

NASD NOTICE TO MEMBERS 97-91

NASD Reminds Members Of Obligations Under Free-Riding And Withholding Interpretation

Suggested Routing

- ☒ Senior Management
- ☐ Advertising
- ☐ Continuing Education
- ☒ Corporate Finance
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
- ☒ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☐ Operations
- ☐ Options
- ☐ Registered Representatives
- ☐ Registration
- ☐ Research
- ☒ Syndicate
- ☐ Systems
- ☐ Trading
- ☐ Training
- ☐ Variable Contracts

Executive Summary

NASD Regulation, Inc., reminds members of their obligations under the Free-Riding and Withholding Interpretation (IM-2110-1) with respect to venture capitalists and the cancellation safe harbor provisions. This information was previously provided to members through Compliance Desk in a Member Alert dated November 21, 1997.

Questions concerning this *Notice* should be directed to Gary L. Goldsholle, Senior Attorney, Office of General Counsel, NASD RegulationSM, at (202) 728-8104.

Background Venture Capital Investors

NASD Regulation is reminding members of their obligations under the Free-Riding and Withholding Interpretation, IM-2110-1 (Interpretation), with respect to allocations of hot issues to venture capitalists. Paragraph (b)(4) of the Interpretation restricts sales of hot issues to certain persons affiliated with "a bank, savings and loan institution, insurance company, investment company, investment advisory firm or any other institutional type account (including, but not limited to, hedge funds, investment partnerships, investment corporations, or investment clubs)."¹ A venture capitalist falls within the scope of paragraph (b)(4) when he or she is a senior officer of an "institutional type account" or otherwise is a person who may influence or whose activities directly or indirectly involve or are related to the function of buying or selling securities of an "institutional type account." This type of account includes, among others, investment partnerships and investment corporations, which are frequently used by venture capitalists. Members should ensure, therefore, that sales of hot issues to venture capitalists who are

restricted under the Interpretation are made consistent with the Interpretation.

Persons restricted under paragraph (b)(4) are generally referred to as conditionally restricted persons. As such, they may purchase hot issues from a member only if the member is "prepared to demonstrate that the securities were sold to such persons in accordance with their normal investment practice, that the aggregate of the securities so sold is insubstantial and not disproportionate in amount as compared to sales to members of the public and that the amount sold to any one of such persons is insubstantial in amount."²

In 1994, the Securities and Exchange Commission (SEC) approved amendments to the Interpretation which, among other things, included an exemption for venture capital investors who meet certain enumerated criteria. The venture capital provisions of paragraph (h) of the Interpretation are not a general exemptive provision for venture capital investors. In fact, these narrow exemptive provisions were adopted because, under most circumstances, members otherwise would be prohibited from selling hot issues to venture capitalists. The venture capital investor provisions included in paragraph (h) of the Interpretation allow venture capital investors to purchase a hot issue security to maintain their percentage ownership interest in an entity, notwithstanding that such venture capital investor may be restricted under the Interpretation.

Cancellation Safe Harbor

NASD Regulation is also reminding members of the scope of the cancellation safe harbor provisions of paragraph (a)(3). Specifically, paragraph (a)(3) provides that it shall not be "a violation of the interpretation if a member which makes an allocation

to a restricted person or account of an offering that trades at a premium in the secondary market, cancels the trade for such restricted person or account, prior to the end of the first business day following the date on which secondary market trading commences and reallocates such security at the public offering price to a non-restricted person or account.”³ The SEC order adopting the cancellation safe harbor⁴ and the related *NASD Notice to Members*⁵ both stated that the cancellation provisions were intended to remedy concerns caused by inadvertent violations of the Interpretation that are corrected

by the member making the distribution. Thus, paragraph (a)(3) permits members to allocate securities to restricted persons and subsequently reallocate such hot issue securities to other accounts within the time limits prescribed by the safe harbor only to the extent that such reallocation is to remedy an inadvertent violation of the Interpretation.⁶

Endnotes

¹ IM-2110-1(b)(4).

² IM-2110-1(b)(5).

³ IM-2110-1(a)(3).

⁴ 59 F. R. 64455, 64458 (December 14, 1994).

⁵ *NASD Notice to Members* 95-7 (February 1995).

⁶ This sentence has been modified from the Member Alert dated November 21, 1997, to more clearly define the scope of paragraph (a)(3).