical to the health of our economy and the creation of jobs and is simply too important to be exempt from a strong regulatory and ethical framework.

We greatly appreciate this opportunity to offer these comments to the NASD and look forward to further dialogue on this critical topic.

Sincerely,

A handwritten signature in black ink, appearing to read 'WR Hambrecht', written in a cursive style.

William R. Hambrecht
Chairman and CEO
WR Hambrecht + Co