

October 14, 1999

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001
Mail Stop 10-1

Re: **File No. SR-NASD-99-60**
Proposed Rule 2790, Trading in Hot Equity Offerings

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed herewith is the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Gary L. Goldsholle, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8104; e-mail gary.goldsholle@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Alden S. Adkins
Senior Vice President and
General Counsel

Attachment

File No. SR-NASD-99-60
Consists of 59 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”), is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to create Rule 2790, Trading in Hot Equity Offerings, to replace the Free-Riding and Withholding Interpretation, IM-2110-1. In addition, there are a number of technical amendments to other NASD rules that refer to IM-2110-1. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

IM-2110-1. [“Free-Riding and Withholding”]

Deleted in its entirety and replaced with:

Reserved.

* * *

IM-2750. Transactions with Related Persons

A member who is acting, or plans to act, as sponsor of a unit investment trust will not violate Rule 2750 if it accumulates securities with respect to which the member has acted as a syndicate member, selling group member or reallocation dealer in an account of the member or related person of the member if, at the time of accumulation, the member in good faith intends to deposit the securities into the unit investment trust at the public offering price and intends to make a bona fide public offering of the participation units of that trust. Members

engaged in such activity, however, will continue to be subject to Rule 2790. [IM-2110-1, “Free-Riding and Withholding.”]

* * *

Rule 2790. Trading in Hot Equity Offerings

(a) Definitions

(1) “Affiliate” shall have the same meaning as in Rule 2720 (b)(1).

(2) “Beneficial interest” means any ownership or other direct financial interest. The receipt of a management or performance based fee for operating a collective investment account shall not be considered a beneficial interest in the account.

(3) “Collective investment account” means any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle that manages assets of other persons. Collective investment account shall not include any entity in which the decision to buy or sell securities is made jointly by each of the persons investing in the entity or by a member of their immediate family.

(4) “Conversion offering” means any offering of securities made as part of a plan by which a savings and loan association, insurance company, or other organization converts from a mutual to a stock form of ownership.

(5) “Hot issue” means any security that is part of a public offering if the volume weighted price during the first five minutes of trading in the secondary market is 5% or more above the public offering price.

(6) “Immediate family member” shall include a person’s parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or

daughter-in-law, and children, and any other individual the person, directly or indirectly, provides material support.

(7) “Joint back office broker/dealer” means any domestic or foreign private investment fund that has voluntarily registered as a broker/dealer solely to take advantage of more favorable margin treatment afforded under Section 220.7 of Regulation T of the Federal Reserve. The activities of a joint back office broker/dealer must not require that it register as a broker/dealer under Section 15(a) of the Act.

(8) “Limited business broker/dealer” means any broker/dealer whose authorization to engage in the securities business is limited solely to the purchase or sale of either investment company/variable contracts securities or direct participation program securities.

(9) “Material support” means providing more than 10% of a person’s income or expenses. Material support shall be presumed for members of the immediate family living in the same household.

(10) “Public offering” means any initial or secondary public offering of an equity security as defined in section 3(a)(11) of the Act, made pursuant to a registration statement or offering circular, including exchange offers, rights offerings, offerings made pursuant to a merger or acquisition, or other securities distributions of any kind whatsoever, including securities that are specifically directed by the issuer on a non-underwritten basis. Public offering shall not include:

(A) Offerings made pursuant to an exemption under Section 4(1), 4(2) or 4(6) of the Securities Act of 1993 or SEC Rule 504, 505 or 506 adopted thereunder; and

(B) Offerings of exempted securities as defined in Section 3(a)(12)

(11) “Restricted person” includes:

(A) Members or other broker/dealers, unless the ultimate purchaser is a non-restricted person purchasing the security at the public offering price;

(B) Officers, directors, general partners, employees or agents of a member or any other broker/dealer (other than a limited business broker/dealer);

(C) With respect to the security being offered, finders or any person acting in a fiduciary capacity to the managing underwriter, including, but not limited to, attorneys, accountants and financial consultants;

(D) Any employee or other person who supervises, or whose activities directly or indirectly involve or are related to, the buying or selling of securities for a bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account;

(E) Any affiliate of a broker/dealer (other than a limited business broker/dealer); and

(F) Any natural person or member of the person’s immediate family who owns 10% or more or has contributed 10% or more of the capital of a broker/dealer (other than a limited business broker/dealer).

(b) General Prohibitions

(1) A member or a person associated with a member may not sell, or cause to sell, a hot issue in a public offering to any account in which a restricted person or a member of the restricted person’s immediate family has a beneficial interest, except as permitted herein or through an exemption pursuant to the Rule 9600 Series.

(2) A member or a person associated with a member may not purchase a hot issue in a public offering, except as permitted herein or through an exemption pursuant to the Rule 9600 Series.

(3) A member may not continue to hold hot issues acquired in a public offering except as permitted herein or through an exemption pursuant to the Rule 9600 Series.

(c) Canceling Trades

A member or a person associated with a member does not violate this rule if it cancels a sale of a hot issue made to the account of a restricted person or a member of the person's immediate family prior to the end of the first business day following the date that market trading commences (i.e., T+1) and reallocates such hot issue at the public offering price to a non-restricted person.

(d) Preconditions for Sale

Before selling a hot issue to any account, a member must have obtained within the previous twelve months documentary evidence from the account holder, or a person authorized to represent the beneficial owners of the account or the ultimate purchasers if the account is a conduit account, demonstrating that no restricted person or ultimate purchaser in the case of a conduit account, has a beneficial interest in the account, except as permitted under the rule. Members shall maintain a copy of all records and information used to determine that an account does not contain a restricted person in its files for at least three years following the member's last sale of a hot issue to that account.

(e) General Exemptions

A member or a person associated with a member may sell hot issues to:

- (1) A registered investment company under the Investment Company Act of 1940.
- (2) A collective investment account (including a joint back office broker/dealer or a collective investment account with a joint back office broker/dealer subsidiary), that is beneficially owned in part by restricted persons, provided that such restricted persons in aggregate own less than 5% of such account.
- (3) A publicly traded corporation (other than an affiliate of a broker/dealer) listed on an exchange or The Nasdaq Stock Market, in which no person with a 10% or more ownership interest is a restricted person.
- (4) A foreign investment company organized under the laws of a foreign jurisdiction, meeting the following criteria:

 - (A) the company has 100 or more investors;
 - (B) the company is listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority;
 - (C) no more than 5% of the company's assets shall be invested in a particular hot issue; and,
 - (D) no person owning more than a 5% interest in such company is a restricted person.
- (5) An employee benefits plan qualified under the Employee Retirement Income Security Act provided that the plan sponsor is not a member or an affiliate; or a state or foreign government employee benefit plan that is subject to separate state and municipal regulation.

(6) A tax exempt charitable organization under Section 501(c)(3) of the Internal Revenue Code.

(7) Employees and directors of the issuer, an entity which controls, is controlled by, or is under common control of the issuer.

(8) An immediate family member of a restricted person in paragraph (a)(9)(B) if:

(A) such restricted person does not directly or indirectly provide material support to, or receive material support from, the immediate family member;

(B) such restricted person is not employed by the member, or an affiliate of the member, selling the hot issue to the immediate family member; and

(C) such restricted person has no ability to control the allocation of the hot issue.

(9) An immediate family member of a restricted person in paragraphs (a)(9)(C)-(D) if such restricted person does not directly or indirectly provide material support to the member of the immediate family;

(10) A restricted person in paragraph (a)(9)(E) provided that the sale is to an account established for the benefit of bona fide public customers, including insurance company general, separate and investment accounts, and bank trust accounts.

(f) Anti-Dilution Provisions

The restrictions on the sale of hot issues in this rule shall not apply to sales to a restricted person in an initial public offering who meets the following criteria:

(1) the restricted person has held an equity ownership interest in the issuer, or a company that has been acquired by the issuer in the past year, for a period of one year prior to the effective date of the public offering;

(2) the sale of the hot issues to the restricted person shall not increase the restricted person's percentage equity ownership in the issuer above the ownership level as of three months prior to the filing of the registration statement with the SEC in connection with the offering;

(3) the sale of hot issues to the restricted person must not include any special terms; and

(4) the hot issues purchased pursuant to this subsection shall be restricted from sale or transfer for a period of three months following the effective date of the offering.

(g) Conversion Offerings

The rule shall not apply to the sale of securities directed by the issuer of a conversion offering, either on an underwritten or non-underwritten basis, to any person eligible to purchase securities in accordance with the governmental agency or instrumentality having authority to regulate such conversion offering.

* * *

Rule 3040. Private Securities Transactions of an Associated Person

* * *

(e) Definitions

For purposes of this Rule, the following terms shall have the stated meanings:

(1) “Private securities transaction” shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Rule 3050, transactions among immediate family members (as defined in Rule 2790 [IM-2110-1, Free-Riding and Withholding]), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded.

* * *

5392. Rules of the Association

* * *

(d) The following Rules of the Association and Interpretative Material thereunder are not applicable to transactions and business activities relating to the PORTAL Market:

(1) Rules 1130, 2450, 2520, 2710, 2730, 2740, 2750, 2790, 2810, 2820, 2830, 2860, 3210, and 3360[; and

(2) IM-2110-1].

* * *

9600. PROCEDURES FOR EXEMPTIONS

9610. Application

(a) Where to File

A member seeking an exemption from Rule 1021, 1022, 1070, 2210, 2320, 2340, 2520, 2710, 2720, 2790, 2810, 2850, 2851, 2860, Interpretive Material 2860-1, 3010(b)(2),

3210, 3350, 8211, 8212, 8213, 11870, or 11900, [Interpretive Material 2110-1,] or Municipal Securities Rulemaking Board Rule G-37 shall file a written application with the appropriate department or staff of the Association and provide a copy of the application to the Office of General Counsel of NASD Regulation.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on October 6, 1999, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market has been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on October 7, 1999. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt NASD Rules without recourse to the membership for approval.

The NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Gary L. Goldsholle, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8104.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

NASD Regulation is proposing Rule 2790, Trading in Hot Equity Offerings, to replace the Free-Riding and Withholding Interpretation, IM-2110-1 (“Interpretation”). The proposed new rule is an effort to focus and streamline the Interpretation, as well as to address feedback received in response to our request for comment on NASD rules in need of modernization in Notice to Members 98-81. NASD Regulation believes that the proposed rule is more carefully targeted towards the purposes of the Interpretation, while at the same time is significantly easier for the membership and the investing public to understand and follow.

Before addressing the specifics of the proposed rule change, it is important to understand its purpose. The purpose of the proposed rule, like the Interpretation it would replace, is to protect the integrity of the public offering process by:

(1) ensuring that members make a bona fide public offering of securities at the public offering price;

(2) ensuring that members do not withhold securities in a public offering for their own benefit or use such securities to reward certain persons who are in a position to direct future business to the member; and

(3) ensuring that industry “insiders,” including members and their associated persons, do not take advantage of their “insider” position in the industry to purchase hot issues for their own benefit at the expense of public customers.

The proposed rule contains several significant changes from the Interpretation, which are discussed in detail below. Members should be aware that notwithstanding the Board of Governors' endorsement of the proposed new rule, members must comply with the Interpretation as written. Additionally, members should be aware that NASD Regulation staff will not grant exemptions from the current Interpretation on the basis of proposals or policy statements contained in proposed Rule 2790.

1. Threshold Premium for "Hot Issue"

Perhaps the most significant change in the proposed rule is the decision to define the term "hot issue" with reference to a threshold premium. The current Interpretation defines a hot issue as any security that trades "at a premium," whenever secondary market trading begins. The NASD and the SEC have stated that any premium, no matter how small, makes an offering a hot issue.¹ Thus, under the current Interpretation, a security that prices at \$15 per share and begins trading at \$15 1/32 is a "hot issue."

NASD Regulation believes that defining a hot issue with reference to a threshold premium is more consistent with the purposes of the rule and avoids imposing limitations on the distribution of securities in a public offering for which there is no substantial or immediate secondary market demand. The proposed rule change defines a hot issue as any security that is part of a public offering if the volume weighted price during the first five minutes of trading in the secondary market is 5% or more above the public offering price. NASD Regulation selected 5% as the threshold premium because it preliminarily believes that a 5% premium effectively distinguishes between offerings for which there is substantial

¹ See *In re Wedbush, Noble, Cooke, Inc.*, 47 S.E.C. 1031, 1032-1033 (1984).

excess investor demand and those that are generally satiated by the market supply. NASD Regulation recognizes that the selection of any threshold is to an extent arbitrary, and expects to receive comments from members and investors on whether 5% is the correct premium.

NASD Regulation selected the volume weighted price during the first five minutes of trading as the benchmark price for determining whether an offering is a hot issue in part because it is a calculation that can readily be performed by any member or investor with access to trade data. It also is similar to the method currently used by Corporate Financing staff in issuing determinations about whether an offering is a “hot issue.” NASD Regulation also selected the volume weighted price because it is generally not susceptible to manipulation. In fact, this same methodology is used to determine the settlement value of Nasdaq-100 options on the Chicago Board Options Exchange.

2. Application to Equity Offerings Only

Another significant change is that the proposed rule would apply to equity offerings only. Specifically, the proposed rule incorporates the definition of equity security, as the term is defined in section 3(a)(11) of the Securities Exchange Act of 1934, as amended. Historically, the Interpretation has applied to equity and debt securities. However, as part of a series of amendments in 1998, NASD Regulation exempted most types of investment grade debt and investment grade asset-backed securities from the Interpretation on the grounds that “such offerings do not raise the same issues as equity offerings inasmuch as the price for a particular debt security generally fluctuates based on interest rate movements rather than demand factors.”² With this proposed rule change, NASD Regulation is going one step

² 59 Fed. Reg. 7030 (February 11, 1998).

further and eliminating application of the rule to non-investment grade debt. NASD Regulation believes that the price of non-investment grade debt is based primarily upon interest rates and the creditworthiness of the issuer rather than the demand factors that typically govern equity securities. In addition, since the debt markets are primarily institutional, debt offerings do not typically attract a lot of retail interest and, thus, the rule's purpose of protecting public customers would not be served in these markets. NASD Regulation, however, believes that offerings of convertible securities or warrants bundled with debt securities more closely resemble equity offerings and should not be exempt from the proposed rule.

3. Secondary Offerings

The proposed rule differs from the Interpretation in that it would apply to all secondary offerings. In 1998, NASD Regulation amended the Interpretation to exempt secondary offerings of actively-traded securities because it found that few secondary offerings traded at a premium, and where there was a premium, it was generally very small. In light of the decision to define a hot issue as requiring a 5% premium, NASD Regulation believes that it is no longer appropriate to exclude all secondary offerings as a class. In practice, most secondary offerings will continue to be exempt from the rule because there will not be a 5% premium. However, for those few offerings that do open at a 5% premium, the proposed rule would apply. NASD Regulation believes that any secondary offering for which there is excess demand, as evidenced by a 5% or more price increase, should not be purchased by restricted persons.

4. Elimination of the "Conditionally Restricted" Status

Another significant change in the proposed rule is the decision to eliminate the so-called “conditionally restricted” status and treat persons either as restricted or non-restricted. Conditionally restricted persons are listed in paragraphs (b)(5)(A)-(C) of the Interpretation and include:

- (1) members of the immediate family of an associated person who are not supported directly or indirectly by such associated person;
- (2) finders in respect to the public offering or any person acting in a fiduciary capacity to the managing underwriter (including accountants, attorneys and consultants); and
- (3) senior officers and directors of a bank, savings and loan institution, insurance company, investment company, investment advisory firm, or any other institutional type account, or any person in the securities department of any of the foregoing entities, or any other employee who may influence or whose activities directly or indirectly involve or are related to the function of buying or selling securities for any of the foregoing entities.

Under the Interpretation, conditionally restricted persons can purchase hot issues if:

- (1) the securities are sold to the customer in accordance with the customer’s normal investment practice;
 - (2) the amount of securities sold to any one such person is insubstantial;
- and

(3) the member's aggregate sales to conditionally restricted persons is insubstantial and not disproportionate in amount as compared to sales to other members of the public.

The concept of conditionally restricted persons appears to be a compromise between an outright prohibition against purchasing hot issues and imposing no restrictions whatsoever. In many cases, treating a person as only conditionally restricted is contrary to the public interest. Many of the persons treated as conditionally restricted are in a position to direct business to a member. If a determination is made that members should not sell hot issues to persons who can direct business to the member, NASD Regulation does not believe that these concerns are alleviated if the person can meet certain criteria, such as a "normal investment practice." Moreover, as a practical matter, certain of these persons, such as hedge fund managers, investment advisers, and other investment and portfolio managers, may have the requisite investment history despite being in a position to direct and control future business to a member. NASD Regulation proposes eliminating the conditionally restricted person status while at the same time more precisely targeting those persons to whom the rule applies.

5. Reconsidering the Category of Restricted Persons

In light of the recommendation to eliminate the conditionally restricted status, NASD Regulation is revising the category of persons subject to the rule.

a. Finders and fiduciaries

NASD Regulation will continue to treat finders and fiduciaries to the managing underwriter as restricted persons. NASD Regulation believes that finders and fiduciaries to

the managing underwriter are for practical purposes industry “insiders.” There is additional support for this position in the Corporate Financing Rule, Rule 2710, which defines the term “underwriter and related persons” as including “financial consultants and advisors, finders, . . .” Rule 2710(a)(6). Moreover, it is necessary to include finders and fiduciaries within the proposed rule to prevent issuers from circumventing the underwriting compensation limits of Rule 2710 by offering finders or fiduciaries access to the hot issue. NASD Regulation proposes treating these persons as restricted only for those offerings for which they are acting in the capacity as a finder or fiduciary. In the case of a law firm or consulting firm, the restriction would apply only to those persons working on a particular offering.

- b. Personnel with respect to the securities activities of a bank, insurance company, investment company, investment advisor, or collective investment account

With respect to the Interpretation’s restricted employees of a bank, savings and loan institution, insurance company, investment company, investment advisory firm, or any other institutional type account, NASD Regulation recommends several changes. The persons identified in this category are subject to the Interpretation because their position allows them the opportunity to direct business to a member, and it is believed that members would direct hot issues to the accounts of these persons in an effort to attract or retain business. NASD Regulation believes that this provision protects an important policy, but that the scope of persons covered may be too broad. NASD Regulation does not believe that all senior officers and all employees in the securities department of the covered entities should be restricted. Rather, a more function-oriented approach is proposed by treating as restricted persons only those employees or other persons who supervise, or whose activities directly or indirectly

involve or are related to, the buying or selling of securities for a bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account.

The proposed rule also eliminates the term “institutional type account” which has been confusing and misleading to members since many of the covered entities are not “institutional.” The term institutional type account covers a broad range of accounts, including a corporation’s investment account, a hedge fund, a family partnership, and an investment club. NASD Regulation notes that this category of persons is restricted under the Interpretation because they are in a position to direct investments. The Interpretation, however, implicitly accepts the practice of member firms awarding hot issues to their best customers. NASD Regulation is developing a distinction between directing investments of one’s own money and other peoples’ money. This concept is addressed in the proposed rule’s definition of “collective investment account” which is defined as “any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle that manages assets of other persons.” The proposed rule clarifies that a collective investment account shall not include any entity in which the decision to buy or sell securities is made jointly by each of the persons investing in the entity or by a member of their immediate family. NASD Regulation does not believe that participation in an investment club, where, for example, ten people contribute their own money and make decisions as a group, is the type of activity that should preclude a person from purchasing hot issues. Likewise, NASD Regulation also does not believe that establishing and managing a family partnership should preclude a person from purchasing hot issues. Family partnerships are

often established for tax and estate planning purposes and, because they do not involve managing other peoples' money, they do not implicate the concerns addressed by the proposed rule.

c. Collective investment accounts with very limited ownership by restricted persons

The proposed rule also contains an exemption for collective investment accounts owned by restricted persons to a very limited extent. Currently, the Interpretation states that investment partnerships and corporations in which a restricted person has a beneficial interest are prohibited from purchasing hot issues unless the investment partnership or corporation “carves-out” the interest of the restricted persons. NASD Regulation is aware that investment partnerships and corporations frequently incur significant expense in determining the status of every participant, particularly in the fund of fund contexts. In an effort to eliminate some of the burdens associated with the Interpretation, the proposed rule creates an exemption from the rule for a collective investment account that is beneficially owned in part by restricted persons, provided that such restricted persons in aggregate own less than 5% of such account. NASD Regulation believes that creating an exemption to accommodate these minimal interests in collective investment accounts is consistent with the purposes of the rule. Investors frequently like to see a general partner invest in the accounts they manage, and the proposed rule will now allow the general partner of a collective investment account to have a small but direct capital interest.

In addition, the 5% limit allows restricted persons who were previously only conditionally restricted, such as hedge fund managers, investment advisors, and other investment and portfolio managers, to participate in hot issues to a limited extent. Under the

new rule, however, the participation by restricted persons will be incidental to what is otherwise a bona fide public distribution to investors beneficially owning 95% or more of the collective investment account. Lastly, this exemption for minimal ownership interests is consistent with the rationales for exempting registered investment companies and foreign investment companies.

As with the current Interpretation, a collective investment account that is beneficially owned 5% or more in aggregate by restricted persons would be able to purchase hot issues so long as the restricted persons do not participate in the hot issue activity, i.e., if their interests have been carved out from the account that purchases hot issues. The proposed rule does not contain specific procedures for carving out the interests of restricted persons. Rather, this requirement is addressed under the general prohibition that states “a member or a person associated with a member may not sell, or cause to sell, a hot issue in a public offering to any account in which a restricted person . . . has a beneficial interest.” Pursuant to the provisions on preconditions for sale, discussed below, a member may not sell a hot issue to a collective investment account unless it has obtained documentary evidence from a person authorized to represent the beneficial owners of the account demonstrating that no restricted person has a beneficial interest in the account, except as permitted under the rule. In the case of sales to a collective investment account that is beneficially owned 5% or more by restricted persons, the documentary evidence furnished to the member would be required to demonstrate that the interests of the restricted persons have been carved out of the collective investment account.

6. Issuer-Directed Share Programs

Currently, the Interpretation permits members to sell hot issue securities to employees and directors of an issuer, a parent of an issuer, a subsidiary of an issuer, or any other entity that controls or is controlled by an issuer, when these persons are otherwise subject to the Interpretation, provided that in the case of an offering of securities for which a bona fide independent market does not exist, such securities are “locked-up” for three months. The proposed rule makes two changes. First, the rule would expand the exemption to reach “employees and directors of the issuer, an entity which controls, is controlled by, or is under common control of the issuer.” For this subparagraph, a company will be presumed to control another if the company beneficially owns 50% or more of the outstanding voting securities of the company. Expanding the scope to reach sister companies of the issuer is consistent with the purposes of the rule and with staff decisions under the exemptive authority.³

Second, the rule would eliminate the requirement for a three month lock-up for sales to restricted persons. The exemptive provisions addressing issuer-directed share programs were adopted in 1994. In announcing these amendments, the NASD explained that issuer-directed share programs are a valuable tool in employee development and retention. The NASD explained that the Interpretation should not interfere with programs that are part of an employer/employee relationship. NASD Regulation believes that issuers should be free to set the conditions for sales of their own securities to their employees, or employees of affiliated companies, even if such employees are otherwise restricted persons. While in many cases

³ See Letter to Phillip D. Parker, Debevoise & Plimpton, from Gary L. Goldsholle, NASD Regulation, dated May 28, 1999; Letter to Mark D. Fitterman, Morgan, Lewis & Bockius LLP, from Gary L. Goldsholle, NASD Regulation, dated May 17, 1999. (Copies of NASD Regulation exemptive and interpretative letters cited herein are available at the NASD Regulation Web site at www.nasdr.com.)

issuers impose lock-up periods, we do not believe they should be mandated by the proposed rule. Eliminating the lock-up period will eliminate the need for members to investigate the status of employees and directors of the issuer and affiliated companies, which was previously necessary solely to comply with the lock-up provisions.

Also, the proposed rule change will allow all employees and directors of the issuer and affiliated companies to be able to purchase securities of the issuer on equal terms. Currently, under the Interpretation, an employee of an issuer with a spouse in the securities business is required to lock-up the securities even though other employees may have no similar lock-up requirement.

7. Preconditions for Sale

Finally, the proposed rule also eliminates the myriad means members must use to demonstrate that they have not sold hot issues to restricted persons. The current Interpretation ranges from:

- (1) providing no specific guidance whatsoever with respect to sales to associated persons of a member;
- (2) to requiring written certifications from foreign broker/dealers and foreign banks;
- (3) to requiring notations on and principal review of order tickets for sales to domestic banks and conduits for undisclosed principal (including registered investment advisers); and
- (4) to written representations from attorneys and/or certified public accountants for sales to certain hedge funds or investment partnerships.

The proposed rule eliminates these various requirements and instead imposes an annual verification requirement on those accounts that purchase hot issues. Specifically, the proposed rule states that “[b]efore selling a hot issue to any account, a member must have obtained within the previous twelve months documentary evidence from the account holder, or a person authorized to represent the beneficial owners of the account or the ultimate purchasers if the account is a conduit account, demonstrating that no restricted person or ultimate purchaser in the case of a conduit account, has a beneficial interest in the account, except as permitted under the rule.” Under the proposed rule, a member may rely upon the written representation furnished by the customer unless it has reason to believe that the representation is inaccurate. The proposed rule requires that members shall maintain a copy of all records and information used to determine that an account does not contain restricted persons in its files for at least three years following the member’s last sale of a hot issue to that account.

8. Other Changes/Miscellaneous

In addition to the changes described above, the proposed rule also makes a number of minor modifications.

Sales to Certain Immediate Family Members of Associated Persons. The proposed rule modifies the exemption for sales to members of the immediate family of an officer, director, general partner, employee or agent of a member or another broker/dealer (collectively referred to as “associated persons”). Currently, members of the immediate family of an associated person may not purchase hot issues from the firm employing the associated person. The proposed rule would expand this prohibition to include affiliates of

the firm employing the associated person. As some firms establish affiliated broker/dealers, including online affiliates, this change is necessary to clarify that immediate family members of associated persons cannot use either the traditional or online distribution channel to circumvent the prohibitions on sales to them.

Second, the proposed rule modifies the exemption for sales of hot issues to immediate family members of an associated person to prevent sales to any immediate family members if the associated person directly or indirectly provides material support to, or receives material support from, the immediate family member. The decision to include the receipt of support from an immediate family member avoids situations where a young broker, in exchange for money or other support from his or her parents, allocates hot issues to them.

Affiliates of Broker/Dealers. The proposed rule also clarifies the restrictions on persons, natural and non-natural, that own more than a specified percentage of a broker/dealer. The definition of restricted person in the proposed rule includes an affiliate of a broker/dealer (other than a limited business broker/dealer) and any natural person or member of the person's immediate family who owns 10% or more or has contributed 10% or more of the capital of a broker/dealer (other than a limited business broker/dealer). NASD Regulation believes that these standards are similar in scope but more clearly articulated than paragraph (b)(9) of the Interpretation.

Sales to Certain Immediate Family Members. The proposed rule also clarifies the meaning of limited business broker/dealer. The Interpretation currently treats as a limited business broker/dealer a member engaged solely in the purchase or sale of either investment company/variable contracts securities or direct participation program securities. The use of

the term “engaged” has created some ambiguity where a firm is planning to expand into or phase out of a line of business. NASD Regulation believes it is more appropriate to look to what businesses a firm is “authorized” to engage in. In determining what business a firm is authorized to engage in, a member should look to the Form BD as well as any Restrictive Agreement.

Joint Back Office Broker/Dealers. The proposed rule also states that collective investment accounts that voluntarily register as broker/dealers for margin purposes (“joint back office broker/dealers”), or that have a joint back office broker/dealer subsidiary, are not automatically precluded from purchasing hot issues. This issue of joint back office broker/dealers first arose following the 1998 amendments to the Interpretation. Because the 1998 amendments expressly precluded sales of hot issues to an entity that owned a broker/dealer, the staff was approached by several hedge funds with joint back office broker/dealer subsidiaries that were suddenly precluded from purchasing hot issues even though investors in the funds were not restricted. Pursuant to its exemptive authority, the staff stated that the decision of a hedge fund or a subsidiary of a hedge fund to voluntarily register as a broker/dealer for the purpose of receiving more favorable margin treatment under Federal Reserve Regulation T should not automatically preclude the hedge fund from purchasing hot issues. Rather, the staff concluded that sales of hot issues to a hedge fund should be based upon a determination of the beneficial owners, and not be a function of whether the fund has sought more favorable margin treatment. The proposed rule codifies this exemptive position.⁴

⁴ See Letter to David Katz, Sidley & Austin, from Gary L. Goldsholle, NASD Regulation, dated January 20, 1999.

Beneficial Interest. The proposed rule also defines the term “beneficial interest.” Specifically, the term “beneficial interest” is defined as any ownership or other direct financial interest. In addition, consistent with the staff position articulated in Notice to Members 95-7, the definition states that the receipt of a management fee or performance based fee for operating a collective investment account shall not be considered a beneficial interest in the account.

Charitable Organizations. The proposed rule exempts sales to tax exempt charities organized under Section 501(c)(3) of the Internal Revenue Code. NASD Regulation believes that sales to charitable organizations are consistent with the purposes of the rule and foster a bona fide public distribution.

Anti-Dilution Provisions. The proposed rule also renames the “Venture Capital Investors” provisions of paragraph (h) of the Interpretation to “Anti-Dilution Provisions” to more accurately describe their effect and to avoid confusion about their scope. In addition, these provisions have been modified slightly to allow an equity holder to tack ownership where a company has been acquired by an issuer for purposes of meeting the one year holding period. This amendment is consistent with a staff interpretative position.⁵

Sales to Employee Benefits Plans. The provisions addressing employee benefits plans qualified under the Employee Retirement Income Security Act (“ERISA”) also have been amended. The proposed new rule would exempt employee benefits plans qualified under ERISA so long as the plan sponsor is not a member or an affiliate. NASD Regulation believes that the concept of an “affiliate” is a more appropriate method for determining

⁵ See Letter to Jeffrey Freiburger, Robert W. Baird & Co., Inc., from Gary L. Goldsholle, NASD Regulation, dated October 14, 1998.

whether an ERISA plan should be able to purchase hot issues. The proposed new rule also exempts state and foreign government employee benefits plans that are subject to separate state or municipal regulation, consistent with a staff interpretative position.⁶

Conversion Offerings. Finally, the provisions addressing conversion offerings have been streamlined. The new provisions have been amended to expressly include insurance company demutualizations. In addition, the provisions exempt conversion offerings regardless of whether the shares offered to eligible participants are part of the underwritten or non-underwritten offering. The proposed rule also eliminates the specific requirement for written notification to the member firm where the eligible purchaser is an associated person. The supervision of securities activity by associated persons is addressed in the NASD's supervision rules and need not be separately addressed or duplicated in the proposed rule.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that the provisions of the new rule protect investors and the public interest by: ensuring that members make a bona fide public offering of securities at the public offering price; ensuring that members do not

⁶ See Letter to Adam J. Karsler, Proskauer Rose LLP, from Gary L. Goldsholle, NASD Regulation, dated April 26, 1999.

withhold securities in a public offering for their own benefit or use such securities to reward certain persons who are in a position to direct future business to the member; and ensuring that industry “insiders,” including members and their associated persons, do not take advantage of their “insider” position in the industry to purchase hot issues for their own benefit at the expense of public customers.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal

Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: _____
Alden S. Adkins, Senior Vice President and
General Counsel

Date: October 14, 1999

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-99-60)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Trading in Hot Equity Offerings

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing to establish new Rule 2790, Trading in Hot Equity Offerings, of the National Association of Securities Dealers, Inc. (“NASD” or “Association”), to replace the Free-Riding and Withholding Interpretation, IM-2110-1. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

IM-2110-1. [“Free-Riding and Withholding”]

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

Deleted in its entirety and replaced with:

Reserved.

* * *

IM-2750. Transactions with Related Persons

A member who is acting, or plans to act, as sponsor of a unit investment trust will not violate Rule 2750 if it accumulates securities with respect to which the member has acted as a syndicate member, selling group member or reallocation dealer in an account of the member or related person of the member if, at the time of accumulation, the member in good faith intends to deposit the securities into the unit investment trust at the public offering price and intends to make a bona fide public offering of the participation units of that trust. Members engaged in such activity, however, will continue to be subject to Rule 2790. [IM-2110-1, “Free-Riding and Withholding.”]

* * *

Rule 2790. Trading in Hot Equity Offerings

(a) Definitions

(1) “Affiliate” shall have the same meaning as in Rule 2720 (b)(1).

(2) “Beneficial interest” means any ownership or other direct financial interest. The receipt of a management or performance based fee for operating a collective investment account shall not be considered a beneficial interest in the account.

(3) “Collective investment account” means any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle that manages assets of other persons. Collective investment account shall not include any entity in which the

decision to buy or sell securities is made jointly by each of the persons investing in the entity or by a member of their immediate family.

(4) “Conversion offering” means any offering of securities made as part of a plan by which a savings and loan association, insurance company, or other organization converts from a mutual to a stock form of ownership.

(5) “Hot issue” means any security that is part of a public offering if the volume weighted price during the first five minutes of trading in the secondary market is 5% or more above the public offering price.

(6) “Immediate family member” shall include a person’s parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children, and any other individual the person, directly or indirectly, provides material support.

(7) “Joint back office broker/dealer” means any domestic or foreign private investment fund that has voluntarily registered as a broker/dealer solely to take advantage of more favorable margin treatment afforded under Section 220.7 of Regulation T of the Federal Reserve. The activities of a joint back office broker/dealer must not require that it register as a broker/dealer under Section 15(a) of the Act.

(8) “Limited business broker/dealer” means any broker/dealer whose authorization to engage in the securities business is limited solely to the purchase or sale of either investment company/variable contracts securities or direct participation program securities.

(9) “Material support” means providing more than 10% of a person’s income or expenses. Material support shall be presumed for members of the immediate family living in the same household.

(10) “Public offering” means any initial or secondary public offering of an equity security as defined in section 3(a)(11) of the Act, made pursuant to a registration statement or offering circular, including exchange offers, rights offerings, offerings made pursuant to a merger or acquisition, or other securities distributions of any kind whatsoever, including securities that are specifically directed by the issuer on a non-underwritten basis. Public offering shall not include:

(A) Offerings made pursuant to an exemption under Section 4(1), 4(2) or 4(6) of the Securities Act of 1993 or SEC Rule 504, 505 or 506 adopted thereunder; and

(B) Offerings of exempted securities as defined in Section 3(a)(12)

(11) “Restricted person” includes:

(A) Members or other broker/dealers, unless the ultimate purchaser is a non-restricted person purchasing the security at the public offering price;

(B) Officers, directors, general partners, employees or agents of a member or any other broker/dealer (other than a limited business broker/dealer);

(C) With respect to the security being offered, finders or any person acting in a fiduciary capacity to the managing underwriter, including, but not limited to, attorneys, accountants and financial consultants;

(D) Any employee or other person who supervises, or whose activities directly or indirectly involve or are related to, the buying or selling of securities for a

bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account;

(E) Any affiliate of a broker/dealer (other than a limited business broker/dealer); and

(F) Any natural person or member of the person's immediate family who owns 10% or more or has contributed 10% or more of the capital of a broker/dealer (other than a limited business broker/dealer).

(b) General Prohibitions

(1) A member or a person associated with a member may not sell, or cause to sell, a hot issue in a public offering to any account in which a restricted person or a member of the restricted person's immediate family has a beneficial interest, except as permitted herein or through an exemption pursuant to the Rule 9600 Series.

(2) A member or a person associated with a member may not purchase a hot issue in a public offering, except as permitted herein or through an exemption pursuant to the Rule 9600 Series.

(3) A member may not continue to hold hot issues acquired in a public offering except as permitted herein or through an exemption pursuant to the Rule 9600 Series.

(c) Canceling Trades

A member or a person associated with a member does not violate this rule if it cancels a sale of a hot issue made to the account of a restricted person or a member of the person's immediate family prior to the end of the first business day following the date that market

trading commences (i.e., T+1) and reallocates such hot issue at the public offering price to a non-restricted person.

(d) Preconditions for Sale

Before selling a hot issue to any account, a member must have obtained within the previous twelve months documentary evidence from the account holder, or a person authorized to represent the beneficial owners of the account or the ultimate purchasers if the account is a conduit account, demonstrating that no restricted person or ultimate purchaser in the case of a conduit account, has a beneficial interest in the account, except as permitted under the rule. Members shall maintain a copy of all records and information used to determine that an account does not contain a restricted person in its files for at least three years following the member's last sale of a hot issue to that account.

(e) General Exemptions

A member or a person associated with a member may sell hot issues to:

(1) A registered investment company under the Investment Company Act of 1940.

(2) A collective investment account (including a joint back office broker/dealer or a collective investment account with a joint back office broker/dealer subsidiary), that is beneficially owned in part by restricted persons, provided that such restricted persons in aggregate own less than 5% of such account.

(3) A publicly traded corporation (other than an affiliate of a broker/dealer) listed on an exchange or The Nasdaq Stock Market, in which no person with a 10% or more ownership interest is a restricted person.

(4) A foreign investment company organized under the laws of a foreign jurisdiction, meeting the following criteria:

(A) the company has 100 or more investors;

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

(C) no more than 5% of the company's assets shall be invested in a particular hot issue; and,

(D) no person owning more than a 5% interest in such company is a restricted person.

(5) An employee benefits plan qualified under the Employee Retirement Income Security Act provided that the plan sponsor is not a member or an affiliate; or a state or foreign government employee benefit plan that is subject to separate state and municipal regulation.

(6) A tax exempt charitable organization under Section 501(c)(3) of the Internal Revenue Code.

(7) Employees and directors of the issuer, an entity which controls, is controlled by, or is under common control of the issuer.

(8) An immediate family member of a restricted person in paragraph (a)(9)(B) if:

(A) such restricted person does not directly or indirectly provide material support to, or receive material support from, the immediate family member;

(B) such restricted person is not employed by the member, or an affiliate of the member, selling the hot issue to the immediate family member; and

(C) such restricted person has no ability to control the allocation of the hot issue.

(9) An immediate family member of a restricted person in paragraphs (a)(9)(C)-(D) if such restricted person does not directly or indirectly provide material support to the member of the immediate family;

(10) A restricted person in paragraph (a)(9)(E) provided that the sale is to an account established for the benefit of bona fide public customers, including insurance company general, separate and investment accounts, and bank trust accounts.

(f) Anti-Dilution Provisions

The restrictions on the sale of hot issues in this rule shall not apply to sales to a restricted person in an initial public offering who meets the following criteria:

(1) the restricted person has held an equity ownership interest in the issuer, or a company that has been acquired by the issuer in the past year, for a period of one year prior to the effective date of the public offering;

(2) the sale of the hot issues to the restricted person shall not increase the restricted person's percentage equity ownership in the issuer above the ownership level as of three months prior to the filing of the registration statement with the SEC in connection with the offering;

(3) the sale of hot issues to the restricted person must not include any special terms; and

(4) the hot issues purchased pursuant to this subsection shall be restricted from sale or transfer for a period of three months following the effective date of the offering.

(g) Conversion Offerings

The rule shall not apply to the sale of securities directed by the issuer of a conversion offering, either on an underwritten or non-underwritten basis, to any person eligible to purchase securities in accordance with the governmental agency or instrumentality having authority to regulate such conversion offering.

* * *

Rule 3040. Private Securities Transactions of an Associated Person

* * *

(e) Definitions

For purposes of this Rule, the following terms shall have the stated meanings:

(1) “Private securities transaction” shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Rule 3050, transactions among immediate family members (as defined in Rule 2790 [IM-2110-1, Free-Riding and Withholding]), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded.

* * *

5392. Rules of the Association

* * *

(d) The following Rules of the Association and Interpretative Material thereunder are not applicable to transactions and business activities relating to the PORTAL Market:

- (1) Rules 1130, 2450, 2520, 2710, 2730, 2740, 2750, 2790, 2810, 2820, 2830, 2860, 3210, and 3360[; and
- (2) IM-2110-1].

* * *

9600. PROCEDURES FOR EXEMPTIONS

9610. Application

(a) Where to File

A member seeking an exemption from Rule 1021, 1022, 1070, 2210, 2320, 2340, 2520, 2710, 2720, 2790, 2810, 2850, 2851, 2860, Interpretive Material 2860-1, 3010(b)(2), 3210, 3350, 8211, 8212, 8213, 11870, or 11900, [Interpretive Material 2110-1,] or Municipal Securities Rulemaking Board Rule G-37 shall file a written application with the appropriate department or staff of the Association and provide a copy of the application to the Office of General Counsel of NASD Regulation.

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory

Basis for, the Proposed Rule Change

(a) Purpose

NASD Regulation is proposing Rule 2790, Trading in Hot Equity Offerings, to replace the Free-Riding and Withholding Interpretation, IM-2110-1 (“Interpretation”). The proposed new rule is an effort to focus and streamline the Interpretation, as well as to address feedback received in response to our request for comment on NASD rules in need of modernization in Notice to Members 98-81. NASD Regulation believes that the proposed rule is more carefully targeted towards the purposes of the Interpretation, while at the same time is significantly easier for the membership and the investing public to understand and follow.

Before addressing the specifics of the proposed rule change, it is important to understand its purpose. The purpose of the proposed rule, like the Interpretation it would replace, is to protect the integrity of the public offering process by:

- (1) ensuring that members make a bona fide public offering of securities at the public offering price;
- (2) ensuring that members do not withhold securities in a public offering for their own benefit or use such securities to reward certain persons who are in a position to direct future business to the member; and
- (3) ensuring that industry “insiders,” including members and their associated persons, do not take advantage of their “insider” position in the industry to purchase hot issues for their own benefit at the expense of public customers.

The proposed rule contains several significant changes from the Interpretation, which

are discussed in detail below. Members should be aware that notwithstanding the Board of Governors' endorsement of the proposed new rule, members must comply with the Interpretation as written. Additionally, members should be aware that NASD Regulation staff will not grant exemptions from the current Interpretation on the basis of proposals or policy statements contained in proposed Rule 2790.

1. Threshold Premium for "Hot Issue"

Perhaps the most significant change in the proposed rule is the decision to define the term "hot issue" with reference to a threshold premium. The current Interpretation defines a hot issue as any security that trades "at a premium," whenever secondary market trading begins. The NASD and the SEC have stated that any premium, no matter how small, makes an offering a hot issue.³ Thus, under the current Interpretation, a security that prices at \$15 per share and begins trading at \$15 1/32 is a "hot issue."

NASD Regulation believes that defining a hot issue with reference to a threshold premium is more consistent with the purposes of the rule and avoids imposing limitations on the distribution of securities in a public offering for which there is no substantial or immediate secondary market demand. The proposed rule change defines a hot issue as any security that is part of a public offering if the volume weighted price during the first five minutes of trading in the secondary market is 5% or more above the public offering price. NASD Regulation selected 5% as the threshold premium because it preliminarily believes that a 5% premium effectively distinguishes between offerings for which there is substantial excess investor demand and those that are generally satiated by the market supply. NASD

³ See *In re Wedbush, Noble, Cooke, Inc.*, 47 S.E.C. 1031, 1032-1033 (1984).

Regulation recognizes that the selection of any threshold is to an extent arbitrary, and expects to receive comments from members and investors on whether 5% is the correct premium.

NASD Regulation selected the volume weighted price during the first five minutes of trading as the benchmark price for determining whether an offering is a hot issue in part because it is a calculation that can readily be performed by any member or investor with access to trade data. It also is similar to the method currently used by Corporate Financing staff in issuing determinations about whether an offering is a “hot issue.” NASD Regulation also selected the volume weighted price because it is generally not susceptible to manipulation. In fact, this same methodology is used to determine the settlement value of Nasdaq-100 options on the Chicago Board Options Exchange.

2. Application to Equity Offerings Only

Another significant change is that the proposed rule would apply to equity offerings only. Specifically, the proposed rule incorporates the definition of equity security, as the term is defined in section 3(a)(11) of the Securities Exchange Act of 1934, as amended. Historically, the Interpretation has applied to equity and debt securities. However, as part of a series of amendments in 1998, NASD Regulation exempted most types of investment grade debt and investment grade asset-backed securities from the Interpretation on the grounds that “such offerings do not raise the same issues as equity offerings inasmuch as the price for a particular debt security generally fluctuates based on interest rate movements rather than demand factors.”⁴ With this proposed rule change, NASD Regulation is going one step further and eliminating application of the rule to non-investment grade debt. NASD

⁴ 59 Fed. Reg. 7030 (February 11, 1998).

Regulation believes that the price of non-investment grade debt is based primarily upon interest rates and the creditworthiness of the issuer rather than the demand factors that typically govern equity securities. In addition, since the debt markets are primarily institutional, debt offerings do not typically attract a lot of retail interest and, thus, the rule's purpose of protecting public customers would not be served in these markets. NASD Regulation, however, believes that offerings of convertible securities or warrants bundled with debt securities more closely resemble equity offerings and should not be exempt from the proposed rule.

3. Secondary Offerings

The proposed rule differs from the Interpretation in that it would apply to all secondary offerings. In 1998, NASD Regulation amended the Interpretation to exempt secondary offerings of actively-traded securities because it found that few secondary offerings traded at a premium, and where there was a premium, it was generally very small. In light of the decision to define a hot issue as requiring a 5% premium, NASD Regulation believes that it is no longer appropriate to exclude all secondary offerings as a class. In practice, most secondary offerings will continue to be exempt from the rule because there will not be a 5% premium. However, for those few offerings that do open at a 5% premium, the proposed rule would apply. NASD Regulation believes that any secondary offering for which there is excess demand, as evidenced by a 5% or more price increase, should not be purchased by restricted persons.

4. Elimination of the "Conditionally Restricted" Status

Another significant change in the proposed rule is the decision to eliminate the so-called “conditionally restricted” status and treat persons either as restricted or non-restricted. Conditionally restricted persons are listed in paragraphs (b)(5)(A)-(C) of the Interpretation and include:

- (1) members of the immediate family of an associated person who are not supported directly or indirectly by such associated person;
- (2) finders in respect to the public offering or any person acting in a fiduciary capacity to the managing underwriter (including accountants, attorneys and consultants); and
- (3) senior officers and directors of a bank, savings and loan institution, insurance company, investment company, investment advisory firm, or any other institutional type account, or any person in the securities department of any of the foregoing entities, or any other employee who may influence or whose activities directly or indirectly involve or are related to the function of buying or selling securities for any of the foregoing entities.

Under the Interpretation, conditionally restricted persons can purchase hot issues if:

- (1) the securities are sold to the customer in accordance with the customer’s normal investment practice;
 - (2) the amount of securities sold to any one such person is insubstantial;
- and

(3) the member's aggregate sales to conditionally restricted persons is insubstantial and not disproportionate in amount as compared to sales to other members of the public.

The concept of conditionally restricted persons appears to be a compromise between an outright prohibition against purchasing hot issues and imposing no restrictions whatsoever. In many cases, treating a person as only conditionally restricted is contrary to the public interest. Many of the persons treated as conditionally restricted are in a position to direct business to a member. If a determination is made that members should not sell hot issues to persons who can direct business to the member, NASD Regulation does not believe that these concerns are alleviated if the person can meet certain criteria, such as a "normal investment practice." Moreover, as a practical matter, certain of these persons, such as hedge fund managers, investment advisers, and other investment and portfolio managers, may have the requisite investment history despite being in a position to direct and control future business to a member. NASD Regulation proposes eliminating the conditionally restricted person status while at the same time more precisely targeting those persons to whom the rule applies.

5. Reconsidering the Category of Restricted Persons

In light of the recommendation to eliminate the conditionally restricted status, NASD Regulation is revising the category of persons subject to the rule.

a. Finders and fiduciaries

NASD Regulation will continue to treat finders and fiduciaries to the managing underwriter as restricted persons. NASD Regulation believes that finders and fiduciaries to

the managing underwriter are for practical purposes industry “insiders.” There is additional support for this position in the Corporate Financing Rule, Rule 2710, which defines the term “underwriter and related persons” as including “financial consultants and advisors, finders, . . .” Rule 2710(a)(6). Moreover, it is necessary to include finders and fiduciaries within the proposed rule to prevent issuers from circumventing the underwriting compensation limits of Rule 2710 by offering finders or fiduciaries access to the hot issue. NASD Regulation proposes treating these persons as restricted only for those offerings for which they are acting in the capacity as a finder or fiduciary. In the case of a law firm or consulting firm, the restriction would apply only to those persons working on a particular offering.

- b. Personnel with respect to the securities activities of a bank, insurance company, investment company, investment advisor, or collective investment account

With respect to the Interpretation’s restricted employees of a bank, savings and loan institution, insurance company, investment company, investment advisory firm, or any other institutional type account, NASD Regulation recommends several changes. The persons identified in this category are subject to the Interpretation because their position allows them the opportunity to direct business to a member, and it is believed that members would direct hot issues to the accounts of these persons in an effort to attract or retain business. NASD Regulation believes that this provision protects an important policy, but that the scope of persons covered may be too broad. NASD Regulation does not believe that all senior officers and all employees in the securities department of the covered entities should be restricted. Rather, a more function-oriented approach is proposed by treating as restricted persons only those employees or other persons who supervise, or whose activities directly or indirectly

involve or are related to, the buying or selling of securities for a bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account.

The proposed rule also eliminates the term “institutional type account” which has been confusing and misleading to members since many of the covered entities are not “institutional.” The term institutional type account covers a broad range of accounts, including a corporation’s investment account, a hedge fund, a family partnership, and an investment club. NASD Regulation notes that this category of persons is restricted under the Interpretation because they are in a position to direct investments. The Interpretation, however, implicitly accepts the practice of member firms awarding hot issues to their best customers. NASD Regulation is developing a distinction between directing investments of one’s own money and other peoples’ money. This concept is addressed in the proposed rule’s definition of “collective investment account” which is defined as “any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle that manages assets of other persons.” The proposed rule clarifies that a collective investment account shall not include any entity in which the decision to buy or sell securities is made jointly by each of the persons investing in the entity or by a member of their immediate family. NASD Regulation does not believe that participation in an investment club, where, for example, ten people contribute their own money and make decisions as a group, is the type of activity that should preclude a person from purchasing hot issues. Likewise, NASD Regulation also does not believe that establishing and managing a family partnership should preclude a person from purchasing hot issues. Family partnerships are

often established for tax and estate planning purposes and, because they do not involve managing other peoples' money, they do not implicate the concerns addressed by the proposed rule.

c. Collective investment accounts with very limited ownership by restricted persons

The proposed rule also contains an exemption for collective investment accounts owned by restricted persons to a very limited extent. Currently, the Interpretation states that investment partnerships and corporations in which a restricted person has a beneficial interest are prohibited from purchasing hot issues unless the investment partnership or corporation “carves-out” the interest of the restricted persons. NASD Regulation is aware that investment partnerships and corporations frequently incur significant expense in determining the status of every participant, particularly in the fund of fund contexts. In an effort to eliminate some of the burdens associated with the Interpretation, the proposed rule creates an exemption from the rule for a collective investment account that is beneficially owned in part by restricted persons, provided that such restricted persons in aggregate own less than 5% of such account. NASD Regulation believes that creating an exemption to accommodate these minimal interests in collective investment accounts is consistent with the purposes of the rule. Investors frequently like to see a general partner invest in the accounts they manage, and the proposed rule will now allow the general partner of a collective investment account to have a small but direct capital interest.

In addition, the 5% limit allows restricted persons who were previously only conditionally restricted, such as hedge fund managers, investment advisors, and other investment and portfolio managers, to participate in hot issues to a limited extent. Under the

new rule, however, the participation by restricted persons will be incidental to what is otherwise a bona fide public distribution to investors beneficially owning 95% or more of the collective investment account. Lastly, this exemption for minimal ownership interests is consistent with the rationales for exempting registered investment companies and foreign investment companies.

As with the current Interpretation, a collective investment account that is beneficially owned 5% or more in aggregate by restricted persons would be able to purchase hot issues so long as the restricted persons do not participate in the hot issue activity, i.e., if their interests have been carved out from the account that purchases hot issues. The proposed rule does not contain specific procedures for carving out the interests of restricted persons. Rather, this requirement is addressed under the general prohibition that states “a member or a person associated with a member may not sell, or cause to sell, a hot issue in a public offering to any account in which a restricted person . . . has a beneficial interest.” Pursuant to the provisions on preconditions for sale, discussed below, a member may not sell a hot issue to a collective investment account unless it has obtained documentary evidence from a person authorized to represent the beneficial owners of the account demonstrating that no restricted person has a beneficial interest in the account, except as permitted under the rule. In the case of sales to a collective investment account that is beneficially owned 5% or more by restricted persons, the documentary evidence furnished to the member would be required to demonstrate that the interests of the restricted persons have been carved out of the collective investment account.

6. Issuer-Directed Share Programs

Currently, the Interpretation permits members to sell hot issue securities to employees and directors of an issuer, a parent of an issuer, a subsidiary of an issuer, or any other entity that controls or is controlled by an issuer, when these persons are otherwise subject to the Interpretation, provided that in the case of an offering of securities for which a bona fide independent market does not exist, such securities are “locked-up” for three months. The proposed rule makes two changes. First, the rule would expand the exemption to reach “employees and directors of the issuer, an entity which controls, is controlled by, or is under common control of the issuer.” For this subparagraph, a company will be presumed to control another if the company beneficially owns 50% or more of the outstanding voting securities of the company. Expanding the scope to reach sister companies of the issuer is consistent with the purposes of the rule and with staff decisions under the exemptive authority.⁵

Second, the rule would eliminate the requirement for a three month lock-up for sales to restricted persons. The exemptive provisions addressing issuer-directed share programs were adopted in 1994. In announcing these amendments, the NASD explained that issuer-directed share programs are a valuable tool in employee development and retention. The NASD explained that the Interpretation should not interfere with programs that are part of an employer/employee relationship. NASD Regulation believes that issuers should be free to set the conditions for sales of their own securities to their employees, or employees of affiliated companies, even if such employees are otherwise restricted persons. While in many cases

⁵ See Letter to Phillip D. Parker, Debevoise & Plimpton, from Gary L. Goldsholle, NASD Regulation, dated May 28, 1999; Letter to Mark D. Fitterman, Morgan, Lewis & Bockius LLP, from Gary L. Goldsholle, NASD Regulation, dated May 17, 1999. (Copies of NASD Regulation exemptive and interpretative letters cited herein are available at the NASD Regulation Web site at www.nasdr.com.)

issuers impose lock-up periods, we do not believe they should be mandated by the proposed rule. Eliminating the lock-up period will eliminate the need for members to investigate the status of employees and directors of the issuer and affiliated companies, which was previously necessary solely to comply with the lock-up provisions.

Also, the proposed rule change will allow all employees and directors of the issuer and affiliated companies to be able to purchase securities of the issuer on equal terms. Currently, under the Interpretation, an employee of an issuer with a spouse in the securities business is required to lock-up the securities even though other employees may have no similar lock-up requirement.

7. Preconditions for Sale

Finally, the proposed rule also eliminates the myriad means members must use to demonstrate that they have not sold hot issues to restricted persons. The current Interpretation ranges from:

- (1) providing no specific guidance whatsoever with respect to sales to associated persons of a member;
- (2) to requiring written certifications from foreign broker/dealers and foreign banks;
- (3) to requiring notations on and principal review of order tickets for sales to domestic banks and conduits for undisclosed principal (including registered investment advisers); and
- (4) to written representations from attorneys and/or certified public accountants for sales to certain hedge funds or investment partnerships.

The proposed rule eliminates these various requirements and instead imposes an annual verification requirement on those accounts that purchase hot issues. Specifically, the proposed rule states that “[b]efore selling a hot issue to any account, a member must have obtained within the previous twelve months documentary evidence from the account holder, or a person authorized to represent the beneficial owners of the account or the ultimate purchasers if the account is a conduit account, demonstrating that no restricted person or ultimate purchaser in the case of a conduit account, has a beneficial interest in the account, except as permitted under the rule.” Under the proposed rule, a member may rely upon the written representation furnished by the customer unless it has reason to believe that the representation is inaccurate. The proposed rule requires that members shall maintain a copy of all records and information used to determine that an account does not contain restricted persons in its files for at least three years following the member’s last sale of a hot issue to that account.

8. Other Changes/Miscellaneous

In addition to the changes described above, the proposed rule also makes a number of minor modifications.

Sales to Certain Immediate Family Members of Associated Persons. The proposed rule modifies the exemption for sales to members of the immediate family of an officer, director, general partner, employee or agent of a member or another broker/dealer (collectively referred to as “associated persons”). Currently, members of the immediate family of an associated person may not purchase hot issues from the firm employing the associated person. The proposed rule would expand this prohibition to include affiliates of

the firm employing the associated person. As some firms establish affiliated broker/dealers, including online affiliates, this change is necessary to clarify that immediate family members of associated persons cannot use either the traditional or online distribution channel to circumvent the prohibitions on sales to them.

Second, the proposed rule modifies the exemption for sales of hot issues to immediate family members of an associated person to prevent sales to any immediate family members if the associated person directly or indirectly provides material support to, or receives material support from, the immediate family member. The decision to include the receipt of support from an immediate family member avoids situations where a young broker, in exchange for money or other support from his or her parents, allocates hot issues to them.

Affiliates of Broker/Dealers. The proposed rule also clarifies the restrictions on persons, natural and non-natural, that own more than a specified percentage of a broker/dealer. The definition of restricted person in the proposed rule includes an affiliate of a broker/dealer (other than a limited business broker/dealer) and any natural person or member of the person's immediate family who owns 10% or more or has contributed 10% or more of the capital of a broker/dealer (other than a limited business broker/dealer). NASD Regulation believes that these standards are similar in scope but more clearly articulated than paragraph (b)(9) of the Interpretation.

Sales to Certain Immediate Family Members. The proposed rule also clarifies the meaning of limited business broker/dealer. The Interpretation currently treats as a limited business broker/dealer a member engaged solely in the purchase or sale of either investment company/variable contracts securities or direct participation program securities. The use of

the term “engaged” has created some ambiguity where a firm is planning to expand into or phase out of a line of business. NASD Regulation believes it is more appropriate to look to what businesses a firm is “authorized” to engage in. In determining what business a firm is authorized to engage in, a member should look to the Form BD as well as any Restrictive Agreement.

Joint Back Office Broker/Dealers. The proposed rule also states that collective investment accounts that voluntarily register as broker/dealers for margin purposes (“joint back office broker/dealers”), or that have a joint back office broker/dealer subsidiary, are not automatically precluded from purchasing hot issues. This issue of joint back office broker/dealers first arose following the 1998 amendments to the Interpretation. Because the 1998 amendments expressly precluded sales of hot issues to an entity that owned a broker/dealer, the staff was approached by several hedge funds with joint back office broker/dealer subsidiaries that were suddenly precluded from purchasing hot issues even though investors in the funds were not restricted. Pursuant to its exemptive authority, the staff stated that the decision of a hedge fund or a subsidiary of a hedge fund to voluntarily register as a broker/dealer for the purpose of receiving more favorable margin treatment under Federal Reserve Regulation T should not automatically preclude the hedge fund from purchasing hot issues. Rather, the staff concluded that sales of hot issues to a hedge fund should be based upon a determination of the beneficial owners, and not be a function of whether the fund has sought more favorable margin treatment. The proposed rule codifies this exemptive position.⁶

⁶ See Letter to David Katz, Sidley & Austin, from Gary L. Goldsholle, NASD Regulation, dated January 20, 1999.

Beneficial Interest. The proposed rule also defines the term “beneficial interest.” Specifically, the term “beneficial interest” is defined as any ownership or other direct financial interest. In addition, consistent with the staff position articulated in Notice to Members 95-7, the definition states that the receipt of a management fee or performance based fee for operating a collective investment account shall not be considered a beneficial interest in the account.

Charitable Organizations. The proposed rule exempts sales to tax exempt charities organized under Section 501(c)(3) of the Internal Revenue Code. NASD Regulation believes that sales to charitable organizations are consistent with the purposes of the rule and foster a bona fide public distribution.

Anti-Dilution Provisions. The proposed rule also renames the “Venture Capital Investors” provisions of paragraph (h) of the Interpretation to “Anti-Dilution Provisions” to more accurately describe their effect and to avoid confusion about their scope. In addition, these provisions have been modified slightly to allow an equity holder to tack ownership where a company has been acquired by an issuer for purposes of meeting the one year holding period. This amendment is consistent with a staff interpretative position.⁷

Sales to Employee Benefits Plans. The provisions addressing employee benefits plans qualified under the Employee Retirement Income Security Act (“ERISA”) also have been amended. The proposed new rule would exempt employee benefits plans qualified under ERISA so long as the plan sponsor is not a member or an affiliate. NASD Regulation believes that the concept of an “affiliate” is a more appropriate method for determining

⁷ See Letter to Jeffrey Freiburger, Robert W. Baird & Co., Inc., from Gary L. Goldsholle, NASD Regulation, dated October 14, 1998.

whether an ERISA plan should be able to purchase hot issues. The proposed new rule also exempts state and foreign government employee benefits plans that are subject to separate state or municipal regulation, consistent with a staff interpretative position.⁸

Conversion Offerings. Finally, the provisions addressing conversion offerings have been streamlined. The new provisions have been amended to expressly include insurance company demutualizations. In addition, the provisions exempt conversion offerings regardless of whether the shares offered to eligible participants are part of the underwritten or non-underwritten offering. The proposed rule also eliminates the specific requirement for written notification to the member firm where the eligible purchaser is an associated person. The supervision of securities activity by associated persons is addressed in the NASD's supervision rules and need not be separately addressed or duplicated in the proposed rule.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that the provisions of the new rule protect investors and the public interest by: ensuring that members make a bona fide public offering of securities at the public offering price; ensuring that members do not

⁸ See Letter to Adam J. Karsler, Proskauer Rose LLP, from Gary L. Goldsholle, NASD Regulation, dated April 26, 1999.

withhold securities in a public offering for their own benefit or use such securities to reward certain persons who are in a position to direct future business to the member; and ensuring that industry “insiders,” including members and their associated persons, do not take advantage of their “insider” position in the industry to purchase hot issues for their own benefit at the expense of public customers.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning

the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary