

NASD NOTICE TO MEMBERS 97-30

NASD Regulation
Requests Comments On
Amendments To The
Free-Riding And
Withholding Interpretation;
**Comment Period
Expires June 16, 1997**

Suggested Routing

- ☒ Senior Management
- ☐ Advertising
- ☒ Corporate Finance
- ☐ Government Securities
- ☐ Institutional
- ☐ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☒ Operations
- ☐ Options
- ☐ Registration
- ☐ Research
- ☒ Syndicate
- ☐ Systems
- ☐ Trading
- ☒ Training

Executive Summary

In the following document, NASD Regulation, Inc. (NASD RegulationSM) requests comment on specific amendments to the NASD[®] Free-Riding and Withholding Interpretation, IM-2110-1 (Interpretation) and also is soliciting comment on how the Interpretation could be more generally revised and streamlined. In particular, commenters are asked to consider whether the Interpretation properly reflects current market conditions.

Questions concerning this *Request for Comment* should be directed to Craig L. Landauer, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8291.

Request For Comment

The NASD encourages all members and other interested parties to comment on IM-2110-1. Comments can be mailed to:

Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

or e-mailed to:
pubcom@nasd.com.

Comments must be received **by June 16, 1997**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

NASD REGULATION REQUEST FOR COMMENT 97-30

Executive Summary

NASD Regulation, Inc. (NASD RegulationSM) requests comment on specific amendments to the NASD[®] Free-Riding and Withholding Interpretation, IM-2110-1 (Interpretation) and also is soliciting comment on how the Interpretation could be more generally revised and streamlined. In particular, commenters are asked to consider whether the Interpretation properly reflects current market conditions.

Background

The Interpretation protects the integrity of the public offering system by ensuring that members make a bona fide public distribution of “hot issue” securities and do not withhold such securities for their own benefit or use the securities to reward other persons who are in a position to direct future business to the member. Improperly withholding securities or directing securities to persons who can direct future business to the member leads to an impairment of public confidence in the fairness of the investment banking and securities business. The Interpretation was created and has been amended over the years to ensure there is a bona fide distribution of securities for which there is public demand.

The NASD Regulation Board of Directors (Board), acting upon recommendations of the National Business Conduct Committee (NBCC), considered various proposed amendments to the Interpretation. Specifically, the Board considered whether the Interpretation should apply in the following contexts:

- (1) secondary offerings;
- (2) distributions of rated investment grade debt;

(3) purchases by non-member broker/dealers and their associated persons; or

(4) distributions of shares of foreign mutual funds.

In addition, the Board considered whether the Interpretation should be amended to provide:

(1) a de minimis exemption for restricted persons under paragraph (b)(4) of the Interpretation¹ and small investment vehicles;

(2) an expansion of the type of firm that qualifies as a limited purpose broker/dealer;

(3) a more prescribed manner for a member to verify that a conduit for an undisclosed principal is complying with the Interpretation;

(4) a clarification of which natural persons and entities should be covered by the Interpretation’s definition of “person associated with a member”;

(5) a clarification of whether and under what circumstances a qualified ERISA plan or other type of retirement plan would be considered a restricted person under the Interpretation;

(6) a clarification of certain provisions of the issuer-directed share exception;² and

(7) a mechanism for granting relief from the application of various provisions of the Interpretation.

Finally, the Board decided that it would be appropriate to examine the entire Interpretation in the context of current market conditions and to seek comment on whether the Interpretation could be simplified and made easier to follow while at the same time remaining true to the Interpretation’s intent.

Recommended Changes

1. Treatment of Direct And/Or Indirect Owners of Broker/Dealers Under the Interpretation

Confusion has arisen over how persons or entities that have an ownership or capital interest in a broker/dealer should be treated under the Interpretation. NASD Regulation is proposing that the Interpretation be modified so that, with two exceptions, *all* equity owners or contributors to capital would be considered restricted persons. First, the Interpretation would exempt purchases by passive investors who own or have contributed 10 percent or less of the firm's equity or capital and who purchase from a member other than the member in which they maintain the ownership interest, provided that the member in which they maintain the ownership interest is not in a position to direct issues to the owner or contributor. Second, the Interpretation would exempt purchases by persons who passively own 10 percent or less of the shares of broker/dealers that are traded on an exchange or Nasdaq®.

The definition of the term "associated person" under the NASD By-Laws includes only natural persons. Interpretative issues may arise under the Interpretation when entities (corporations, limited partnerships, and general partnerships) have an ownership interest in a broker/dealer, either in the form of equity ownership or as a contribution to the capital of the broker/dealer. Accordingly, the proposal would create a new definition of "restricted person" to include "any person," which would include an entity that invests in a member firm with ownership or capital contribution interest.

A second issue involves how to treat investors, whether natural persons or entities, that invest indirectly in a broker/dealer. NASD Regulation believes that indirect investors should

be treated for purposes of the Interpretation in the same way as direct investors, and should be precluded, therefore, from purchasing hot issues from the broker/dealer in which they maintain the indirect investment. For purposes of calculating the 10 percent threshold, the proposed Interpretation provides that the percentage of the direct investment is multiplied by the percentage interest in the investing entity. For example, an investor with a 50 percent investment in a investment partnership that in turn owns 50 percent of the equity capital of a broker/dealer would be deemed to own 25 percent of the broker/dealer for the purposes of the Interpretation. Accordingly, the investor would be considered a restricted person because his or her indirect ownership interest would be deemed to have exceeded the 10 percent threshold.

2. Rated Investment Grade Debt

Debt offerings are included in the definition of "public offering" under the Interpretation. NASD Regulation believes that it is appropriate to delete offerings of rated investment grade debt from the Interpretation on the ground that investment grade debt does not raise the same issues that are posed by equities under the Interpretation. In particular, the prices for such debt securities generally fluctuate based on interest rate movements, rather than on excess demand for a particular security. Specifically, the exception would apply to "non-convertible debt securities rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories."

3. Exemptive Authority Under The Interpretation

There is no provision in the Interpretation itself to allow for the NBCC, the Board, or NASD Regulation staff to grant exemptive relief. In the past, the NBCC, relying on the NASD By-

Law's grant of authority to the Board and its Committees, has provided interpretations in certain unique circumstances. NASD Regulation believes that it is important to provide express authority to grant exemptions in individual cases, and is proposing to amend the Interpretation for this purpose.

The Interpretation gives the District Committees and the NASD Board the authority to issue interpretations. The proposed amendments would make this provision consistent with current practice by giving NASD Regulation staff the authority to provide interpretations, after consultation with appropriate persons involved in the securities industry, that would be subject to oversight by the Board.

4. Foreign Mutual Funds

Purchases of shares of investment companies registered under the Investment Company Act of 1940 (1940 Act) are exempt from the restrictions of the Interpretation. The rationale for this existing provision is that the interest of any one restricted person in an investment company ordinarily is de minimis and that, because the ownership of investment company shares generally is subject to frequent turnover, determining compliance with the Interpretation would be extremely difficult in this context.

NASD Regulation is proposing to extend this rationale to the purchase of shares of foreign entities that are similar to U.S. investment companies. In particular, NASD Regulation is proposing to allow members to allocate shares to a foreign mutual fund if the fund provides written certification from a U.S. attorney or accountant stating that: (1) the fund has 100 or more shareholders; (2) the fund is publicly offered; (3) no more than 5 percent of the fund's securities

assets are invested in the securities of any one issuer; (4) any person owning more than 5 percent of the shares of the fund is not a restricted person as defined in subparagraphs (b)(1) through (b)(4) of the Interpretation; and (5) the fund is properly registered or authorized to do business in the foreign jurisdiction.

In addition to addressing the above rationale, the amendments seek to create roughly equivalent standards between U.S. and foreign mutual funds, by adding a new definition of foreign investment company that is designed to parallel the existing exemptions for domestic funds. Under the 1940 Act, U.S. investment companies are required to register with the SEC if their shares are publicly offered to more than 100 investors. In addition, the 1940 Act generally requires that no more than 5 percent of diversified fund assets invested in cash and securities be invested in the securities of one issuer. NASD Regulation specifically requests comment on whether this exemption is appropriate, given differences in foreign fund regulation and the nature of investment in such funds.

Other Issues

The NASD and the Board considered, but determined not to propose, the following amendments to the Interpretation:

1. Secondary Offerings

Secondary offerings are included in the definition of “public offering” under the Interpretation. Statistical information reviewed by the Board indicated that approximately 33 percent of secondary offerings trade at a premium, although the premium is generally small. NASD Regulation believes that because a relatively high percentage of secondary offerings trade at a premium, these offer-

ings should continue to be subject to the Interpretation.

2. Non-Member Broker/Dealers And Their Associated Persons

All member and non-member broker/dealers and their associated persons are deemed to be restricted persons under paragraph (b)(2) of the Interpretation.³ Therefore, the Interpretation restricts purchases by firms that are involved solely in executing transactions on the floor of an exchange, including exchange specialists and options Market Makers. NASD Regulation believes that these entities and their associated persons are engaged in activities similar to those of other NASD members that are subject to the Interpretation’s restrictions and that they should continue to be considered restricted persons.

3. De Minimis Exemption

In 1994, the NASD considered providing an exemption for purchases that are de minimis in amount by persons identified in paragraph (b)(4) (persons affiliated with certain financial institutions and entities that are not members). The NASD rejected this proposal on the grounds that: (i) any de minimis amount would be an arbitrary figure; and (ii) monitoring accounts to ensure compliance with such a provision would be difficult. The Board considered this matter again based on several requests to reconsider the prior position and has determined not to amend the Interpretation in this respect.

4. Limited Purpose Broker/Dealers

Changes made in 1994 exempted, from the Interpretation, persons associated with broker/dealers whose business is limited to direct participation programs, mutual funds, and variable contracts products. Persons associated with firms engaged solely in proprietary trading or investment

or merchant banking activities have asked that they be included in the limited broker/dealer exemption. NASD Regulation does not believe the exemption should be expanded to such firms because of the difficulty in defining those firms under the Interpretation, and because such broker/dealers may influence or be involved in various aspects of the underwriting process. Further, NASD Regulation is concerned that such firms may enter into reciprocal arrangements with other members that would violate the intent of the Interpretation.

Comment On Specific Provisions Of The Rule

NASD Regulation is not proposing other changes but is requesting comment on the issues identified below:

1. Member Verification Of Conduit For Undisclosed Principal And Compliance With The Interpretation

A member selling a hot issue to an account identified in subparagraphs (b)(7) and (b)(8) of the Interpretation (*i.e.*, accounts managed by an investment advisor and foreign broker/dealers) must follow certain enumerated steps to comply with the Interpretation. One of these steps requires the member to make “an affirmative inquiry” of the conduit that it is not allocating the shares purchased to restricted persons. The term “affirmative inquiry” is not defined in the Interpretation and confusion may exist as to the meaning of this term.

NASD Regulation solicits comment on the adequacy of the existing verification procedure described above and whether a different verification process would be more meaningful.

2. Accounts For Qualified Plans Under The Employment Retirement Income Security Act (Qualified ERISA Plans)

Questions have been raised from various sources relating to the applicability of the Interpretation to the account of a qualified ERISA plan. Two frequently asked questions relate to: (1) whether a qualified ERISA plan is considered an investment partnership or corporation under paragraph (f) of the Interpretation; and (2) whether the “carve out” mechanism⁴ described in paragraph (f) could permit sales to be made to qualified ERISA accounts. NASD Regulation believes as a general rule that a qualified ERISA plan should not be deemed an “investment partnership or corporation” and should not be considered a “restricted account.” The NBCC has suggested the following methodology to determine under what circumstances a qualified ERISA plan would be deemed restricted:

(i) Any plan sponsor that is not involved in financial services activities would not be considered restricted even though some plan participants may be restricted.

(ii) Any plan sponsored by a broker/dealer would be deemed *per se* restricted.

(iii) All other financial services plans, including those involving banks, insurance companies, investment advisors, or other money managers, would be exempt unless they had been created to circumvent the purposes of the Interpretation, *e.g.*, where a financial services plan had only restricted persons as beneficiaries. The rationale for this provision is that the intent of any restricted person in such plans is likely to be *de minimis*. NASD Regulation is asking for comment on whether this would be a reasonable solution to handling sales to ERISA accounts.

3. Issuer-Directed Share Exemption

Paragraph (d) of the Interpretation was amended in 1994 to allow members to allocate “hot issue” securities to “restricted” persons who also were employees of the issuer, without having to receive prior approval of the NBCC, as had been required prior to the 1994 amendments. Persons have requested that the language of this exemption be modified so that it is clear that employees of the issuer who are materially supported by a restricted person may purchase and that outside directors be given similar treatment.

NASD Regulation believes that the intent of the 1994 amendments was to allow all employees and directors of the issuer to purchase securities of the issuer, regardless of status as a restricted person. NASD Regulation is asking for comment on the appropriate nature and scope of such an exemption.

Questions concerning this *Request for Comment* should be directed to Craig L. Landauer, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8291.

Request For Comment

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Comments must be received **by June 16, 1997**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of

Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

Text Of Proposed Amendments

(*Note: Proposed new language is underlined; deletions are bracketed.*)

IM-2110-1. Free-Riding and Withholding

(a) Introduction

(1) No change.

(2) As in the case of any other interpretation issued by the [Board of Governors of the] Association, the implementation thereof is a function of the NASD Regulation staff [District Business Conduct Committee] and the [Board of Governors] NASD Regulation Board of Directors. Thus, the interpretation will be applied to a given factual situation by NASD Regulation staff, subject to oversight by the Board, with staff soliciting input from individuals active in the investment banking and securities business [who are serving on these committees or on the Board. They]. In making such interpretations, staff and the Board will construe this interpretation to effectuate its overall purpose to assure a public distribution of securities for which there is a public demand.

(3) through (4) No change.

(5) The NASD Regulation staff, upon written request, may, taking into consideration all relevant factors, provide an exemption either unconditionally or on specified terms from any or all of the provisions of this interpretation upon a determination that such exemption is consistent with the purposes of the interpretation, the protection of investors, and the public interest. Any person aggrieved by such staff determination may appeal such decision to the National Busi-

(b) Violations of Rule 2110

(1) No change.

(2) Sell any of the securities to any officer, director, general partner, employee or agent of the member or of any other broker/dealer, or to a person associated with the member or with any other broker/dealer, or to a restricted person as defined in paragraph (l)(1) of this interpretation, or to a member of the immediate family of any such person; provided however, that:

(A) This prohibition shall not apply to a person in a limited registration category as that term is defined below; and

(B) The prohibition shall not apply to sales to a member of the immediate family of a person associated with a member or a restricted person defined in paragraph (l)(1) of this interpretation who is not supported directly or indirectly to a material extent by such person if the sale is by a broker/dealer other than that employing the restricted person and the restricted person has no ability to control the allocation of the hot issue.

(3) through (7) No change.

(f) Investment Partnerships and Corporations

(l) A member may not sell a hot issue to the account of any investment partnership or corporation, domestic or foreign (except companies registered under the Investment Company Act of 1940 and foreign investment companies as defined herein) including but not limited to hedge funds, investment clubs, and other like

accounts unless the member complies with either of the following alternatives:

(2) No change.

(g) through (k) No change.

(1) Explanation of Terms

(Delete existing paragraph and replace as follows.)

(1) Restricted Person

(A) The term “restricted person” shall include: any person who owns, directly or indirectly, any class of equity securities of, or who has made a contribution of capital to, a member, other than any such person whose ownership or capital interest is passive and amounts to not more than 10% of the equity or capital of the member, provided that:

(i) such member (a) does not sell securities to such person and (b) is not in a position by virtue of its participation in a distribution of securities to direct the allocation of securities to such person; or

(ii) the securities of such member are traded on a national securities exchange or the Nasdaq system.

(B) For purposes of this definition, any person with an equity ownership or capital interest in an entity that maintains an investment in a member shall be deemed to have a percentage interest in the member equal to the percentage interest of the entity in the member multiplied by the percentage interest of such person in such entity.

(2) Public Offering

The term public offering shall mean any primary or secondary distribution

of securities made pursuant to a registration statement or offering circular including exchange offers, rights offerings, offerings made pursuant to a merger or acquisition, straight debt offerings, and all other securities distributions of any kind whatsoever except any offering made pursuant to an exemption under Section 4(1), 4(2) or 4(6) of the Securities Act of 1933, as amended. It shall not mean exempted securities as defined in Section 3(a)(12) of the Act or non-convertible debt securities rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories.

(3) through (6) No change.

(7) Foreign Investment Company

The term foreign investment company shall include any fund company organized under the laws of a foreign jurisdiction, which has provided to the member a written certification prepared by counsel admitted to practice law before the highest court of any state of the United States or by an independent certified public accountant licensed to practice in any state of the United States that states that:

(1) the fund has 100 or more investors;

(2) the fund is listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority;

(3) no more than 5% of the fund assets are to be invested in the securities being offered; and

(4) any person owning more than 5% of the shares of fund is not a person described in subparagraphs (b)(1), (2), (3) or (4) of the Rule.

Endnotes

¹ Restricted persons under paragraph (b)(4) of the Interpretation include senior officers of banks, savings and loans, insurance companies, investment companies, investment advisory firms, managers of investment partnerships or hedge funds, and any other person whose activities involve buying or selling securities on behalf of an institutional account.

² Paragraph (d) of the Interpretation allows an issuer to direct shares in a public offering, without limitation, to employees, directors, and potential employees and directors under specified conditions.

³ Restricted persons under paragraph (b)(2) of the Interpretation include any officer, director, general partner, employee or agent of the member or of any other broker/dealer, or a person associated with the member or with any other broker/dealer.

⁴ Paragraph (f) of the Interpretation allows a member to sell a hot issue of the account of any investment partnership or corporation that establishes a separate brokerage account in which no restricted persons have a beneficial interest.

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