October 10, 2000

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

Re: **File No. SR-NASD-99-60**
Restrictions on the Purchase and Sale of Initial Equity Public Offerings
Amendment No. 2

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-l/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release. With this filing, NASD Regulation also hereby consents to the extension of time for Securities and Exchange Commission action on the above-referenced rule filing to December 30, 2000.

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

Enclosures

File No. SR-NASD-99-60
Consists of 91 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") Amendment No. 2 ("Amendment") to proposed Rule 2790 to address the comments received in response to publication of the proposed rule change in the Federal Register. Among other things, the Amendment addresses the scope of securities covered by the rule, the documentation required by member firms to evidence compliance, the restrictions on hedge fund and other portfolio managers, the restrictions on owners of broker/dealers, and the application of the rule to issuer-directed share programs. Below is the text of the proposed rule change.

Rule 2790. Restrictions on the Purchase and Sale of Initial Equity Public Offerings

(a) General Prohibitions

(1) A member or a person associated with a member may not sell, or cause to be sold, a new issue to any account in which a restricted person has a beneficial interest, except as otherwise permitted herein.

(2) A member or a person associated with a member may not purchase a new issue in any account in which such member or person associated with a member has a beneficial interest, except as otherwise permitted herein.

(3) A member may not continue to hold new issues acquired by the member as an underwriter, selling group member, or otherwise, except as otherwise permitted herein.

(b) Preconditions for Sale

Before selling a new issue to any account, a member must in good faith have obtained within the twelve months prior to such sale, a representation from the account holder(s), or a person authorized to represent the beneficial owners of the account, that the account is eligible to purchase new issues in compliance with this rule. A member may not rely upon any representation that it believes, or has reason to believe, is inaccurate. A member shall maintain a copy of all records and information relating to whether an account is eligible to purchase new issues in its files for at least three years following the member's last sale of a new issue to that account.

(c) General Exemptions

The general prohibitions in paragraph (a) of this rule shall not apply to sales to and purchases by:

(1) An investment company registered under the Investment Company Act of 1940;

(2) A common trust fund or similar fund as described in Section 3(a)(12)(A)(iii) of the Act, provided that:

(A) the fund has investments from 1,000 or more trust accounts; and

(B) the fund does not limit beneficial interests in the fund principally to trust accounts of restricted persons;

(3) An insurance company general, separate or investment account, provided that:

(A) the account has investments from 1,000 or more policyholders; and

(B) the insurance company does not limit beneficial interests in the account principally to restricted persons;

(4) An account that is beneficially owned in part by restricted persons, provided that such restricted persons in the aggregate own less than 5% of such account, and that:

(A) each such restricted person does not manage or otherwise direct investments in the account; and

(B) on a pro rata basis, each such restricted person who is a natural person receives less than 100 shares of any new issue;

(5) A publicly traded entity (other than a broker/dealer) that is listed on a national securities exchange or is traded on the Nasdaq National Market, provided that the gains or losses from new issues are passed on directly or indirectly to public shareholders;

(6) An investment company organized under the laws of a foreign jurisdiction, provided that:

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

(B) no person owning more than 5% of the shares of the investment company is a restricted person;

(7) An Employee Retirement Income Security Act benefits plan that is qualified under Section 401(a) of the Internal Revenue Code, provided that such plan is not sponsored solely by a broker/dealer;

(8) A state or municipal government benefits plan that is subject to state and/or municipal regulation; or

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

(d) Issuer-Directed Securities

The prohibitions on the purchase and sale of new issues in this rule shall not apply to securities that:

(1) are specifically directed by the issuer; provided, however, that this exemption shall not apply to securities directed by the issuer to an account in which any restricted person specified in subparagraphs (i)(10)(B) or (i)(10)(C) of this rule has a beneficial interest, unless such person, or a member of his or her immediate family, is an employee or director of the issuer, the issuer's parent, or a subsidiary of the issuer. Also, for purposes of this subparagraph (d)(1) only, a parent/subsidiary relationship is established if the parent has the right to vote 50% or more of a class of voting security of the subsidiary, or has the power to sell or direct 50% or more of a class of voting securities of the subsidiary;

(2) are part of a program sponsored by the issuer or an affiliate of the issuer that meets the following criteria:

(a) the opportunity to purchase a new issue under the program is offered to at least 10,000 participants;

(b) every participant is offered an opportunity to purchase an equivalent number of shares, or will receive a specified number of shares under a predetermined formula applied uniformly across all participants;

(c) if not all participants receive shares under the program, the selection of the participants eligible to purchase shares is based upon a random or other non-discretionary allocation method;

(d) the class of participants does not contain a disproportionate number of restricted persons as compared to the investing public generally; and

(e) sales are not made to participants who are managing underwriter(s), the broker/dealer administering the program ("Administering Broker/Dealer"), the officers or directors of the managing underwriter(s) or Administering Broker/Dealer, or any employee of

the managing underwriter(s) or Administering Broker/Dealer with access to non-publicly available information about the new issue; or

(3) are directed to eligible purchasers as part of a conversion offering in accordance with the standards of the governmental agency or instrumentality having authority to regulate such conversion offering.

(e) Anti-Dilution Provisions

The prohibitions on the purchase and sale of new issues in this rule shall not apply to an account in which a restricted person has a beneficial interest that meets the following conditions:

(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 offering;

(2) the sale of the new issue to the account 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 in connection with the offering;

(3) the sale of the new issue to the account shall not include any special terms; and

(4) the new issue purchased pursuant to this subparagraph (e) shall not be sold, transferred, assigned, pledged or hypothecated for a period of three months following the effective date of the offering.

(f) Stand-by Purchasers

The prohibitions on the purchase and sale of new issues in this rule shall not apply to the purchase and sale of securities pursuant to a stand-by agreement that meets the following conditions:

(1) the stand-by agreement is disclosed in the prospectus;

(2) the stand-by agreement is the subject of a formal written agreement;

(3) the managing underwriter(s) represents in writing that it was unable to find any other purchasers for the securities; and

(4) the securities sold pursuant to the stand-by agreement shall not be sold, transferred, assigned, pledged or hypothecated for a period of three months following the effective date of the offering.

(g) Under-Subscribed Offerings

Nothing in this rule shall prohibit an underwriter, pursuant to an underwriting agreement, from placing a portion of a public offering in its investment account when it is unable to sell that portion to the public.

(h) Exemptive Relief

Pursuant to the Rule 9600 series, the staff, for good cause shown after taking into consideration all relevant factors, may conditionally or unconditionally exempt any person, security or transaction (or any class or classes of persons, securities or transactions) from this rule to the extent that such exemption is consistent with the purposes of the rule, the protection of investors, and the public interest.

(i) Definitions

(1) "Beneficial interest" means any economic interest, such as the right to share in gains or losses. 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.

(2) "Collective investment account" means any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle.

(3) "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.

(4) "Family partnership" means a partnership comprised solely of immediate family members.

(5) "Immediate family member" means 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 to whom the person provides material support.

(6) "Investment club" means a group of friends, neighbors, business associates, or others that pool their money to invest in stock or other securities and are collectively responsible for making investment decisions.

(7) "Limited business broker/dealer" means any broker/dealer whose authorization to engage in the securities business is limited solely to the purchase and sale of investment company/variable contracts securities and direct participation program securities.

(8) "Material support" means directly or indirectly providing more than 25% of a person's income in the current or prior calendar year. Members of the immediate family living in the same household are deemed to be providing each other with material support.

(9) "New issue" means any initial 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, or other securities distributions of any kind whatsoever, including securities that are specifically directed by the issuer on a non-underwritten basis. New issue shall not include:

(A) offerings made pursuant to an exemption under Section 4(1), 4(2) or 4(6) of the Securities Act of 1933, or SEC Rule 504 if the securities are "restricted securities" under SEC Rule 144(a)(3), or Rule 505 or Rule 506 adopted thereunder;

(B) offerings of exempted securities as defined in Section 3(a)(12) of the Act;

(C) rights offerings, exchange offers, or offerings made pursuant to a merger or acquisition;

(D) offerings of investment grade asset-backed securities;

(E) offerings of convertible securities;

(F) offerings of preferred securities; and

(G) offerings of securities of closed-end companies as defined under Section (5)(a)(2) of the Investment Company Act of 1940.

(10) "Restricted person" means:

(A) Members or other broker/dealers;

(B) Broker/Dealer Personnel

(i) Any officer, director, general partner, associated person, or employee of a member or any other broker/dealer (other than a limited business broker/dealer), or any agent of a member or any other broker/dealer (other than a limited business broker/dealer) that is engaged in the investment banking or securities business;

(ii) An immediate family member of a person specified in subparagraph (B)(i) if the person specified in subparagraph (B)(i):

(a) materially supports, or receives material support from, the immediate family member;

(b) is employed by or associated with the member, or an affiliate of the member, selling the new issue to the immediate family member; or

(c) has an ability to control the allocation of the new issue.

(C) Finders and Fiduciaries

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

(ii) An immediate family member of a person specified in subparagraph (C)(i) if the person specified in subparagraph (C)(i) materially supports, or receives material support from, the immediate family member.

(D) Portfolio Managers

(i) Any person who has authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account, other than with respect to a beneficial interest in the bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account over which such person has investment authority;

(ii) An immediate family member of a person specified in subparagraph (D)(i) that is materially supported by such person, other than with respect to a beneficial interest in the bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account over which such person has investment authority.

Provided, however, that the term “restricted person” under this subparagraph (D) shall not include a person solely because he or she is a participant in an investment club or a family partnership.

(E) Persons Owning a Broker/Dealer

(i) Any person listed, or required to be listed, in Schedule A of a Form BD, except persons with ownership interests of less than 10%;

(ii) any person listed, or required to be listed, in Schedule B of a Form BD, except persons whose listing on Schedule B relates to an ownership interest in a person listed on Schedule A with an ownership interest of less than 10%;

(iii) any person listed, or required to be listed, in Schedule C of a Form BD that meets the criteria of subparagraphs (E)(i) and (E)(ii) above;

(iv) any person that directly or indirectly owns 10% or more of a public reporting company listed on Schedule A of a Form BD (other than a reporting company that is listed on a national securities exchange or is traded on the Nasdaq National Market, provided that the gains or losses from new issues are passed on directly or indirectly to public shareholders);

(v) Any person that directly or indirectly owns 25% or more of a public reporting company listed on Schedule B of a Form BD (other than a reporting company that is listed on a national securities exchange or is traded on the Nasdaq National Market, provided that the gains or losses from new issues are passed on directly or indirectly to public shareholders).

(vi) An immediate family member of a person specified in subparagraphs (E)(i)-(v) unless the person owning the broker/dealer:

(a) does not materially support, or receive material support from, the immediate family member;

(b) is not an owner of the member, or an affiliate of the member, selling the new issue to the immediate family member; and

(c) has no ability to control the allocation of the new issue.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The Board of Directors of NASD Regulation approved the revisions to the proposed rule change at its meeting on July 26, 2000, and 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 July 27, 2000. 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 approximately 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, Associate 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

(i) Background

On October 15, 1999, NASD Regulation filed proposed Rule 2790, Trading in Hot Equity Offerings, with the SEC. The SEC published the proposed rule for comment on January 10, 2000.[1] The SEC received 24 comment letters.[2] In general, the commenters applauded NASD Regulation's efforts to reform the Free-Riding and Withholding Interpretation.[3] Several commenters believed that the proposed rule change was a significant improvement over the Interpretation. Testa stated that "[i]n general, the Proposal presents a much more easily understood and more workable regulatory scheme." Katten and Schwab stated that the proposed rule change was more carefully targeted

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[1] Notice of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Trading in Hot Equity Offerings, Exchange Act Release No. 42325, 65 Fed. Reg. 2656 (Jan. 18, 2000).

[2] Letter from Willkie Farr & Gallagher to Jonathan G. Katz, SEC, dated January 28, 2000 ("Willkie"); Letter from Faith Colish to Jonathan G. Katz, SEC, dated January 31, 2000 ("Colish"); Letter from Katten Muchin Zavis to Jonathan G. Katz, SEC, dated January 28, 2000 ("Katten"); Letter from Driehaus Capital Management, Inc. to Jonathan G. Katz, SEC, dated February 4, 2000 ("Driehaus"); Letter from Fu Associates, Ltd. to Jonathan G. Katz, SEC, dated February 7, 2000 ("Fu"); Letter from Cadwalader, Wickersham & Taft to Jonathan G. Katz, SEC, dated February 4, 2000 ("Cadwalader"); Letter from Schulte Roth & Zabel LLP to Jonathan G. Katz, SEC, dated February 7, 2000 ("Schulte"); Letter from Rosenman & Colin LLP to Jonathan G. Katz, SEC, dated February 7, 2000 ("Rosenman"); Letter from Fried, Frank, Harris, Shriver & Jacobson to Jonathan G. Katz, SEC, dated May 9, 2000 ("Fried"); Letter from Ropes & Gray to Jonathan G. Katz, SEC, dated February 8, 2000 ("Ropes"); Letter from The Washington Group to Jonathan G. Katz, SEC, dated February 8, 2000 ("Washington"); Letter from Testa, Hurwitz & Thibeault, LLP to Jonathan G. Katz, SEC, dated February 8, 2000 ("Testa"); Letter from Chicago Board Options Exchange to Jonathan G. Katz, SEC, dated February 14, 2000 ("CBOE"); Letter from Sullivan & Cromwell to Jonathan G. Katz, SEC, dated February 15, 2000 ("Sullivan"); Letter from Charles Schwab to Jonathan G. Katz, SEC, dated February 15, 2000 ("Schwab"); Letter from Sidley & Austin to Jonathan G. Katz, SEC, dated February 16, 2000 ("Sidley"); Letter from North American Securities Administrators Association, Inc. to Jonathan G. Katz, SEC, dated February 18, 2000 ("NASAA"); Letter from Northern Trust Global Advisors, Inc. to Jonathan G. Katz, SEC, dated February 13, 2000 ("Northern"); Letter from Securities Industry Association to Jonathan G. Katz, SEC, dated February 18, 2000 ("SIA"); Letter from Morgan Stanley Dean Witter to Jonathan G. Katz, SEC, dated March 17, 2000 ("MSDW"); Letter from Mayor, Day, Caldwell & Keeton, LLP to Jonathan G. Katz, SEC, dated June 2, 2000 ("Mayor"); Letter from Covington & Burling to Jonathan G. Katz, SEC, dated April 14, 2000 ("Covington"); Letter from Orrick, Herrington & Sutcliffe LLP to Jonathan G. Katz, SEC, dated May 2, 2000 ("Orrick"); and Letter from Sandra K. Smith to Jonathan G. Katz, SEC, dated February 1, 2000 ("Smith").

[3] See, e.g., Sullivan, SIA, and Schwab.

towards the purpose of the rule while at the same time was easier for firms, institutional investors and the investing public in general to understand and follow. Katten also added that protecting the integrity of the public offering process is a noteworthy objective that benefits all investors.

As expected, the commenters supported certain elements of the proposed rule change, opposed others, and made suggestions for further changes. A summary and analysis of the specific comments are provided below.

(ii) Scope of Securities Covered by the Proposed Rule Change

The area that generated the most comment was the proposed definition of "hot issue." Currently, under the Interpretation, a hot issue is any security in a public offering that trades at a "premium" in the secondary market. In the October 1999 filing, NASD Regulation defined a hot issue as a security that is part of a public offering "if the volume weighted price during the first five minutes of trading in the secondary market was 5% or more above the public offering price." Many commenters supported NASD Regulation's decision to adopt a clear and measurable standard for determining whether an offering is a hot issue, but believed that the 5% threshold was too low. Colish, Driehaus, SIA, and MSDW questioned whether the methodology proposed by NASD Regulation would be effective in identifying those offerings that should be subject to the rule. Colish and Dreihaus added that NASD Regulation should supply data to support its chosen methodology.

By contrast, Schwab and the SIA suggested what they termed a more "straightforward" approach: prohibiting allocations of all initial public offerings ("IPOs") to restricted persons. Schwab stated that even though the Interpretation and the proposed rule change contain a safe harbor for canceling a sale and reallocating the security to a non-restricted account, many firms do not and would not avail themselves of the safe harbor. In practice, Schwab said, under the proposed hot issue

definition, firms would continue to treat all IPOs as hot issues. The SIA, which argued in the alternative for a higher threshold premium, agreed and stated that if a 5% threshold were adopted, firms would continue to treat all IPOs as being subject to the rule because they cannot be in a position of having to anticipate which offerings will trade through the 5% threshold.

Based upon these comments, NASD Regulation has amended the proposed rule change to restrict the purchase and sale of all initial equity public offerings,[4] not just those that open above a certain premium. Like Schwab and the SIA, NASD Regulation believes that this approach is the most straightforward way to achieve the purposes of the rule. It is both easier to understand and avoids many of the complexities associated with canceling and reallocating the sale of an IPO to a non-restricted person in the event that an offering unexpectedly becomes a hot issue. NASD Regulation disagrees with those commenters who recommended a higher threshold premium, such as 10% or more. In NASD Regulation's view, allocating IPOs with such notable gains (approaching 10% or even more) to restricted persons is precisely the type of conduct that the rule is designed to prevent.

As a corollary to the proposal to apply the proposed rule change to all IPOs, NASD Regulation is proposing to exempt secondary offerings. Many of the commenters opposed NASD Regulation's decision in the October 1999 filing to roll back the exemption for secondary offerings of actively traded securities. As NASD Regulation stated in the October 1999 filing, the decision to roll back the exemption for secondary offerings was premised upon the decision to adopt a 5% threshold premium for hot issues. NASD Regulation believed that with a 5% premium, as a practical matter, all secondary offerings would be exempt from the rule. In proposing to eliminate the requirement for a 5% threshold premium, however, NASD Regulation believes that reinstating the exemption for

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[4] The Amendment, like the October 1999 filing, limits the application of the proposed rule change to equity offerings only.

secondary offerings is now appropriate. NASD Regulation has observed that secondary offerings rarely, if at all, trade at a significant premium to the public offering price. We also agree with Schwab that the negative consequences to both issuers and customers in applying the rule to secondary offerings would outweigh any benefits associated with including such offerings in the proposed rule change.

Schwab, Sullivan and others also recommended that all secondary offerings, not just those that are actively traded, should be excluded from the proposed rule change. NASD Regulation has not observed any unique concerns with respect to secondary offerings of non-actively traded securities. Accordingly, consistent with its objective to develop a more streamlined rule, NASD Regulation has proposed expanding the exemption for secondary offerings to include all secondary offerings.

The decision to apply the proposed rule change to all IPOs, not just those that are hot issues, may lead to problems in offerings for which there is insufficient investor demand. Under the current Interpretation, such offerings would typically not open at a premium and would not be hot issues. With a rule that applies to all IPOs, however, NASD Regulation is proposing to add provisions to address circumstances where purchases by restricted persons are necessary for the successful completion of an offering. The Amendment contains provisions for stand-by purchasers that are identical to the stand-by provisions in the Interpretation. With respect to the stand-by provisions, MSDW suggested imposing minimum capital contribution requirements and extending the lock-up requirements from three months to one year. NASD Regulation does not believe that these additional requirements are necessary. The Amendment also contains provisions addressing under-subscribed offerings. Specifically, the proposed rule change states that nothing in the rule shall prohibit an underwriter, pursuant to an underwriting agreement, from placing a portion of a public offering in its investment account when it is unable to sell that portion to the public.

In the October 1999 filing, NASD Regulation targeted the proposed rule change to equity offerings only. Historically, the Interpretation applied to equity and debt offerings; in a series of amendments in 1998, however, NASD Regulation exempted most types of debt. Several commenters, including the SIA and Sullivan, expressed support for the elimination of debt securities entirely from the rule's coverage. These commenters generally believed that debt offerings do not raise the same issues as equity offerings and for that reason should be excluded.

There are a number of other categories of offerings that NASD Regulation does not believe should be covered by the proposed rule change. First, NASD Regulation recommends exempting public offerings of investment grade asset-backed securities as defined in SEC Form S-3, some of which may otherwise fall within the definition of new issue. The Interpretation currently exempts investment grade, financing instrument-backed securities and, in view of the decision to eliminate the 5% threshold, NASD Regulation believes that it is appropriate to reinstate the exemption.

Second, NASD Regulation recommends exempting convertible securities.[5] NASD Regulation staff has already exempted many convertible securities from the Interpretation under its exemptive authority.[6] NASD Regulation found that in light of the Interpretation's current exclusion for debt securities and secondary offerings, the failure to exclude convertible securities led to an anomalous result. A law firm noted that an issuer could issue a non-convertible debt security and make a secondary offering of an actively traded security and neither would be subject to the Interpretation. Yet, if an issuer decided to in effect combine these two securities and issue a debt security that had

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[5] Although the proposed rule change applies only to equity securities, the definition of equity security in section 3(a)(11) of the Exchange Act, which is used in the proposed rule change, includes any security, including a debt security, that is convertible into stock.

[6] See Letter to Peter C. Manbeck, Sullivan, from Gary L. Goldsholle, NASD Regulation, dated December 21, 1998.

the additional feature of being convertible into an actively traded security, then the Interpretation would apply. To correct this inconsistency, NASD Regulation staff has used its exemptive authority to exempt from the Interpretation debt securities that are convertible into an actively traded security. NASD Regulation now proposes to codify this exemption. However, in view of the decision to exclude all secondary offerings from the proposed rule change, NASD Regulation has expanded the exemption to include all convertible securities, not just those that are convertible into actively traded securities.

Third, NASD Regulation recommends exempting preferred securities. In connection with amendments to the Interpretation in 1998, NASD Regulation considered, but deferred an exemption for preferred securities.[7] Specifically, NASD Regulation stated that it would "evaluate the impact of excluding investment grade debt and investment grade financing backed securities from the Interpretation and will consider in the future whether preferred [securities] should also be excluded."[8] Based upon its experience with the 1998 amendments, and the purposes of the proposed rule change, NASD Regulation now recommends excluding preferred securities. On balance, NASD Regulation believes that preferred securities exhibit pricing and trading behavior that more closely resemble debt than equity securities.

Fourth, NASD Regulation recommends exempting offerings of closed-end company securities as defined under Section 5(a)(2) of the Investment Company Act of 1940 from the restriction of the rule. Generally, when closed-end companies make a public offering they are seeking as large an infusion of capital as possible and will expand the number of shares offered to meet the demand. These shares typically commence trading at the public offering price; if there is a premium, it is very

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[7] 63 Fed. Reg. 28535, 28537 (May 26, 1998).

[8] Id.

small. Accordingly, applying the proposed rule change to closed-end companies does not further the purposes of the rule and may impair the ability of closed-end companies to obtain capital. NASD Regulation therefore recommends an exemption for closed-end companies.

(iii) Portfolio Fund Managers

Another area that generated a significant amount of comment was the proposed definition and treatment of portfolio managers. In the October 1999 filing, NASD Regulation proposed a "more function-oriented approach" towards personnel with respect to the securities activities of a bank, insurance company, investment company, investment advisor, or collective investment account. NASD Regulation suggested that only persons who supervise or whose activities are directly or indirectly related to the buying or selling of securities for one of the listed entities should be restricted. Ropes, Testa, and Schwab supported this function-oriented approach, but believed that the proposed rule change was still too broad and could reach persons whose functions were purely ministerial. These commenters suggested that the restrictions in the proposed rule change should apply only to those persons who have "the authority to make investment decisions." Ropes believed that this would be a better and more precise indicator of whether a person is in a position to direct business to a member. NASD Regulation believes that this is a useful clarification and has amended the proposed rule change accordingly.[9]

The proposed rule change also sought to remove the restrictions on persons who participate in an investment club or manage a family partnership. Fu, Sullivan, Smith, and Schwab all strongly supported these changes. Fu, the general partner of a small investment club, believed that he had

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[9] Schwab also requested an exemption for persons who, on a volunteer basis, make investment decisions of behalf of a tax-exempt charitable organization. NASD Regulation is not proposing such an exemption. Depending on the particular facts, NASD Regulation believes the purposes of the rule may be implicated by a person who manages the investments of a tax-exempt charitable organization.

been unfairly restricted access to IPOs because the Interpretation treated an investment club as an "institutional account." Similarly, Smith viewed her participation in an investment club as a "learning and social activity" and did not believe that her participation in an investment club should affect her, or her husband's, ability to purchase an IPO. Cadwalader noted, however, that, as drafted, the exemption for investment clubs and family partnerships would inadvertently exempt sales to an investment club or family partnership consisting solely or predominantly of restricted persons. NASD Regulation agrees that this was not an intended result. To correct this problem, the proposed rule change no longer exempts investment clubs or family partnerships per se, but rather states that participation in an investment club or family partnership does not by itself make a person restricted.

A number of commenters, including Willkie, Katten, Washington, and Northern, were strongly opposed to the restrictions on portfolio managers, and in particular hedge fund managers, because they would prohibit a hedge fund manager from investing in hot issues through a fund he or she manages. Although the proposed rule change allowed portfolio managers and other restricted persons in aggregate to own up to 5% of a collective investment account that invests in hot issues, these commenters believed that the 5% figure was too low. They added that investors generally expect portfolio managers to make significant investments in accounts they manage as it helps to align the managers' interests with those of investors. Several commenters, including Rosenman, Willkie, and Northern urged NASD Regulation to exempt hedge fund managers with respect to the accounts they manage, while retaining the restriction with respect to purchases of IPOs in their personal accounts. Northern, for example, stated "[w]e would not be in favor of letting a hedge fund manager receive benefits on the side that might permit the manager to divert hot issues to his or her own personal account." Willkie added that the fiduciary duty of a hedge fund manager would prevent him or her from profiting from new issues personally at the expense of hedge fund investors.

Based upon these comments, NASD Regulation has amended the restriction on portfolio managers. NASD Regulation agrees with the commenters that the 5% exemption in the October 1999 filing did not achieve its intended purpose and could, as discussed below, undermine the purposes of the rule by allowing broker/dealer personnel and other restricted persons to purchase substantial quantities of IPOs. The Amendment treats a portfolio manager and certain members of his or her immediate family as restricted persons other than with respect to a beneficial interest in the bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account, over which such person has investment authority. The Amendment thus permits a hedge fund manager who is not otherwise restricted to invest in IPOs through a fund he or she manages. Under the Amendment, however, a portfolio manager may not purchase IPOs in his or her personal accounts. Several commenters, including Willkie and Rosenman, proposed language that is substantively similar to that proposed by NASD Regulation.

The Amendment does not define what constitutes a personal account of a portfolio manager. NASD Regulation believes that a number of factors will contribute to a determination of whether an account is a personal account. These factors include, but are not limited to, the number of beneficial owners in the account, the identity of the participants, whether the account participants are members of the portfolio manager's immediate family, the compensation scheme, the manner in which profits and losses are distributed, the expectations of the account participants, and the overall trading activity in the account.

Despite this change, NASD Regulation does not believe that the treatment of portfolio managers in the Amendment will lead to an environment that is significantly different from that under the current Interpretation. Under the Interpretation, portfolio mangers are entitled to purchase hot issues if such purchases are, among other things, consistent with their normal investment practices.

They also are entitled to receive benefits from new issues in accounts they manage in the form of performance fees.

Katten sought clarification on whether an investment adviser organized as an entity is a restricted person. Katten stated that the proposed rule change treats certain employees of an investment adviser as restricted but does not state whether an investment adviser organized as an entity is a restricted person. NASD Regulation believes that the status of an entity organized as an investment advisor would depend on the status of its beneficial owners. If the beneficial owners are restricted persons because of their investment advisory activities or otherwise, then the entity would be a restricted person.

(iv) Preconditions for Sale/Documentation

The proposed rule change streamlined the requirements for members to demonstrate that sales of IPOs were made in conformity with the rule. NASD Regulation replaced the myriad means for members to demonstrate that they have not sold IPOs to restricted persons, with a single requirement applicable to all accounts – a representation from the account holder, or a person authorized to represent the beneficial owners of the account, that the account is eligible to purchase new issues in compliance with the rule. Colish supported these changes. The SIA stated that the requirement as to the type of evidence that is needed "is a significant improvement over current requirements." Commenters also had concerns. Schwab and MSDW were concerned that the proposed rule change would require an annual mailing to all customers that may be interested in purchasing new issues and would prohibit the use of electronic communications. The SIA and MSDW stated that firms should be permitted to develop their own methods to verify the status of a customer, including the use of oral representations so long as such representations are documented internally. In response to these comments, NASD Regulation intends to state in a *Notice to Members*

announcing SEC approval of the proposed rule change that an annual mailing is not required, and that electronic or oral communications are permitted so long as such communications and the response are documented internally by the member firm.

MSDW also stated that the documentation requirements may hinder a bona fide public distribution if members withhold securities from public customers because they have not provided the necessary information. NASD Regulation disagrees and believes that MSDW's comment may be based on a misinterpretation of the nature of the required documentation. In general, NASD Regulation does not believe that adhering to these requirements, even if it means that certain public customers cannot purchase IPOs, will cause a member to fail to make a bona fide public offering. In addition, NASD Regulation expects that public customers will provide the necessary information or certifications to afford them the opportunity to purchase IPOs.

NASD Regulation also is maintaining the interval required for verification at one year. The SIA, Sullivan, and MSDW suggested lengthening the verification period from one year to every two or three years. By contrast, NASAA suggested shortening the verification period to something significantly shorter than one year, to reflect possible changes in ownership that could occur within that period. NASD Regulation believes that as a matter of policy, allowing members to wait longer between verifying that their customers are eligible to purchase new issues undermines the effectiveness of the rule. Currently, under the Interpretation, verification is required as frequently as before every sale or as long as every 18 months. With the streamlined documentation procedures and the availability of electronic and oral communications, NASD Regulation believes that an annual verification requirement strikes an appropriate balance between benefit and burden. We anticipate that in light of the clarifications made above, the commenters generally will agree with NASD Regulation that the burdens of ensuring that customers are eligible to purchase IPOs on an annual

basis are not unreasonable. NASAA's concerns are addressed by the fact that a member may not rely on a representation that it has reason to believe is inaccurate.

Several commenters, including Cadwalader and Ropes, were concerned about how the documentation requirement would apply in light of the fact that a customer's status or percentage ownership in a collective investment account may change over the course of a year. NASD Regulation recognizes that the potential exists for a customer's status under the rule to change, but believes that members may rely upon information obtained as part of the ordinary, annual verification process, so long as the member does not believe or have reason to believe that an account is restricted. Currently, under the Interpretation, NASD Regulation allows members to rely upon certain certifications dated not more than 18 months prior to the date of sale of the hot issue. Under the proposed rule change, members would be able to rely, in good faith, on representations dated not more than twelve months prior to the date of sale of the new issue.

On the issue of intent, Schwab stated that the rule should not impose a strict liability standard. Specifically, Schwab believed that a member should not be in violation of the proposed rule change if the member is unaware that an account is beneficially owned by a restricted person because the customer provided false information. On this point, we agree. As stated in the October 1999 filing, a member may rely upon the information it has received from a customer unless it believes, or has reason to believe, that the information is inaccurate. The proposed rule change has been amended to expressly include this standard.

Several commenters, particularly law firms such as Katten, Schulte, Rosenman, and Sullivan, sought guidance on what type of information a member would be required to review to determine whether an account is beneficially owned by restricted persons, especially in a fund of funds context. The proposed rule change allows an account holder, or a person authorized to represent the beneficial

owners of the account, to represent that an account is eligible to purchase new issues. So long as a member has no reason to believe that the representation is not accurate, it may rely upon the representation. Alternatively, a registered representative may ask questions of a customer to allow him or her to determine whether an account is eligible to purchase new issues under the rule. The application of the rule would be the same for a fund of funds. In that case, a member could secure a representation from a person authorized to represent the beneficial owners of the fund that is purchasing the new issue from the member (such as the fund's general partner) that the account is eligible to purchase new issues. Naturally, the ability of a general partner to make such a representation will be contingent on his or her receiving similar representations from general partners of the other funds investing in the fund, or by reviewing information about the investors in such funds. However, unlike the current Interpretation, there are no provisions requiring certifications by attorneys or certified public accountants. While members may wish to rely upon counsel or an accountant to investigate the status of an account, such an approach is no longer required by the rule.

NASD Regulation will announce in the *Notice to Members* announcing approval of Rule 2790 that members may use negative consent letters in all but the initial account verification. Several commenters, including MSDW, believed that the ability to use negative consent letters would greatly ease the burden of complying with the rule without undermining its effectiveness. NASD Regulation believes that once a member firm verifies the status of an account, it may use negative consent procedures for each subsequent, annual verification.

Finally, the SIA asked NASD Regulation to explore an automated means of updating certain account information regarding restricted person status. While NASD Regulation does not currently intend to develop such a system, NASD Regulation is not opposed to third party vendors compiling or aggregating information about the status of persons under the rule. If a private vendor developed a

reliable automated application to track the status of purchasers under the rule, NASD Regulation believes that members generally could rely upon data from such a vendor.

(v) De Minimis Exemption

As stated above, one purpose behind the proposed rule change is to streamline the rule. One area in which NASD Regulation believes that it can benefit investors without sacrificing the integrity and protections of the rule is with respect to certain de minimis owners. The de minimis ownership exemption avoids imposing on investors the burden of creating segregated accounts in those instances where restricted persons have only a nominal and passive interest in an account that purchases new issues. Commenters appreciated the efficiencies that the de minimis exemption would provide and generally urged that it be expanded.

Several commenters asked NASD Regulation to expand the de minimis exemption to include a collective investment account that is owned 10% or more by restricted persons. NASD Regulation, however, does not support such an expansion. One of the rationales for the de minimis exemption was to alleviate the impact of the October 1999 filing's decision to treat portfolio managers as restricted persons. As discussed in the previous section, that issue has been addressed separately. Thus, a large class of persons for whom the de minimis exemption was intended have already been excluded from the rule. In view of this change, NASD Regulation is maintaining the de minimis level at 5%. This comports with recommendations by Katten, Schulte, and Rosenman, which supported a 5% de minimis level so long as portfolio managers were excluded.

Northern noted that as originally proposed, the de minimis exemption may "tempt some brokers to favor hedge funds that permit the brokers themselves or their senior executives or friends to invest in the hedge funds, which would cut against the purposes of the NASD proposal." In response to this comment and to ensure that the de minimis exemption is consistent with the purposes

of the rule and the public interest, NASD Regulation has revised the de minimis exemption to impose a strict numerical limit of 100 shares on the number of shares that any one person can purchase under the de minimis exemption. In complying with the 100 share limit, members may look through an investing entity to a person's beneficial interest. The numerical limit reduces the incentive for self-dealing and the appearance that restricted persons are receiving shares at the expense of public investors. Under the Amendment, the de minimis exemption also requires that a restricted person does not manage or otherwise direct investments in the account.

Members should be aware that the de minimis exemption does not allow restricted persons to purchase 100 shares directly. The de minimis exemption was developed as an accommodation to collective investment accounts with only a small percentage of restricted persons. Because the sale of IPOs to such a collective investment account principally benefits non-restricted persons, NASD Regulation believes, for administration purposes, it should not be necessary to carve-out the restricted persons or exclude the account altogether. On the other hand, direct purchases of IPOs by restricted persons do not in any way facilitate a public distribution and will continue to be prohibited under the proposed rule change.

Several commenters, such as Cadwalader, Ropes, Covington, and Fried, suggested a variation on the de minimis exemption in that the proposed rule change should be amended to exempt all passive investors in a collective investment account, regardless of the size of their interest. While passive investors have no control over the investment decisions made by a collective investment account, their participation in a particular account may be known or inferred by the member allocating new issues. A passive investor exemption would allow restricted persons to circumvent the purposes of the rule by having such purchases made on their behalf by a portfolio manager. For these reasons, NASD Regulation is not proposing to exempt all passive investors.

NASD Regulation also disagrees with MSDW's recommendation that the de minimis exemption be amended to apply if a collective investment account invests less than 10% of its assets in new issues. For many collective investment accounts, and certainly all large accounts, such a limitation would be tantamount to no limitation at all. MSDW's recommendation would allow a fund comprised solely of broker/dealer personnel to invest up to 10% of their assets in new issues. NASD Regulation believes that such an expansion of the de minimis exemption is unwarranted and would be inconsistent with the purposes of the rule.

Sidley asked whether the proposed rule change and the creation of the de minimis exemption eliminated the ability for collective investment accounts to create carve-out accounts that segregate the interests of restricted persons. NASD Regulation did not intend for the proposed rule change to eliminate the ability of a collective investment account that does not meet the de minimis exemption to create a separate account and carve out the interests of restricted persons from the account investing in new issues. Accordingly, an account that wishes to purchase a greater number of shares such that a restricted person's pro rata allocation would exceed 100 shares, or an account that wishes to allow restricted persons to own collectively more than 5% of the fund's assets, would be able to use carve-out procedures and segregate the new issue activity from restricted persons to keep it below the threshold in the proposed rule. However, unlike the current Interpretation, the proposed rule change does not contain detailed procedures concerning how an account is required to carve-out the interests of restricted persons. A member's obligation under the proposed rule change is to receive a representation from the account holder, or a person authorized to represent the beneficial owners of the account, that the account is not restricted from purchasing new issues under the rule. At this time, NASD Regulation does not intend to regulate the manner in which an account carves out restricted

persons. If NASD Regulation has reason to believe that closer scrutiny of carve-out accounts is necessary, it will consider additional rulemaking in this area.

Sidley also asked NASD Regulation to revise the proposal to permit funds to transfer securities from a carve-out account to a general account without undertaking a secondary market transaction, which it argued is inefficient and unnecessarily costly. Sidley correctly noted that current NASD Regulation policy requires a transfer from a carve-out account with non-restricted persons to a fund's general account that is beneficially owned by restricted person to be effected in a market transaction. Under the proposed rule change a fund manager would be permitted to determine how best to transfer new issues that he or she intends to keep for investment purposes from one account to another, consistent with all other applicable laws and regulations. NASD Regulation cautions that where a carve-out account purchases new issues with a view towards distributing such shares to another account, that such carve-out account may be viewed as an "underwriter" under Section 2(a)(11) of the Securities Act of 1933.

(vi) Owners of Broker/Dealers

NASD Regulation has substantially revised the restrictions on owners of broker/dealers. The October 1999 filing treated as restricted persons affiliates of a broker/dealer and natural persons, and certain members of their immediate family, who owned 10% or more, or contributed 10% or more of the capital of a broker/dealer. Many of the commenters, including Willkie, Colish, Sidley, and the SIA, stated that this approach was too broad. Several commenters stated that reaching all companies that are under common control with a broker/dealer, and in particular sister companies, would reach entities without any nexus to the securities industry. The commenters also were concerned about the

impact on affiliates in light of the repeal of the restrictions on affiliation among banks, insurance companies and securities firms under the Gramm-Leach-Bliley Act of 1999.[10]

The Amendment adopts a new approach and treats as restricted persons owners of broker/dealers as defined in Schedule A of Form BD, with at least a 10% ownership interest,[11] and as defined in Schedule B of Form BD. NASD Regulation believes that this approach is desirable from a compliance perspective because the definitions are understood by members and the information is already required to be maintained. NASD Regulation opted to use existing ownership standards rather than create a new concept for purposes of this rule. From a technical standpoint, this approach no longer treats affiliates of broker/dealers as restricted persons per se. The ownership provisions look only at the direct and indirect owners of a broker/dealer. Moreover, the standard of control for indirect owners in Schedule B of Form BD is a 25% interest, not a 10% interest as proposed in the October 1999 filing. In this regard, the Amendment is narrower in scope than the October 1999 filing.

The rationale for applying the rule to owners of broker/dealers is straightforward. A prohibition on a broker/dealer could be easily circumvented if IPOs could be purchased by the broker/dealer's parent. Similarly, to avoid circumventing the restriction on the owners and the broker/dealer itself, it is necessary for the rule to prohibit sales of new issues to any account in which the owner or broker/dealer has a beneficial interest. If the rule did not restrict any account in which a restricted person had a beneficial interest, restricted persons could purchase new issues in downstream affiliates and flow the profits back up to the restricted person. The application of the rule

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[10] Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[11] Schedule A of Form BD lists all direct owners with ownership interests of 5% or more in a broker/dealer. The ownership level is indicated by various "ownership codes": A for 5% but less than 10%, B for 10% but less than 25%, and so on. For purposes of Rule 2790, only persons with a 10% or more interest, as indicated by ownership codes B and higher will be restricted persons.

to all accounts in which a restricted person has a beneficial interest is a fundamental principle of the proposed rule change and the Interpretation.

The net effect of these provisions is that both upstream and downstream affiliates, including sister companies, are restricted persons. Although commenters may view this approach as unnecessarily broad, NASD Regulation believes that it is necessary to effectuate the purposes of the rule. However, NASD Regulation has made a number of reforms that we believe address many of the commenters' concerns.

The primary source of relief comes from NASD Regulation's decision to exempt sales to and purchases by nearly all publicly traded companies. The commenters generally supported the exemption in the October 1999 filing for publicly traded companies. Sullivan, for example, stated "that a blanket exemption . . . for sales to publicly traded corporations would substantially lighten the administrative burden of implementing the rule without undermining the underlying objectives of the rule in any meaningful way."

The Amendment expands the exemption for publicly traded companies to now include all publicly traded companies listed on a national securities exchange or traded on the Nasdaq National Market, even those that are affiliates of a broker/dealer.[12] NASD Regulation believes that purchases of new issues by this class of publicly traded companies, which in turn have broad public ownership and whose securities may be purchased by any investor, is not the type of activity the rule is designed to prevent. Purchases in these instances benefit public investors in much the same way that IPO purchases by mutual funds benefit their shareholders. To ensure that purchases by publicly traded

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[12] The exemption does not apply to a broker/dealer itself. NASD Regulation continues to believe that broker/dealers, even publicly traded broker/dealers, should not purchase or withhold IPOs. As discussed below, NASD Regulation believes that an exemption for publicly traded companies, even affiliates of a broker/dealer, was appropriate in light of protections against self-dealing under NASD Rule 2750, which applies to related persons of the broker/dealer, but not the broker/dealer itself.

companies do in fact benefit their shareholders, the exemption requires that the gains or losses from the IPOs must be passed on to shareholders.

The decision to exempt publicly traded companies in the Amendment greatly minimizes the rule's impact on many financial services conglomerates and industrial companies that own a broker/dealer. Where the owner is a publicly traded company with a broker/dealer subsidiary, the rule would no longer apply, either at the parent level or at the downstream affiliate level. Thus, for example, a manufacturing unit of an exchange listed financial services holding company would not be a restricted person. For publicly traded companies, therefore, the Amendment would exempt sales to and purchases by affiliates.

NASD Regulation is not, however, expanding the exemption for owners of broker/dealers that are private companies. The purchase of IPOs in this case does not reach public investors because ownership of private companies is not open to the public. NASD Regulation also is not expanding the exemption to include owners of broker/dealers listed solely on a foreign exchange. Sidley was concerned that limiting the exemption to publicly traded companies listed on a domestic exchange would disadvantage publicly owned foreign companies without a U.S. listing. Despite these concerns, NASD Regulation does not believe at this time that foreign publicly traded companies should be exempt from the proposed rule change. Foreign jurisdictions have various listing standards and levels of regulatory oversight. As such, there is greater potential that a foreign publicly traded company could be used to circumvent the purposes of the rule. NASD Regulation will, however, consider its experience under the proposed rule change and may in the future consider whether it is appropriate to extend the exemption to publicly traded companies listed or traded solely on foreign markets.

The Amendment also contains an exemption for the purchase of new issues by a bank common trust fund or an insurance company general, separate or investment account, provided that

the account has investments from 1000 or more investors, and is not limited principally to restricted persons. These exemptions will allow, for example, private banks and mutual and private insurance companies with broker/dealer subsidiaries to purchase new issues for these accounts. NASD Regulation believes that, collectively, these restrictions on the owners of broker/dealers will address many commenters' concerns about the application of the rule to broker/dealer affiliates.

The SIA was concerned that the proposed rule change would adversely affect "asset management affiliates that manage discretionary accounts as well as accounts for unaffiliated persons." The SIA stated that to the extent that affiliates of broker/dealers become restricted persons under the rule, the rule should more clearly exempt certain classes of accounts maintained by broker/dealer affiliates. The SIA's concerns appear unfounded. To the extent that broker/dealer affiliates manage accounts for non-restricted persons, such accounts would not be restricted under the proposed rule change. On the other hand, if the SIA is concerned about accounts at broker/dealer affiliates that are owned by restricted persons, NASD Regulation believes that the rule should apply.

In proposing to allow purchases by publicly traded companies that are affiliates of broker/dealers, NASD Regulation is relying in part on the restrictions on a member engaged in a fixed price offering under Rule 2750, Transactions with Related Persons. Specifically, Rule 2750 prohibits a member from selling any securities in a fixed price offering to any person or account that is a related person of the member. NASD Regulation believes that Rule 2750 addresses the potential for self-dealing in allocating new issues to a publicly traded affiliate of a broker/dealer.

Finally, Sullivan asked why immediate family members of owners of broker/dealers were treated differently than immediate family members of associated persons of a broker/dealer. NASD Regulation did not intend for different treatment of such family members and has corrected the proposed rule change.

(vii) Beneficial Interest Definition

At its own initiative, NASD Regulation is revising the definition of "beneficial interest." The term beneficial interest was defined in the October 1999 filing as "any ownership or other direct financial interest." NASD Regulation is aware that members found the reference to ownership as distinct from a financial interest misleading. Because the rule is intended to prohibit sales of new issues to certain persons who stand to profit from them, legal ownership, such as that held by a trustee for beneficiaries, or a hedge fund for its limited partners, is not the type of interest that is the focus of the rule.

NASD Regulation also is recommending eliminating the term "direct" from the definition. In determining whether an account is beneficially owned by restricted persons, members are often required to look through a number of investment vehicles. For instance, if Fund A invests in Fund B, a member may not sell new issues to Fund B unless it determines the sale is consistent with the rule, taking into account the status of each beneficial owner of Fund A. To some, the owners of Fund A may be viewed as having an "indirect" ownership in Fund B.

Rosenman stated that the definition of beneficial interest should specifically exclude management or performance based fees that are deferred for bona fide taxation reasons. Rosenman was concerned of the effect that deferred management or performance fees may have on a hedge fund manager's interest in a collective investment account that he or she manages. Because NASD Regulation has eliminated the restrictions on a hedge fund manager with respect to a collective investment account that he or she manages, we do not believe it is necessary to amend the definition of beneficial interest as Rosenman suggests.

Finally, as a result of the amendments to the definition of beneficial interest and the definition of restricted person, the conditions that gave rise to the need for the exemption for joint back office

broker/dealers in the October 1999 filing have been removed. By clarifying that beneficial ownership means a financial interest, such as the right to share in gains or losses, we have clarified that a hedge fund broker/dealer's legal ownership of securities does not constitute a beneficial interest for purposes of the rule. As a result, the rule no longer needs a separate exemption for joint back office broker/dealers.[13]

(viii) Issuer-Directed Share Programs

In the October 1999 filing, NASD Regulation proposed amendments to the exemption for securities distributed as part of an issuer-directed share program to all employees and directors of the issuer, or an entity that controls, is controlled by, or is under common control with the issuer. NASD Regulation proposed expanding the scope of employees and directors of the issuer that are covered by the exemption to include employees and directors of sister companies. NASD Regulation also proposed eliminating the requirement for a three month lock up for those issuer-directed shares that are sold to restricted persons. Schwab supported the elimination of the lock-up and stated that it provides substantive relief to members who will no longer be required to investigate the status of employee or director participants.

Issuer-directed share programs are a valuable tool in employee development and retention, and are often an integral part of the employer/employee relationship. In recent years, issuer-directed share programs have become more popular, and issuers have sought to expand the lists of persons invited to participate in an IPO to include business contacts, family and friends. In general, NASD Regulation believes that sales directed by an issuer are outside the scope of activities that the

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[13] The rationale for the joint back office broker/dealer exemption was that a collective investment account registered as a broker/dealer or with a broker/dealer subsidiary would be precluded from purchasing new issues even if none of its investors were restricted persons. Under the revised definition of beneficial interest, such a collective investment account would no longer be restricted.

proposed rule change is designed to address. Accordingly, the Amendment proposes to exempt IPO shares that specifically are directed by the issuer to such persons as employees, directors, and friends and family of the issuer. NASD Regulation believes, however, that whether directed by the issuer or otherwise, broker/dealers, broker/dealer personnel and their immediate family, and certain persons acting as finders or in a fiduciary capacity to the managing underwriter, should not purchase IPOs, unless such persons are employees or directors of the issuer, the issuer's parent, or a subsidiary of the issuer or members of the immediate family of an employee or director of the issuer.[14] Similarly, NASD Regulation disagrees with MSDW that all non-underwritten securities directed by the issuer should be exempt from the proposed rule change. NASD Regulation believes that a general exclusion for all issuer-directed or all non-underwritten securities would be readily susceptible to abuse. Consequenlty, NASD Regulation will continue its practice of holding a managing underwriter responsible for ensuring that all securities that are part of the public offering are distributed in accordance with the rule.

As recommended by Testa, the proposed rule change now expressly states that for purposes of the issuer-directed exemption only, a parent/subsidiary relationship is established if the parent has the right to vote 50% or more of a class of voting security or has the power to sell or direct 50% or more of a class of voting securities of the subsidiary. NASD Regulation does not agree with Sullivan that a 10% ownership standard should apply for this exemption. NASD Regulation believes that it is not uncommon for a member through its merchant banking activities, or otherwise, to make venture

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[14] NASD Regulation proposes allowing an employee or director of an issuer to direct shares in the issuer's initial public offering to members of his or her immediate family, even if such persons are otherwise restricted persons. In recent years, the staff has been presented with situations in which, for example, an employee of a issuer wanted to direct shares to his or her parent, but was unable to do so because the parent was a restricted person (and not an employee or director of the issuer). As amended, the proposed rule change would allow directed shares to be sold to, for example, a parent of an issuer's employee.

capital investments in issuers that exceed 10% of the issuer's securities. In such cases, all employees of the member would be able to purchase the new issue. NASD Regulation does not believe that exempting broker/dealer personnel by virtue of venture capital investments is consistent with the purposes of the rule or the issuer-directed exemption.[15]

NASD Regulation believes that the Amendment strikes the correct balance between providing issuers with flexibility to direct shares while preserving the objectives of the rule. NASD Regulation also believes that the issuer-directed exemption should apply only when shares are in fact directed by the issuer; if a member firm asks or otherwise suggests that an issuer direct securities to a restricted person, NASD Regulation does not believe that such securities should be exempt from the rule.

Sidley suggested that the scope of permissible purchasers under the issuer-directed share provisions should be amended to conform with the permitted categories of offerees set forth in Rule 701 of the Securities Act of 1933. Rule 701 provides an exemption for private companies to sell securities to their employees without a need to file a registration statement. Rule 701 provides an exemption from the registration provisions of the Securities Act of 1933 for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation. NASD Regulation believes that this approach is potentially less broad and is far more difficult for members to implement.

The SIA, Sullivan, and MSDW all believed that the proposed rule change should exclude exchange offers, rights offerings and offerings made pursuant to a merger or acquisition. MSDW stated that "[i]f rights or other securities are offered to existing shareholders, particularly shareholders of a publicly traded company, it would seem the purpose of the [proposed rule change] (i.e., to assure

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[15] The proposed rule change contains separate provisions that permit venture capital investors to participate in IPOs to avoid dilution in a public offering. NASD Regulation believes that going beyond these protections for venture capital investors would be inconsistent with the purposes of the proposed rule change.

a bona fide public distribution of securities) is achieved." Sullivan noted that the NASD has previously stated that the Interpretation does not apply to "exchange offers" and "offerings made pursuant to an merger or acquisition." SIA and MSDW noted with approval the exemptive relief NASD Regulation staff has granted in connection with certain rights offerings. NASD Regulation agrees with the commenters and has amended the proposed rule change to exclude from the definition of public offering, exchange offers, rights offerings and offerings made pursuant to a merger or acquisition. NASD Regulation also has codified the staff's existing exemptive positions regarding certain directed share programs. The conditions imposed on such offerings in the proposed rule change generally track those in the exemptive letters and continue to ensure that these offerings are conducted in a manner that is consistent with the purposes of the proposed rule.

(ix) Limited Business Broker/Dealers

The proposed rule change, like the Interpretation, does not apply to persons associated with a limited business broker/dealer. The proposed rule change defined a limited business broker/dealer as a broker/dealer whose authorization to engage in the securities business is limited solely to the purchase and sale of investment company/variable contracts securities and direct participation program securities. Several commenters believed that this definition was too narrow. The CBOE believed that its market-makers and floor brokers also should be treated as limited business broker/dealers.[16] The CBOE stated that "[a]n options market-maker typically is not a professional equities trader and is generally removed from the equities side of trading." The CBOE also stated that the "functions of a floor broker on the CBOE . . . are limited to the execution of orders for other market professionals or

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[16] The CBOE also stated that members that lease out their seats and who are not engaged in a securities business should not be restricted persons. NASD Regulation agrees. NASD Regulation does not believe that a person who merely leases out a seat to a broker/dealer should be treated as a restricted person.

public customers of other broker/dealers. Floor brokers, with the exception of a transaction effected for their error accounts, do not effect principal transactions." Despite these limited activities, NASD Regulation does not believe that market-makers and floor brokers should be treated as limited business broker/dealers. Notwithstanding the limited nature of their activities, NASD Regulation believes that market-makers and floor brokers are in a position to direct business to a member. The CBOE also appeared to recognize the potential for these individuals to direct business to a member in seeking to exclude from the exemption an "IPO [that] is underwritten by the broker/dealer which clears and carries the member's professional CBOE business." NASD Regulation also believes that the relationships between market-makers and member firms and floor brokers and member firms, even in the absence of an established clearing relationship, may give rise to preferential allocations of new issues. Moreover, the potential to direct business to a member in exchange for IPOs is just one of the reasons for restricting broker/dealers. As noted in the October 1999 filing, the proposed rule change also is designed to ensure that industry insiders do not take advantage of their insider position in the industry to purchase IPOs for their own benefit at the expense of public customers. NASD Regulation believes that options market-makers and options floor brokers are integral to the functioning of an exchange and properly characterized and perceived as industry insiders.

Colish, Washington, and Fried also believed the definition of limited business broker/dealers should be expanded. They suggested including broker/dealers that do not have any involvement in the capital formation or underwriting business, such as market-makers and electronic communications networks. Colish suggested including broker/dealers that engage in private placements. Washington suggested that the proposed rule change should apply only to broker/dealers that engage in an equity

securities business.[17] NASD Regulation disagrees. NASD Regulation believes that persons associated with members engaged in these activities are, like persons associated with other broker/dealers, in a position to direct business to, and to enter into reciprocal arrangements with, other members. They also are industry insiders. While it is undoubtedly true that not every person associated with a member engaged in these activities is in a position to enter into reciprocal arrangements, many persons are. The proposed rule change, like the current Interpretation, is a prophylactic rule. It achieves its goals by applying across a class of persons to whom sales of IPOs may violate the purposes of the rule.

In general, the SIA agreed with NASD Regulation that reciprocal arrangements between industry members in the allocation of public offerings must be prevented. The SIA, however, stated that a rule targeted towards "conduct which has the purpose or effect of creating reciprocal arrangements, rather than one [that is] . . . based on complex definitions of status in the industry, would better serve the capital markets and would be more fair to industry members, their relatives, and other market participants." The SIA did not offer any suggestion on how such a rule would operate in practice. NASD Regulation believes that a rule that requires members to determine whether a particular individual is engaged in reciprocal arrangements with a broker/dealer would be difficult both from an administration and examination standpoint, and would eliminate the certainty sought by the proposed rule change.

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[17] These requests are similar to requests previously considered by NASD Regulation. As noted in *Notice to Members 97-30*, NASD Regulation continues to believe that persons associated with firms engaged solely in proprietary trading or investment or merchant banking activities may enter into reciprocal arrangements with other members that would violate the purposes of the rule. In *Notice to Members 97-30*, NASD Regulation stated that the limited business broker/dealer definition should not be expanded to include such firms "because of the difficulty in defining those firms" and because "such broker/dealers may influence or be involved in various aspects of the underwriting process." Further, NASD Regulation was concerned that "such firms may enter into reciprocal arrangements with other members that would violate the intent of the Interpretation."

(x) Elimination of Conditionally Restricted Persons

Another significant reform in the proposed rule change was the elimination of the so-called "conditionally restricted" status[18] and the decision to treat persons as either restricted or non-restricted. Commenters generally supported the decision to eliminate the conditionally restricted status. The proposed rule change continues to treat persons as either restricted or non-restricted as NASD Regulation continues to believe that this bright-line approach best serves investors and members.

(xi) ERISA Plans

NASD Regulation has further simplified the restrictions on Employee Retirement Income Security Act ("ERISA") plans. The October 1999 filing proposed exempting tax-qualified plans under ERISA, so long as such plans were not sponsored by a broker/dealer or an affiliate. A number of commenters, including SIA, MSDW, and Sullivan, believed that this exemption was unnecessarily narrow and would exclude a large number of non-restricted plan participants in plans sponsored by financial services companies. The commenters added that ERISA plans are already subject to a separate regulatory scheme and that they were unaware of any perceived or actual abuses to cause NASD Regulation to narrow the exemption for ERISA plans from the current Interpretation.

NASD Regulation agrees with the commenters that the treatment of ERISA plans in the October 1999 filing could reach many non-restricted persons participating in a plan sponsored by an affiliate of a broker/dealer. The Amendment exempts an ERISA plan that is qualified under Section

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[18] Under the Interpretation, conditionally restricted persons can purchase hot issues "if the member is prepared to demonstrate that the securities were sold to such persons in accordance with their normal investment practice, that the aggregate of the securities so sold is insubstantial and not disproportionate in amount as compared to sales to members of the public and that the amount sold to any one of such persons is insubstantial in amount."

401(a) of the Internal Revenue Code, provided that such plan is not sponsored solely by a broker/dealer.

(xii) Foreign Investment Companies

The October 1999 filing proposed an exemption for foreign investment companies that is substantially similar to the Interpretation. Specifically, it stated that a foreign investment company is exempt from the proposed rule change if: (1) it has 100 or more investors; (2) it is listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority; (3) no more than 5% of its assets are invested in a particular hot issue; and (4) no person owning more than a 5% interest in such company is a restricted person.

MSDW suggested exempting all foreign investment companies that are traded on a "designated offshore securities market" as defined in Rule 902(b) under the Securities Act of 1933.[19] NASD Regulation believes that such an exemption would be too broad. The standards for inclusion in Rule 902(b) do not appear related to the concerns underlying the proposed rule change. Although inclusion in Rule 902(b) requires oversight by a governmental or self-regulatory body, NASD Regulation is not confident that such regulation would prevent restricted persons from using foreign investment companies to circumvent the rule. The NASD continues to believe that is often difficult to assess the comparability of a foreign country's investment company statutes and regulations to those in the United States, particularly as it relates to the purposes of this rule, and believes, therefore, that it is necessary to impose certain conditions.

Colish and Sullivan suggested that NASD Regulation eliminate the fourth condition – a requirement that no person owning more than 5% of the foreign investment company is a restricted

[19] This is similar to a request made during the 1994 rulemaking when the exemption for foreign investment companies was first proposed.

person – because it is often difficult to ascertain the ownership of a foreign investment company. Despite these concerns, NASD Regulation believes that this requirement is necessary to avoid purchases of new issues by funds with concentrated ownership interests of restricted persons.

However, in response to concerns generally about the exemption for foreign investment companies, NASD Regulation has simplified the exemption by eliminating the 100 person requirement and the limitation on the size of the purchase in relation to the size of the investment company. The 100 person condition basically addressed the same concerns about concentration of ownership as condition (4) and, therefore, was eliminated. The limitation on the size of the purchase in relation to the size of the investment company appeared unnecessary and was potentially burdensome for members to calculate. Moreover, for very large funds, the limitation was meaningless inasmuch as 5% of their total assets would often exceed the size of the entire IPO. The other conditions are maintained.

(xiii) Minor or Technical Revisions

In addition to the changes discussed above, NASD Regulation made a number of minor or technical amendments in response to the comment letters.

Testa stated that the anti-dilution provisions, which were similar in scope to the venture capital provisions of paragraph (g) of the Interpretation, applied to natural persons only. Testa believed that entities as well as natural persons that have a prior equity ownership interest in an issuer, should be able to avail themselves of the anti-dilution provisions. The omission of entities in the anti-dilution provisions was inadvertent and has been changed. The anti-dilution provisions thus allow an entity or a natural person investing in such entity to retain the percentage equity ownership in the issuer at a level up to the ownership interest as of three months prior to the filing of the registration statement.

Testa also stated that, as a general matter, family members of a restricted person who receive "material support" from the restricted person should be treated similarly to the restricted person. Testa noted that the proposed rule change in some cases made an exemption for a restricted person to purchase new issues, but did not extend the exemption to the restricted person's immediate family members. NASD Regulation believes that an exemption for a restricted person also should be available to an immediate family member who is restricted under the rule, and it has amended the proposed rule change accordingly.

Several commenters, including Colish and Washington, stated that the use of the word "includes" in the definition of restricted person creates uncertainty by suggesting that the list is non-exclusive. NASD Regulation agrees and has removed the word "includes" from the definition of restricted person.

Schwab stated that the definition of restricted person should exclude consultants or contractors of a broker/dealer member who are not engaged in securities-related activities. Schwab stated that the policy concerns underlying the rule do not require restricting these individuals from participating in new issues. NASD Regulation agrees that consultants or contractors of a broker/dealer should not be restricted persons unless they are engaged in the investment banking or securities business. If, for example, Schwab hires a contractor or consultant to perform photocopying services or a compensation survey, it should not preclude such contractor or consultant from purchasing new issues. The definition of restricted person has been revised to exclude agents of a broker/dealer who are not engaged in the investment banking or securities business.

Schwab also supported the addition of a bright line definition of "material support" but believed that the 10% threshold for support is too low and recommended that a time frame be established for measuring support. NASD Regulation agrees and has revised the definition of "material support" to

providing more than 25% of a person's income in the current or prior calendar year. Separately, NASD Regulation recommends clarifying that members of the immediate family living in the same household will be deemed to be providing each other with material support. Using this language makes clear that the proposed rule change establishes a bright line test, and NASD Regulation will not evaluate material support issues on a case-by-case basis.

(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 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 new 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

The SEC received 24 comment letters. NASD Regulation's response to those comment letters is discussed in section 3 above.

6. Extension of Time Period for Commission Action

NASD Regulation also hereby consents to the extension of time for Securities and Exchange Commission action on the above-referenced rule filing to December 30, 2000.

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 10, 2000

EXHIBIT 1

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

Self-Regulatory Organizations; Notice of Filing of Amendment No. 2 to Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Restrictions on the Purchase and Sale of Initial Equity Public 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") Amendment No. 2 to 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 as further amended by Amendment No. 2 from interested persons.[3]

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, Restrictions on the Purchase and Sale of Initial Equity Public Offerings, of the National Association of Securities Dealers, Inc.

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1 15 USC 78s(b)(1).

2 17 CFR 240.19b-4.

3 The Commission previously published notice of the proposed rule change and Amendment No. 1 to SR-NASD-99-60 on January 18, 2000. See Securities Exchange Act Release No. 42325 (Jan. 10, 2000), 65 FR 2656 (Jan. 18, 2000). Amendment No. 1 made clerical changes to the original rule filing.

("NASD" or "Association"), to replace the Free-Riding and Withholding Interpretation, IM-2110-1. Below is the revised text of the proposed rule change.

Rule 2790. Restrictions on the Purchase and Sale of Initial Equity Public Offerings

(a) General Prohibitions

(1) A member or a person associated with a member may not sell, or cause to be sold, a new issue to any account in which a restricted person has a beneficial interest, except as otherwise permitted herein.

(2) A member or a person associated with a member may not purchase a new issue in any account in which such member or person associated with a member has a beneficial interest, except as otherwise permitted herein.

(3) A member may not continue to hold new issues acquired by the member as an underwriter, selling group member, or otherwise, except as otherwise permitted herein.

(b) Preconditions for Sale

Before selling a new issue to any account, a member must in good faith have obtained within the twelve months prior to such sale, a representation from the account holder(s), or a person authorized to represent the beneficial owners of the account, that the account is eligible to purchase new issues in compliance with this rule. A member may not rely upon any representation that it believes, or has reason to believe, is inaccurate. A member shall maintain a copy of all records and information relating to whether an account is eligible to purchase new issues in its files for at least three years following the member's last sale of a new issue to that account.

(c) General Exemptions

The general prohibitions in paragraph (a) of this rule shall not apply to sales to and purchases by:

(1) An investment company registered under the Investment Company Act of 1940;

(2) A common trust fund or similar fund as described in Section 3(a)(12)(A)(iii) of the Act, provided that:

(A) the fund has investments from 1,000 or more trust accounts; and

(B) the fund does not limit beneficial interests in the fund principally to trust accounts of restricted persons;

(3) An insurance company general, separate or investment account, provided that:

(A) the account has investments from 1,000 or more policyholders; and

(B) the insurance company does not limit beneficial interests in the account principally to restricted persons;

(4) An account that is beneficially owned in part by restricted persons, provided that such restricted persons in the aggregate own less than 5% of such account, and that:

(A) each such restricted person does not manage or otherwise direct investments in the account; and

(B) on a pro rata basis, each such restricted person who is a natural person receives less than 100 shares of any new issue;

(5) A publicly traded entity (other than a broker/dealer) that is listed on a national securities exchange or is traded on the Nasdaq National Market, provided that the gains or losses from new issues are passed on directly or indirectly to public shareholders;

(6) An investment company organized under the laws of a foreign jurisdiction, provided that:

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

(B) no person owning more than 5% of the shares of the investment company is a restricted person;

(7) An Employee Retirement Income Security Act benefits plan that is qualified under Section 401(a) of the Internal Revenue Code, provided that such plan is not sponsored solely by a broker/dealer;

(8) A state or municipal government benefits plan that is subject to state and/or municipal regulation; or

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

(d) Issuer-Directed Securities

The prohibitions on the purchase and sale of new issues in this rule shall not apply to securities that:

(1) are specifically directed by the issuer; provided, however, that this exemption shall not apply to securities directed by the issuer to an account in which any restricted person specified in subparagraphs (i)(10)(B) or (i)(10)(C) of this rule has a beneficial interest, unless such person, or a member of his or her immediate family, is an employee or director of the issuer, the issuer's parent, or a subsidiary of the issuer. Also, for purposes of this subparagraph (d)(1) only, a parent/subsidiary relationship is established if the parent has the right to vote 50% or more of a class of voting security of the subsidiary, or has the power to sell or direct 50% or more of a class of voting securities of the subsidiary;

(2) are part of a program sponsored by the issuer or an affiliate of the issuer that meets the following criteria:

(a) the opportunity to purchase a new issue under the program is offered to at least 10,000 participants;

(b) every participant is offered an opportunity to purchase an equivalent number of shares, or will receive a specified number of shares under a predetermined formula applied uniformly across all participants;

(c) if not all participants receive shares under the program, the selection of the participants eligible to purchase shares is based upon a random or other non-discretionary allocation method;

(d) the class of participants does not contain a disproportionate number of restricted persons as compared to the investing public generally; and

(e) sales are not made to participants who are managing underwriter(s), the broker/dealer administering the program ("Administering Broker/Dealer"), the officers or directors of the managing underwriter(s) or Administering Broker/Dealer, or any employee of the managing underwriter(s) or Administering Broker/Dealer with access to non-publicly available information about the new issue; or

(3) are directed to eligible purchasers as part of a conversion offering in accordance with the standards of the governmental agency or instrumentality having authority to regulate such conversion offering.

(e) Anti-Dilution Provisions

The prohibitions on the purchase and sale of new issues in this rule shall not apply to an account in which a restricted person has a beneficial interest that meets the following conditions:

(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 offering;

(2) the sale of the new issue to the account 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 in connection with the offering;

(3) the sale of the new issue to the account shall not include any special terms; and

(4) the new issue purchased pursuant to this subparagraph (e) shall not be sold, transferred, assigned, pledged or hypothecated for a period of three months following the effective date of the offering.

(f) Stand-by Purchasers

The prohibitions on the purchase and sale of new issues in this rule shall not apply to the purchase and sale of securities pursuant to a stand-by agreement that meets the following conditions:

(1) the stand-by agreement is disclosed in the prospectus;

(2) the stand-by agreement is the subject of a formal written agreement;

(3) the managing underwriter(s) represents in writing that it was unable to find any other purchasers for the securities; and

(4) the securities sold pursuant to the stand-by agreement shall not be sold, transferred, assigned, pledged or hypothecated for a period of three months following the effective date of the offering.

(g) Under-Subscribed Offerings

Nothing in this rule shall prohibit an underwriter, pursuant to an underwriting agreement, from placing a portion of a public offering in its investment account when it is unable to sell that portion to the public.

(h) Exemptive Relief

Pursuant to the Rule 9600 series, the staff, for good cause shown after taking into consideration all relevant factors, may conditionally or unconditionally exempt any person, security or transaction (or any class or classes of persons, securities or transactions) from this rule to the extent that such exemption is consistent with the purposes of the rule, the protection of investors, and the public interest.

(i) Definitions

(1) "Beneficial interest" means any economic interest, such as the right to share in gains or losses. 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.

(2) "Collective investment account" means any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle.

(3) "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.

(4) "Family partnership" means a partnership comprised solely of immediate family members.

(5) "Immediate family member" means 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 to whom the person provides material support.

(6) "Investment club" means a group of friends, neighbors, business associates, or others that pool their money to invest in stock or other securities and are collectively responsible for making investment decisions.

(7) "Limited business broker/dealer" means any broker/dealer whose authorization to engage in the securities business is limited solely to the purchase and sale of investment company/variable contracts securities and direct participation program securities.

(8) "Material support" means directly or indirectly providing more than 25% of a person's income in the current or prior calendar year. Members of the immediate family living in the same household are deemed to be providing each other with material support.

(9) "New issue" means any initial 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, or other securities distributions of any kind whatsoever, including securities that are specifically directed by the issuer on a non-underwritten basis. New issue shall not include:

(A) offerings made pursuant to an exemption under Section 4(1), 4(2) or 4(6) of the Securities Act of 1933, or SEC Rule 504 if the securities are "restricted securities" under SEC Rule 144(a)(3), or Rule 505 or Rule 506 adopted thereunder;

(B) offerings of exempted securities as defined in Section 3(a)(12) of the Act;

(C) rights offerings, exchange offers, or offerings made pursuant to a merger or acquisition;

(D) offerings of investment grade asset-backed securities;

(E) offerings of convertible securities;

(F) offerings of preferred securities; and

(G) offerings of securities of closed-end companies as defined under Section (5)(a)(2) of the Investment Company Act of 1940.

(10) "Restricted person" means:

(A) Members or other broker/dealers;

(B) Broker/Dealer Personnel

(i) Any officer, director, general partner, associated person, or employee of a member or any other broker/dealer (other than a limited business broker/dealer), or any agent of a member or any other broker/dealer (other than a limited business broker/dealer) that is engaged in the investment banking or securities business;

(ii) An immediate family member of a person specified in subparagraph (B)(i) if the person specified in subparagraph (B)(i):

(a) materially supports, or receives material support from, the immediate family member;

(b) is employed by or associated with the member, or an affiliate of the member, selling the new issue to the immediate family member; or

(c) has an ability to control the allocation of the new issue.

(C) Finders and Fiduciaries

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

(ii) An immediate family member of a person specified in subparagraph (C)(i) if the person specified in subparagraph (C)(i) materially supports, or receives material support from, the immediate family member.

(D) Portfolio Managers

(i) Any person who has authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account, other than with respect to a beneficial interest in the bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account over which such person has investment authority;

(ii) An immediate family member of a person specified in subparagraph (D)(i) that is materially supported by such person, other than with respect to a beneficial interest in the bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account over which such person has investment authority.

Provided, however, that the term "restricted person" under this subparagraph (D) shall not include a person solely because he or she is a participant in an investment club or a family partnership.

(E) Persons Owning a Broker/Dealer

(i) Any person listed, or required to be listed, in Schedule A of a Form BD, except persons with ownership interests of less than 10%;

(ii) any person listed, or required to be listed, in Schedule B of a Form BD, except persons whose listing on Schedule B relates to an ownership interest in a person listed on Schedule A with an ownership interest of less than 10%;

(iii) any person listed, or required to be listed, in Schedule C of a Form BD that meets the criteria of subparagraphs (E)(i) and (E)(ii) above;

(iv) any person that directly or indirectly owns 10% or more of a public reporting company listed on Schedule A of a Form BD (other than a reporting company that is listed on a national securities exchange or is traded on the Nasdaq National Market, provided that the gains or losses from new issues are passed on directly or indirectly to public shareholders);

(v) Any person that directly or indirectly owns 25% or more of a public reporting company listed on Schedule B of a Form BD (other than a reporting company that is listed on a national securities exchange or is traded on the Nasdaq National Market, provided that the gains or losses from new issues are passed on directly or indirectly to public shareholders).

(vi) An immediate family member of a person specified in subparagraphs (E)(i)-(v) unless the person owning the broker/dealer:

(a) does not materially support, or receive material support from, the immediate family member;

(b) is not an owner of the member, or an affiliate of the member, selling the new issue to the immediate family member; and

(c) has no ability to control the allocation of the new issue.

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

(i) Background

On October 15, 1999, NASD Regulation filed proposed Rule 2790, Trading in Hot Equity Offerings, with the SEC. The SEC published the proposed rule for comment on January 10, 2000.[4] The SEC received 24 comment letters.[5] In general, the commenters applauded NASD Regulation's efforts to reform the Free-Riding and Withholding Interpretation.[6] Several commenters believed that the proposed rule change was a significant improvement over the Interpretation. Testa stated that

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[4] Notice of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Trading in Hot Equity Offerings, Exchange Act Release No. 42325, 65 Fed. Reg. 2656 (Jan. 18, 2000).

[5] Letter from Willkie Farr & Gallagher to Jonathan G. Katz, SEC, dated January 28, 2000 ("Willkie"); Letter from Faith Colish to Jonathan G. Katz, SEC, dated January 31, 2000 ("Colish"); Letter from Katten Muchin Zavis to Jonathan G. Katz, SEC, dated January 28, 2000 ("Katten"); Letter from Driehaus Capital Management, Inc. to Jonathan G. Katz, SEC, dated February 4, 2000 ("Driehaus"); Letter from Fu Associates, Ltd. to Jonathan G. Katz, SEC, dated February 7, 2000 ("Fu"); Letter from Cadwalader, Wickersham & Taft to Jonathan G. Katz, SEC, dated February 4, 2000 ("Cadwalader"); Letter from Schulte Roth & Zabel LLP to Jonathan G. Katz, SEC, dated February 7, 2000 ("Schulte"); Letter from Rosenman & Colin LLP to Jonathan G. Katz, SEC, dated February 7, 2000 ("Rosenman"); Letter from Fried, Frank, Harris, Shriver & Jacobson to Jonathan G. Katz, SEC, dated May 9, 2000 ("Fried"); Letter from Ropes & Gray to Jonathan G. Katz, SEC, dated February 8, 2000 ("Ropes"); Letter from The Washington Group to Jonathan G. Katz, SEC, dated February 8, 2000 ("Washington"); Letter from Testa, Hurwitz & Thibeault, LLP to Jonathan G. Katz, SEC, dated February 8, 2000 ("Testa"); Letter from Chicago Board Options Exchange to Jonathan G. Katz, SEC, dated February 14, 2000 ("CBOE"); Letter from Sullivan & Cromwell to Jonathan G. Katz, SEC, dated February 15, 2000 ("Sullivan"); Letter from Charles Schwab to Jonathan G. Katz, SEC, dated February 15, 2000 ("Schwab"); Letter from Sidley & Austin to Jonathan G. Katz, SEC, dated February 16, 2000 ("Sidley"); Letter from North American Securities Administrators Association, Inc. to Jonathan G. Katz, SEC, dated February 18, 2000 ("NASAA"); Letter from Northern Trust Global Advisors, Inc. to Jonathan G. Katz, SEC, dated February 13, 2000 ("Northern"); Letter from Securities Industry Association to Jonathan G. Katz, SEC, dated February 18, 2000 ("SIA"); Letter from Morgan Stanley Dean Witter to Jonathan G. Katz, SEC, dated March 17, 2000 ("MSDW"); Letter from Mayor, Day, Caldwell & Keeton, LLP to Jonathan G. Katz, SEC, dated June 2, 2000 ("Mayor"); Letter from Covington & Burling to Jonathan G. Katz, SEC, dated April 14, 2000 ("Covington"); Letter from Orrick, Herrington & Sutcliffe LLP to Jonathan G. Katz, SEC, dated May 2, 2000 ("Orrick"); and Letter from Sandra K. Smith to Jonathan G. Katz, SEC, dated February 1, 2000 ("Smith").

"[i]n general, the Proposal presents a much more easily understood and more workable regulatory scheme." Katten and Schwab stated that the proposed rule change was more carefully targeted towards the purpose of the rule while at the same time was easier for firms, institutional investors and the investing public in general to understand and follow. Katten also added that protecting the integrity of the public offering process is a noteworthy objective that benefits all investors.

As expected, the commenters supported certain elements of the proposed rule change, opposed others, and made suggestions for further changes. A summary and analysis of the specific comments are provided below.

(ii) Scope of Securities Covered by the Proposed Rule Change

The area that generated the most comment was the proposed definition of "hot issue." Currently, under the Interpretation, a hot issue is any security in a public offering that trades at a "premium" in the secondary market. In the October 1999 filing, NASD Regulation defined a hot issue as a security that is part of a public offering "if the volume weighted price during the first five minutes of trading in the secondary market was 5% or more above the public offering price." Many commenters supported NASD Regulation's decision to adopt a clear and measurable standard for determining whether an offering is a hot issue, but believed that the 5% threshold was too low. Colish, Driehaus, SIA, and MSDW questioned whether the methodology proposed by NASD Regulation would be effective in identifying those offerings that should be subject to the rule. Colish and Dreihaus added that NASD Regulation should supply data to support its chosen methodology.

By contrast, Schwab and the SIA suggested what they termed a more "straightforward" approach: prohibiting allocations of all initial public offerings ("IPOs") to restricted persons. Schwab stated that even though the Interpretation and the proposed rule change contain a safe harbor for

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[6] See, e.g., Sullivan, SIA, and Schwab.

canceling a sale and reallocating the security to a non-restricted account, many firms do not and would not avail themselves of the safe harbor. In practice, Schwab said, under the proposed hot issue definition, firms would continue to treat all IPOs as hot issues. The SIA, which argued in the alternative for a higher threshold premium, agreed and stated that if a 5% threshold were adopted, firms would continue to treat all IPOs as being subject to the rule because they cannot be in a position of having to anticipate which offerings will trade through the 5% threshold.

Based upon these comments, NASD Regulation has amended the proposed rule change to restrict the purchase and sale of all initial equity public offerings,[7] not just those that open above a certain premium. Like Schwab and the SIA, NASD Regulation believes that this approach is the most straightforward way to achieve the purposes of the rule. It is both easier to understand and avoids many of the complexities associated with canceling and reallocating the sale of an IPO to a non-restricted person in the event that an offering unexpectedly becomes a hot issue. NASD Regulation disagrees with those commenters who recommended a higher threshold premium, such as 10% or more. In NASD Regulation's view, allocating IPOs with such notable gains (approaching 10% or even more) to restricted persons is precisely the type of conduct that the rule is designed to prevent.

As a corollary to the proposal to apply the proposed rule change to all IPOs, NASD Regulation is proposing to exempt secondary offerings. Many of the commenters opposed NASD Regulation's decision in the October 1999 filing to roll back the exemption for secondary offerings of actively traded securities. As NASD Regulation stated in the October 1999 filing, the decision to roll back the exemption for secondary offerings was premised upon the decision to adopt a 5% threshold premium for hot issues. NASD Regulation believed that with a 5% premium, as a practical matter, all

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[7] The Amendment, like the October 1999 filing, limits the application of the proposed rule change to equity offerings only.

secondary offerings would be exempt from the rule. In proposing to eliminate the requirement for a 5% threshold premium, however, NASD Regulation believes that reinstating the exemption for secondary offerings is now appropriate. NASD Regulation has observed that secondary offerings rarely, if at all, trade at a significant premium to the public offering price. We also agree with Schwab that the negative consequences to both issuers and customers in applying the rule to secondary offerings would outweigh any benefits associated with including such offerings in the proposed rule change.

Schwab, Sullivan and others also recommended that all secondary offerings, not just those that are actively traded, should be excluded from the proposed rule change. NASD Regulation has not observed any unique concerns with respect to secondary offerings of non-actively traded securities. Accordingly, consistent with its objective to develop a more streamlined rule, NASD Regulation has proposed expanding the exemption for secondary offerings to include all secondary offerings.

The decision to apply the proposed rule change to all IPOs, not just those that are hot issues, may lead to problems in offerings for which there is insufficient investor demand. Under the current Interpretation, such offerings would typically not open at a premium and would not be hot issues. With a rule that applies to all IPOs, however, NASD Regulation is proposing to add provisions to address circumstances where purchases by restricted persons are necessary for the successful completion of an offering. The Amendment contains provisions for stand-by purchasers that are identical to the stand-by provisions in the Interpretation. With respect to the stand-by provisions, MSDW suggested imposing minimum capital contribution requirements and extending the lock-up requirements from three months to one year. NASD Regulation does not believe that these additional requirements are necessary. The Amendment also contains provisions addressing under-subscribed offerings.

Specifically, the proposed rule change states that nothing in the rule shall prohibit an underwriter, pursuant to an underwriting agreement, from placing a portion of a public offering in its investment account when it is unable to sell that portion to the public.

In the October 1999 filing, NASD Regulation targeted the proposed rule change to equity offerings only. Historically, the Interpretation applied to equity and debt offerings; in a series of amendments in 1998, however, NASD Regulation exempted most types of debt. Several commenters, including the SIA and Sullivan, expressed support for the elimination of debt securities entirely from the rule's coverage. These commenters generally believed that debt offerings do not raise the same issues as equity offerings and for that reason should be excluded.

There are a number of other categories of offerings that NASD Regulation does not believe should be covered by the proposed rule change. First, NASD Regulation recommends exempting public offerings of investment grade asset-backed securities as defined in SEC Form S-3, some of which may otherwise fall within the definition of new issue. The Interpretation currently exempts investment grade, financing instrument-backed securities and, in view of the decision to eliminate the 5% threshold, NASD Regulation believes that it is appropriate to reinstate the exemption.

Second, NASD Regulation recommends exempting convertible securities.[8] NASD Regulation staff has already exempted many convertible securities from the Interpretation under its exemptive authority.[9] NASD Regulation found that in light of the Interpretation's current exclusion for debt securities and secondary offerings, the failure to exclude convertible securities led to an anomalous

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[8] Although the proposed rule change applies only to equity securities, the definition of equity security in section 3(a)(11) of the Exchange Act, which is used in the proposed rule change, includes any security, including a debt security, that is convertible into stock.

[9] See Letter to Peter C. Manbeck, Sullivan, from Gary L. Goldsholle, NASD Regulation, dated December 21, 1998.

result. A law firm noted that an issuer could issue a non-convertible debt security and make a secondary offering of an actively traded security and neither would be subject to the Interpretation. Yet, if an issuer decided to in effect combine these two securities and issue a debt security that had the additional feature of being convertible into an actively traded security, then the Interpretation would apply. To correct this inconsistency, NASD Regulation staff has used its exemptive authority to exempt from the Interpretation debt securities that are convertible into an actively traded security. NASD Regulation now proposes to codify this exemption. However, in view of the decision to exclude all secondary offerings from the proposed rule change, NASD Regulation has expanded the exemption to include all convertible securities, not just those that are convertible into actively traded securities.

Third, NASD Regulation recommends exempting preferred securities. In connection with amendments to the Interpretation in 1998, NASD Regulation considered, but deferred an exemption for preferred securities.[10] Specifically, NASD Regulation stated that it would "evaluate the impact of excluding investment grade debt and investment grade financing backed securities from the Interpretation and will consider in the future whether preferred [securities] should also be excluded."[11] Based upon its experience with the 1998 amendments, and the purposes of the proposed rule change, NASD Regulation now recommends excluding preferred securities. On balance, NASD Regulation believes that preferred securities exhibit pricing and trading behavior that more closely resemble debt than equity securities.

Fourth, NASD Regulation recommends exempting offerings of closed-end company securities as defined under Section 5(a)(2) of the Investment Company Act of 1940 from the restriction of the

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[10] 63 Fed. Reg. 28535, 28537 (May 26, 1998).

[11] Id.

rule. Generally, when closed-end companies make a public offering they are seeking as large an infusion of capital as possible and will expand the number of shares offered to meet the demand. These shares typically commence trading at the public offering price; if there is a premium, it is very small. Accordingly, applying the proposed rule change to closed-end companies does not further the purposes of the rule and may impair the ability of closed-end companies to obtain capital. NASD Regulation therefore recommends an exemption for closed-end companies.

(iii) Portfolio Fund Managers

Another area that generated a significant amount of comment was the proposed definition and treatment of portfolio managers. In the October 1999 filing, NASD Regulation proposed a "more function-oriented approach" towards personnel with respect to the securities activities of a bank, insurance company, investment company, investment advisor, or collective investment account. NASD Regulation suggested that only persons who supervise or whose activities are directly or indirectly related to the buying or selling of securities for one of the listed entities should be restricted. Ropes, Testa, and Schwab supported this function-oriented approach, but believed that the proposed rule change was still too broad and could reach persons whose functions were purely ministerial. These commenters suggested that the restrictions in the proposed rule change should apply only to those persons who have "the authority to make investment decisions." Ropes believed that this would be a better and more precise indicator of whether a person is in a position to direct business to a member. NASD Regulation believes that this is a useful clarification and has amended the proposed rule change accordingly.[12]

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[12] Schwab also requested an exemption for persons who, on a volunteer basis, make investment decisions of behalf of a tax-exempt charitable organization. NASD Regulation is not proposing such an exemption. Depending on the particular facts, NASD Regulation believes the purposes of the rule may be implicated by a person who manages the investments of a tax-exempt charitable organization.

The proposed rule change also sought to remove the restrictions on persons who participate in an investment club or manage a family partnership. Fu, Sullivan, Smith, and Schwab all strongly supported these changes. Fu, the general partner of a small investment club, believed that he had been unfairly restricted access to IPOs because the Interpretation treated an investment club as an "institutional account." Similarly, Smith viewed her participation in an investment club as a "learning and social activity" and did not believe that her participation in an investment club should affect her, or her husband's, ability to purchase an IPO. Cadwalader noted, however, that, as drafted, the exemption for investment clubs and family partnerships would inadvertently exempt sales to an investment club or family partnership consisting solely or predominantly of restricted persons. NASD Regulation agrees that this was not an intended result. To correct this problem, the proposed rule change no longer exempts investment clubs or family partnerships per se, but rather states that participation in an investment club or family partnership does not by itself make a person restricted.

A number of commenters, including Willkie, Katten, Washington, and Northern, were strongly opposed to the restrictions on portfolio managers, and in particular hedge fund managers, because they would prohibit a hedge fund manager from investing in hot issues through a fund he or she manages. Although the proposed rule change allowed portfolio managers and other restricted persons in aggregate to own up to 5% of a collective investment account that invests in hot issues, these commenters believed that the 5% figure was too low. They added that investors generally expect portfolio managers to make significant investments in accounts they manage as it helps to align the managers' interests with those of investors. Several commenters, including Rosenman, Willkie, and Northern urged NASD Regulation to exempt hedge fund managers with respect to the accounts they manage, while retaining the restriction with respect to purchases of IPOs in their personal accounts. Northern, for example, stated "[w]e would not be in favor of letting a hedge fund manager receive

benefits on the side that might permit the manager to divert hot issues to his or her own personal account." Willkie added that the fiduciary duty of a hedge fund manager would prevent him or her from profiting from new issues personally at the expense of hedge fund investors.

Based upon these comments, NASD Regulation has amended the restriction on portfolio managers. NASD Regulation agrees with the commenters that the 5% exemption in the October 1999 filing did not achieve its intended purpose and could, as discussed below, undermine the purposes of the rule by allowing broker/dealer personnel and other restricted persons to purchase substantial quantities of IPOs. The Amendment treats a portfolio manager and certain members of his or her immediate family as restricted persons other than with respect to a beneficial interest in the bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account, over which such person has investment authority. The Amendment thus permits a hedge fund manager who is not otherwise restricted to invest in IPOs through a fund he or she manages. Under the Amendment, however, a portfolio manager may not purchase IPOs in his or her personal accounts. Several commenters, including Willkie and Rosenman, proposed language that is substantively similar to that proposed by NASD Regulation.

The Amendment does not define what constitutes a personal account of a portfolio manager. NASD Regulation believes that a number of factors will contribute to a determination of whether an account is a personal account. These factors include, but are not limited to, the number of beneficial owners in the account, the identity of the participants, whether the account participants are members of the portfolio manager's immediate family, the compensation scheme, the manner in which profits and losses are distributed, the expectations of the account participants, and the overall trading activity in the account.

Despite this change, NASD Regulation does not believe that the treatment of portfolio managers in the Amendment will lead to an environment that is significantly different from that under the current Interpretation. Under the Interpretation, portfolio mangers are entitled to purchase hot issues if such purchases are, among other things, consistent with their normal investment practices. They also are entitled to receive benefits from new issues in accounts they manage in the form of performance fees.

Katten sought clarification on whether an investment adviser organized as an entity is a restricted person. Katten stated that the proposed rule change treats certain employees of an investment adviser as restricted but does not state whether an investment adviser organized as an entity is a restricted person. NASD Regulation believes that the status of an entity organized as an investment advisor would depend on the status of its beneficial owners. If the beneficial owners are restricted persons because of their investment advisory activities or otherwise, then the entity would be a restricted person.

(iv) Preconditions for Sale/Documentation

The proposed rule change streamlined the requirements for members to demonstrate that sales of IPOs were made in conformity with the rule. NASD Regulation replaced the myriad means for members to demonstrate that they have not sold IPOs to restricted persons, with a single requirement applicable to all accounts – a representation from the account holder, or a person authorized to represent the beneficial owners of the account, that the account is eligible to purchase new issues in compliance with the rule. Colish supported these changes. The SIA stated that the requirement as to the type of evidence that is needed "is a significant improvement over current requirements." Commenters also had concerns. Schwab and MSDW were concerned that the proposed rule change would require an annual mailing to all customers that may be interested in

purchasing new issues and would prohibit the use of electronic communications. The SIA and MSDW stated that firms should be permitted to develop their own methods to verify the status of a customer, including the use of oral representations so long as such representations are documented internally. In response to these comments, NASD Regulation intends to state in a Notice to Members announcing SEC approval of the proposed rule change that an annual mailing is not required, and that electronic or oral communications are permitted so long as such communications and the response are documented internally by the member firm.

MSDW also stated that the documentation requirements may hinder a bona fide public distribution if members withhold securities from public customers because they have not provided the necessary information. NASD Regulation disagrees and believes that MSDW's comment may be based on a misinterpretation of the nature of the required documentation. In general, NASD Regulation does not believe that adhering to these requirements, even if it means that certain public customers cannot purchase IPOs, will cause a member to fail to make a bona fide public offering. In addition, NASD Regulation expects that public customers will provide the necessary information or certifications to afford them the opportunity to purchase IPOs.

NASD Regulation also is maintaining the interval required for verification at one year. The SIA, Sullivan, and MSDW suggested lengthening the verification period from one year to every two or three years. By contrast, NASAA suggested shortening the verification period to something significantly shorter than one year, to reflect possible changes in ownership that could occur within that period. NASD Regulation believes that as a matter of policy, allowing members to wait longer between verifying that their customers are eligible to purchase new issues undermines the effectiveness of the rule. Currently, under the Interpretation, verification is required as frequently as before every sale or as long as every 18 months. With the streamlined documentation procedures and

the availability of electronic and oral communications, NASD Regulation believes that an annual verification requirement strikes an appropriate balance between benefit and burden. We anticipate that in light of the clarifications made above, the commenters generally will agree with NASD Regulation that the burdens of ensuring that customers are eligible to purchase IPOs on an annual basis are not unreasonable. NASAA's concerns are addressed by the fact that a member may not rely on a representation that it has reason to believe is inaccurate.

Several commenters, including Cadwalader and Ropes, were concerned about how the documentation requirement would apply in light of the fact that a customer's status or percentage ownership in a collective investment account may change over the course of a year. NASD Regulation recognizes that the potential exists for a customer's status under the rule to change, but believes that members may rely upon information obtained as part of the ordinary, annual verification process, so long as the member does not believe or have reason to believe that an account is restricted. Currently, under the Interpretation, NASD Regulation allows members to rely upon certain certifications dated not more than 18 months prior to the date of sale of the hot issue. Under the proposed rule change, members would be able to rely, in good faith, on representations dated not more than twelve months prior to the date of sale of the new issue.

On the issue of intent, Schwab stated that the rule should not impose a strict liability standard. Specifically, Schwab believed that a member should not be in violation of the proposed rule change if the member is unaware that an account is beneficially owned by a restricted person because the customer provided false information. On this point, we agree. As stated in the October 1999 filing, a member may rely upon the information it has received from a customer unless it believes, or has reason to believe, that the information is inaccurate. The proposed rule change has been amended to expressly include this standard.

Several commenters, particularly law firms such as Katten, Schulte, Rosenman, and Sullivan, sought guidance on what type of information a member would be required to review to determine whether an account is beneficially owned by restricted persons, especially in a fund of funds context. The proposed rule change allows an account holder, or a person authorized to represent the beneficial owners of the account, to represent that an account is eligible to purchase new issues. So long as a member has no reason to believe that the representation is not accurate, it may rely upon the representation. Alternatively, a registered representative may ask questions of a customer to allow him or her to determine whether an account is eligible to purchase new issues under the rule. The application of the rule would be the same for a fund of funds. In that case, a member could secure a representation from a person authorized to represent the beneficial owners of the fund that is purchasing the new issue from the member (such as the fund's general partner) that the account is eligible to purchase new issues. Naturally, the ability of a general partner to make such a representation will be contingent on his or her receiving similar representations from general partners of the other funds investing in the fund, or by reviewing information about the investors in such funds. However, unlike the current Interpretation, there are no provisions requiring certifications by attorneys or certified public accountants. While members may wish to rely upon counsel or an accountant to investigate the status of an account, such an approach is no longer required by the rule.

NASD Regulation will announce in the Notice to Members announcing approval of Rule 2790 that members may use negative consent letters in all but the initial account verification. Several commenters, including MSDW, believed that the ability to use negative consent letters would greatly ease the burden of complying with the rule without undermining its effectiveness. NASD Regulation believes that once a member firm verifies the status of an account, it may use negative consent procedures for each subsequent, annual verification.

Finally, the SIA asked NASD Regulation to explore an automated means of updating certain account information regarding restricted person status. While NASD Regulation does not currently intend to develop such a system, NASD Regulation is not opposed to third party vendors compiling or aggregating information about the status of persons under the rule. If a private vendor developed a reliable automated application to track the status of purchasers under the rule, NASD Regulation believes that members generally could rely upon data from such a vendor.

(v) De Minimis Exemption

As stated above, one purpose behind the proposed rule change is to streamline the rule. One area in which NASD Regulation believes that it can benefit investors without sacrificing the integrity and protections of the rule is with respect to certain de minimis owners. The de minimis ownership exemption avoids imposing on investors the burden of creating segregated accounts in those instances where restricted persons have only a nominal and passive interest in an account that purchases new issues. Commenters appreciated the efficiencies that the de minimis exemption would provide and generally urged that it be expanded.

Several commenters asked NASD Regulation to expand the de minimis exemption to include a collective investment account that is owned 10% or more by restricted persons. NASD Regulation, however, does not support such an expansion. One of the rationales for the de minimis exemption was to alleviate the impact of the October 1999 filing's decision to treat portfolio managers as restricted persons. As discussed in the previous section, that issue has been addressed separately. Thus, a large class of persons for whom the de minimis exemption was intended have already been excluded from the rule. In view of this change, NASD Regulation is maintaining the de minimis level at 5%. This comports with recommendations by Katten, Schulte, and Rosenman, which supported a 5% de minimis level so long as portfolio managers were excluded.

Northern noted that as originally proposed, the de minimis exemption may "tempt some brokers to favor hedge funds that permit the brokers themselves or their senior executives or friends to invest in the hedge funds, which would cut against the purposes of the NASD proposal." In response to this comment and to ensure that the de minimis exemption is consistent with the purposes of the rule and the public interest, NASD Regulation has revised the de minimis exemption to impose a strict numerical limit of 100 shares on the number of shares that any one person can purchase under the de minimis exemption. In complying with the 100 share limit, members may look through an investing entity to a person's beneficial interest. The numerical limit reduces the incentive for self-dealing and the appearance that restricted persons are receiving shares at the expense of public investors. Under the Amendment, the de minimis exemption also requires that a restricted person does not manage or otherwise direct investments in the account.

Members should be aware that the de minimis exemption does not allow restricted persons to purchase 100 shares directly. The de minimis exemption was developed as an accommodation to collective investment accounts with only a small percentage of restricted persons. Because the sale of IPOs to such a collective investment account principally benefits non-restricted persons, NASD Regulation believes, for administration purposes, it should not be necessary to carve-out the restricted persons or exclude the account altogether. On the other hand, direct purchases of IPOs by restricted persons do not in any way facilitate a public distribution and will continue to be prohibited under the proposed rule change.

Several commenters, such as Cadwalader, Ropes, Covington, and Fried, suggested a variation on the de minimis exemption in that the proposed rule change should be amended to exempt all passive investors in a collective investment account, regardless of the size of their interest. While passive investors have no control over the investment decisions made by a collective investment account, their

participation in a particular account may be known or inferred by the member allocating new issues. A passive investor exemption would allow restricted persons to circumvent the purposes of the rule by having such purchases made on their behalf by a portfolio manager. For these reasons, NASD Regulation is not proposing to exempt all passive investors.

NASD Regulation also disagrees with MSDW's recommendation that the de minimis exemption be amended to apply if a collective investment account invests less than 10% of its assets in new issues. For many collective investment accounts, and certainly all large accounts, such a limitation would be tantamount to no limitation at all. MSDW's recommendation would allow a fund comprised solely of broker/dealer personnel to invest up to 10% of their assets in new issues. NASD Regulation believes that such an expansion of the de minimis exemption is unwarranted and would be inconsistent with the purposes of the rule.

Sidley asked whether the proposed rule change and the creation of the de minimis exemption eliminated the ability for collective investment accounts to create carve-out accounts that segregate the interests of restricted persons. NASD Regulation did not intend for the proposed rule change to eliminate the ability of a collective investment account that does not meet the de minimis exemption to create a separate account and carve out the interests of restricted persons from the account investing in new issues. Accordingly, an account that wishes to purchase a greater number of shares such that a restricted person's pro rata allocation would exceed 100 shares, or an account that wishes to allow restricted persons to own collectively more than 5% of the fund's assets, would be able to use carve-out procedures and segregate the new issue activity from restricted persons to keep it below the threshold in the proposed rule. However, unlike the current Interpretation, the proposed rule change does not contain detailed procedures concerning how an account is required to carve-out the interests of restricted persons. A member's obligation under the proposed rule change is to receive a

representation from the account holder, or a person authorized to represent the beneficial owners of the account, that the account is not restricted from purchasing new issues under the rule. At this time, NASD Regulation does not intend to regulate the manner in which an account carves out restricted persons. If NASD Regulation has reason to believe that closer scrutiny of carve-out accounts is necessary, it will consider additional rulemaking in this area.

Sidley also asked NASD Regulation to revise the proposal to permit funds to transfer securities from a carve-out account to a general account without undertaking a secondary market transaction, which it argued is inefficient and unnecessarily costly. Sidley correctly noted that current NASD Regulation policy requires a transfer from a carve-out account with non-restricted persons to a fund's general account that is beneficially owned by restricted person to be effected in a market transaction. Under the proposed rule change a fund manager would be permitted to determine how best to transfer new issues that he or she intends to keep for investment purposes from one account to another, consistent with all other applicable laws and regulations. NASD Regulation cautions that where a carve-out account purchases new issues with a view towards distributing such shares to another account, that such carve-out account may be viewed as an "underwriter" under Section 2(a)(11) of the Securities Act of 1933.

(vi) Owners of Broker/Dealers

NASD Regulation has substantially revised the restrictions on owners of broker/dealers. The October 1999 filing treated as restricted persons affiliates of a broker/dealer and natural persons, and certain members of their immediate family, who owned 10% or more, or contributed 10% or more of the capital of a broker/dealer. Many of the commenters, including Willkie, Colish, Sidley, and the SIA, stated that this approach was too broad. Several commenters stated that reaching all companies that are under common control with a broker/dealer, and in particular sister companies, would reach

entities without any nexus to the securities industry. The commenters also were concerned about the impact on affiliates in light of the repeal of the restrictions on affiliation among banks, insurance companies and securities firms under the Gramm-Leach-Bliley Act of 1999.[13]

The Amendment adopts a new approach and treats as restricted persons owners of broker/dealers as defined in Schedule A of Form BD, with at least a 10% ownership interest,[14] and as defined in Schedule B of Form BD. NASD Regulation believes that this approach is desirable from a compliance perspective because the definitions are understood by members and the information is already required to be maintained. NASD Regulation opted to use existing ownership standards rather than create a new concept for purposes of this rule. From a technical standpoint, this approach no longer treats affiliates of broker/dealers as restricted persons per se. The ownership provisions look only at the direct and indirect owners of a broker/dealer. Moreover, the standard of control for indirect owners in Schedule B of Form BD is a 25% interest, not a 10% interest as proposed in the October 1999 filing. In this regard, the Amendment is narrower in scope than the October 1999 filing.

The rationale for applying the rule to owners of broker/dealers is straightforward. A prohibition on a broker/dealer could be easily circumvented if IPOs could be purchased by the broker/dealer's parent. Similarly, to avoid circumventing the restriction on the owners and the broker/dealer itself, it is necessary for the rule to prohibit sales of new issues to any account in which the owner or broker/dealer has a beneficial interest. If the rule did not restrict any account in which a restricted person had a beneficial interest, restricted persons could purchase new issues in

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13 Pub. L. No. 106-102, 113 Stat. 1338 (1999).

14 Schedule A of Form BD lists all direct owners with ownership interests of 5% or more in a broker/dealer. The ownership level is indicated by various "ownership codes": A for 5% but less than 10%, B for 10% but less than 25%, and so on. For purposes of Rule 2790, only persons with a 10% or more interest, as indicated by ownership codes B and higher will be restricted persons.

downstream affiliates and flow the profits back up to the restricted person. The application of the rule to all accounts in which a restricted person has a beneficial interest is a fundamental principle of the proposed rule change and the Interpretation.

The net effect of these provisions is that both upstream and downstream affiliates, including sister companies, are restricted persons. Although commenters may view this approach as unnecessarily broad, NASD Regulation believes that it is necessary to effectuate the purposes of the rule. However, NASD Regulation has made a number of reforms that we believe address many of the commenters' concerns.

The primary source of relief comes from NASD Regulation's decision to exempt sales to and purchases by nearly all publicly traded companies. The commenters generally supported the exemption in the October 1999 filing for publicly traded companies. Sullivan, for example, stated "that a blanket exemption . . . for sales to publicly traded corporations would substantially lighten the administrative burden of implementing the rule without undermining the underlying objectives of the rule in any meaningful way."

The Amendment expands the exemption for publicly traded companies to now include all publicly traded companies listed on a national securities exchange or traded on the Nasdaq National Market, even those that are affiliates of a broker/dealer.[15] NASD Regulation believes that purchases of new issues by this class of publicly traded companies, which in turn have broad public ownership and whose securities may be purchased by any investor, is not the type of activity the rule is designed to prevent. Purchases in these instances benefit public investors in much the same way that IPO

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[15] The exemption does not apply to a broker/dealer itself. NASD Regulation continues to believe that broker/dealers, even publicly traded broker/dealers, should not purchase or withhold IPOs. As discussed below, NASD Regulation believes that an exemption for publicly traded companies, even affiliates of a broker/dealer, was appropriate in light of protections against self-dealing under NASD Rule 2750, which applies to related persons of the broker/dealer, but not the broker/dealer itself.

purchases by mutual funds benefit their shareholders. To ensure that purchases by publicly traded companies do in fact benefit their shareholders, the exemption requires that the gains or losses from the IPOs must be passed on to shareholders.

The decision to exempt publicly traded companies in the Amendment greatly minimizes the rule's impact on many financial services conglomerates and industrial companies that own a broker/dealer. Where the owner is a publicly traded company with a broker/dealer subsidiary, the rule would no longer apply, either at the parent level or at the downstream affiliate level. Thus, for example, a manufacturing unit of an exchange listed financial services holding company would not be a restricted person. For publicly traded companies, therefore, the Amendment would exempt sales to and purchases by affiliates.

NASD Regulation is not, however, expanding the exemption for owners of broker/dealers that are private companies. The purchase of IPOs in this case does not reach public investors because ownership of private companies is not open to the public. NASD Regulation also is not expanding the exemption to include owners of broker/dealers listed solely on a foreign exchange. Sidley was concerned that limiting the exemption to publicly traded companies listed on a domestic exchange would disadvantage publicly owned foreign companies without a U.S. listing. Despite these concerns, NASD Regulation does not believe at this time that foreign publicly traded companies should be exempt from the proposed rule change. Foreign jurisdictions have various listing standards and levels of regulatory oversight. As such, there is greater potential that a foreign publicly traded company could be used to circumvent the purposes of the rule. NASD Regulation will, however, consider its experience under the proposed rule change and may in the future consider whether it is appropriate to extend the exemption to publicly traded companies listed or traded solely on foreign markets.

The Amendment also contains an exemption for the purchase of new issues by a bank common trust fund or an insurance company general, separate or investment account, provided that the account has investments from 1000 or more investors, and is not limited principally to restricted persons. These exemptions will allow, for example, private banks and mutual and private insurance companies with broker/dealer subsidiaries to purchase new issues for these accounts. NASD Regulation believes that, collectively, these restrictions on the owners of broker/dealers will address many commenters' concerns about the application of the rule to broker/dealer affiliates.

The SIA was concerned that the proposed rule change would adversely affect "asset management affiliates that manage discretionary accounts as well as accounts for unaffiliated persons." The SIA stated that to the extent that affiliates of broker/dealers become restricted persons under the rule, the rule should more clearly exempt certain classes of accounts maintained by broker/dealer affiliates. The SIA's concerns appear unfounded. To the extent that broker/dealer affiliates manage accounts for non-restricted persons, such accounts would not be restricted under the proposed rule change. On the other hand, if the SIA is concerned about accounts at broker/dealer affiliates that are owned by restricted persons, NASD Regulation believes that the rule should apply.

In proposing to allow purchases by publicly traded companies that are affiliates of broker/dealers, NASD Regulation is relying in part on the restrictions on a member engaged in a fixed price offering under Rule 2750, Transactions with Related Persons. Specifically, Rule 2750 prohibits a member from selling any securities in a fixed price offering to any person or account that is a related person of the member. NASD Regulation believes that Rule 2750 addresses the potential for self-dealing in allocating new issues to a publicly traded affiliate of a broker/dealer.

Finally, Sullivan asked why immediate family members of owners of broker/dealers were treated differently than immediate family members of associated persons of a broker/dealer. NASD

Regulation did not intend for different treatment of such family members and has corrected the proposed rule change.

(vii) Beneficial Interest Definition

At its own initiative, NASD Regulation is revising the definition of "beneficial interest." The term beneficial interest was defined in the October 1999 filing as "any ownership or other direct financial interest." NASD Regulation is aware that members found the reference to ownership as distinct from a financial interest misleading. Because the rule is intended to prohibit sales of new issues to certain persons who stand to profit from them, legal ownership, such as that held by a trustee for beneficiaries, or a hedge fund for its limited partners, is not the type of interest that is the focus of the rule.

NASD Regulation also is recommending eliminating the term "direct" from the definition. In determining whether an account is beneficially owned by restricted persons, members are often required to look through a number of investment vehicles. For instance, if Fund A invests in Fund B, a member may not sell new issues to Fund B unless it determines the sale is consistent with the rule, taking into account the status of each beneficial owner of Fund A. To some, the owners of Fund A may be viewed as having an "indirect" ownership in Fund B.

Rosenman stated that the definition of beneficial interest should specifically exclude management or performance based fees that are deferred for bona fide taxation reasons. Rosenman was concerned of the effect that deferred management or performance fees may have on a hedge fund manager's interest in a collective investment account that he or she manages. Because NASD Regulation has eliminated the restrictions on a hedge fund manager with respect to a collective investment account that he or she manages, we do not believe it is necessary to amend the definition of beneficial interest as Rosenman suggests.

Finally, as a result of the amendments to the definition of beneficial interest and the definition of restricted person, the conditions that gave rise to the need for the exemption for joint back office broker/dealers in the October 1999 filing have been removed. By clarifying that beneficial ownership means a financial interest, such as the right to share in gains or losses, we have clarified that a hedge fund broker/dealer's legal ownership of securities does not constitute a beneficial interest for purposes of the rule. As a result, the rule no longer needs a separate exemption for joint back office broker/dealers.[16]

(viii) Issuer-Directed Share Programs

In the October 1999 filing, NASD Regulation proposed amendments to the exemption for securities distributed as part of an issuer-directed share program to all employees and directors of the issuer, or an entity that controls, is controlled by, or is under common control with the issuer. NASD Regulation proposed expanding the scope of employees and directors of the issuer that are covered by the exemption to include employees and directors of sister companies. NASD Regulation also proposed eliminating the requirement for a three month lock up for those issuer-directed shares that are sold to restricted persons. Schwab supported the elimination of the lock-up and stated that it provides substantive relief to members who will no longer be required to investigate the status of employee or director participants.

Issuer-directed share programs are a valuable tool in employee development and retention, and are often an integral part of the employer/employee relationship. In recent years, issuer-directed share programs have become more popular, and issuers have sought to expand the lists of persons

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[16] The rationale for the joint back office broker/dealer exemption was that a collective investment account registered as a broker/dealer or with a broker/dealer subsidiary would be precluded from purchasing new issues even if none of its investors were restricted persons. Under the revised definition of beneficial interest, such a collective investment account would no longer be restricted.

invited to participate in an IPO to include business contacts, family and friends. In general, NASD Regulation believes that sales directed by an issuer are outside the scope of activities that the proposed rule change is designed to address. Accordingly, the Amendment proposes to exempt IPO shares that specifically are directed by the issuer to such persons as employees, directors, and friends and family of the issuer. NASD Regulation believes, however, that whether directed by the issuer or otherwise, broker/dealers, broker/dealer personnel and their immediate family, and certain persons acting as finders or in a fiduciary capacity to the managing underwriter, should not purchase IPOs, unless such persons are employees or directors of the issuer, the issuer's parent, or a subsidiary of the issuer or members of the immediate family of an employee or director of the issuer.[17] Similarly, NASD Regulation disagrees with MSDW that all non-underwritten securities directed by the issuer should be exempt from the proposed rule change. NASD Regulation believes that a general exclusion for all issuer-directed or all non-underwritten securities would be readily susceptible to abuse. Consequenlty, NASD Regulation will continue its practice of holding a managing underwriter responsible for ensuring that all securities that are part of the public offering are distributed in accordance with the rule.

As recommended by Testa, the proposed rule change now expressly states that for purposes of the issuer-directed exemption only, a parent/subsidiary relationship is established if the parent has the right to vote 50% or more of a class of voting security or has the power to sell or direct 50% or more of a class of voting securities of the subsidiary. NASD Regulation does not agree with Sullivan

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[17] NASD Regulation proposes allowing an employee or director of an issuer to direct shares in the issuer's initial public offering to members of his or her immediate family, even if such persons are otherwise restricted persons. In recent years, the staff has been presented with situations in which, for example, an employee of a issuer wanted to direct shares to his or her parent, but was unable to do so because the parent was a restricted person (and not an employee or director of the issuer). As amended, the proposed rule change would allow directed shares to be sold to, for example, a parent of an issuer's employee.

that a 10% ownership standard should apply for this exemption. NASD Regulation believes that it is not uncommon for a member through its merchant banking activities or otherwise to make venture capital investments in issuers that exceed 10% of the issuer's securities. In such cases, all employees of the member would be able to purchase the new issue. NASD Regulation does not believe that exempting broker/dealer personnel by virtue of venture capital investments is consistent with the purposes of the rule or the issuer-directed exemption.[18]

NASD Regulation believes that the Amendment strikes the correct balance between providing issuers with flexibility to direct shares while preserving the objectives of the rule. NASD Regulation also believes that the issuer-directed exemption should apply only when shares are in fact directed by the issuer; if a member firm asks or otherwise suggests that an issuer direct securities to a restricted person, NASD Regulation does not believe that such securities should be exempt from the rule.

Sidley suggested that the scope of permissible purchasers under the issuer-directed share provisions should be amended to conform with the permitted categories of offerees set forth in Rule 701 of the Securities Act of 1933. Rule 701 provides an exemption for private companies to sell securities to their employees without a need to file a registration statement. Rule 701 provides an exemption from the registration provisions of the Securities Act of 1933 for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation. NASD Regulation believes that this approach is potentially less broad and is far more difficult for members to implement.

The SIA, Sullivan, and MSDW all believed that the proposed rule change should exclude exchange offers, rights offerings and offerings made pursuant to a merger or acquisition. MSDW

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[18] The proposed rule change contains separate provisions that permit venture capital investors to participate in IPOs to avoid dilution in a public offering. NASD Regulation believes that going beyond these protections for venture capital investors would be inconsistent with the purposes of the proposed rule change.

stated that "[i]f rights or other securities are offered to existing shareholders, particularly shareholders of a publicly traded company, it would seem the purpose of the [proposed rule change] (i.e., to assure a bona fide public distribution of securities) is achieved." Sullivan noted that the NASD has previously stated that the Interpretation does not apply to "exchange offers" and "offerings made pursuant to an merger or acquisition." SIA and MSDW noted with approval the exemptive relief NASD Regulation staff has granted in connection with certain rights offerings. NASD Regulation agrees with the commenters and has amended the proposed rule change to exclude from the definition of public offering, exchange offers, rights offerings and offerings made pursuant to a merger or acquisition. NASD Regulation also has codified the staff's existing exemptive positions regarding certain directed share programs. The conditions imposed on such offerings in the proposed rule change generally track those in the exemptive letters and continue to ensure that these offerings are conducted in a manner that is consistent with the purposes of the proposed rule.

(ix) Limited Business Broker/Dealers

The proposed rule change, like the Interpretation, does not apply to persons associated with a limited business broker/dealer. The proposed rule change defined a limited business broker/dealer as a broker/dealer whose authorization to engage in the securities business is limited solely to the purchase and sale of investment company/variable contracts securities and direct participation program securities. Several commenters believed that this definition was too narrow. The CBOE believed that its market-makers and floor brokers also should be treated as limited business broker/dealers.[19] The CBOE stated that "[a]n options market-maker typically is not a professional equities trader and is

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[19] The CBOE also stated that members that lease out their seats and who are not engaged in a securities business should not be restricted persons. NASD Regulation agrees. NASD Regulation does not believe that a person who merely leases out a seat to a broker/dealer should be treated as a restricted person.

generally removed from the equities side of trading." The CBOE also stated that the "functions of a floor broker on the CBOE . . . are limited to the execution of orders for other market professionals or public customers of other broker/dealers. Floor brokers, with the exception of a transaction effected for their error accounts, do not effect principal transactions." Despite these limited activities, NASD Regulation does not believe that market-makers and floor brokers should be treated as limited business broker/dealers. Notwithstanding the limited nature of their activities, NASD Regulation believes that market-makers and floor brokers are in a position to direct business to a member. The CBOE also appeared to recognize the potential for these individuals to direct business to a member in seeking to exclude from the exemption an "IPO [that] is underwritten by the broker/dealer which clears and carries the member's professional CBOE business." NASD Regulation also believes that the relationships between market-makers and member firms and floor brokers and member firms, even in the absence of an established clearing relationship, may give rise to preferential allocations of new issues. Moreover, the potential to direct business to a member in exchange for IPOs is just one of the reasons for restricting broker/dealers. As noted in the October 1999 filing, the proposed rule change also is designed to ensure that industry insiders do not take advantage of their insider position in the industry to purchase IPOs for their own benefit at the expense of public customers. NASD Regulation believes that options market-makers and options floor brokers are integral to the functioning of an exchange and properly characterized and perceived as industry insiders.

Colish, Washington, and Fried also believed the definition of limited business broker/dealers should be expanded. They suggested including broker/dealers that do not have any involvement in the capital formation or underwriting business, such as market-makers and electronic communications networks. Colish suggested including broker/dealers that engage in private placements. Washington suggested that the proposed rule change should apply only to broker/dealers that engage in an equity

securities business.[20] NASD Regulation disagrees. NASD Regulation believes that persons associated with members engaged in these activities are, like persons associated with other broker/dealers, in a position to direct business to, and to enter into reciprocal arrangements with, other members. They also are industry insiders. While it is undoubtedly true that not every person associated with a member engaged in these activities is in a position to enter into reciprocal arrangements, many persons are. The proposed rule change, like the current Interpretation, is a prophylactic rule. It achieves its goals by applying across a class of persons to whom sales of IPOs may violate the purposes of the rule.

In general, the SIA agreed with NASD Regulation that reciprocal arrangements between industry members in the allocation of public offerings must be prevented. The SIA, however, stated that a rule targeted towards "conduct which has the purpose or effect of creating reciprocal arrangements, rather than one [that is] . . . based on complex definitions of status in the industry, would better serve the capital markets and would be more fair to industry members, their relatives, and other market participants." The SIA did not offer any suggestion on how such a rule would operate in practice. NASD Regulation believes that a rule that requires members to determine whether a particular individual is engaged in reciprocal arrangements with a broker/dealer would be difficult both from an administration and examination standpoint, and would eliminate the certainty sought by the proposed rule change.

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[20] These requests are similar to requests previously considered by NASD Regulation. As noted in Notice to Members 97-30, NASD Regulation continues to believe that persons associated with firms engaged solely in proprietary trading or investment or merchant banking activities may enter into reciprocal arrangements with other members that would violate the purposes of the rule. In Notice to Members 97-30, NASD Regulation stated that the limited business broker/dealer definition should not be expanded to include such firms "because of the difficulty in defining those firms" and because "such broker/dealers may influence or be involved in various aspects of the underwriting process." Further, NASD Regulation was concerned that "such firms may enter into reciprocal arrangements with other members that would violate the intent of the Interpretation."

(x) Elimination of Conditionally Restricted Persons

Another significant reform in the proposed rule change was the elimination of the so-called "conditionally restricted" status[21] and the decision to treat persons as either restricted or non-restricted. Commenters generally supported the decision to eliminate the conditionally restricted status. The proposed rule change continues to treat persons as either restricted or non-restricted as NASD Regulation continues to believe that this bright-line approach best serves investors and members.

(xi) ERISA Plans

NASD Regulation has further simplified the restrictions on Employee Retirement Income Security Act ("ERISA") plans. The October 1999 filing proposed exempting tax-qualified plans under ERISA, so long as such plans were not sponsored by a broker/dealer or an affiliate. A number of commenters, including SIA, MSDW, and Sullivan, believed that this exemption was unnecessarily narrow and would exclude a large number of non-restricted plan participants in plans sponsored by financial services companies. The commenters added that ERISA plans are already subject to a separate regulatory scheme and that they were unaware of any perceived or actual abuses to cause NASD Regulation to narrow the exemption for ERISA plans from the current Interpretation.

NASD Regulation agrees with the commenters that the treatment of ERISA plans in the October 1999 filing could reach many non-restricted persons participating in a plan sponsored by an affiliate of a broker/dealer. The Amendment exempts an ERISA plan that is qualified under Section

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[21] Under the Interpretation, conditionally restricted persons can purchase hot issues "if the member is prepared to demonstrate that the securities were sold to such persons in accordance with their normal investment practice, that the aggregate of the securities so sold is insubstantial and not disproportionate in amount as compared to sales to members of the public and that the amount sold to any one of such persons is insubstantial in amount."

401(a) of the Internal Revenue Code, provided that such plan is not sponsored solely by a broker/dealer.

(xii) Foreign Investment Companies

The October 1999 filing proposed an exemption for foreign investment companies that is substantially similar to the Interpretation. Specifically, it stated that a foreign investment company is exempt from the proposed rule change if: (1) it has 100 or more investors; (2) it is listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority; (3) no more than 5% of its assets are invested in a particular hot issue; and (4) no person owning more than a 5% interest in such company is a restricted person.

MSDW suggested exempting all foreign investment companies that are traded on a "designated offshore securities market" as defined in Rule 902(b) under the Securities Act of 1933.[22] NASD Regulation believes that such an exemption would be too broad. The standards for inclusion in Rule 902(b) do not appear related to the concerns underlying the proposed rule change. Although inclusion in Rule 902(b) requires oversight by a governmental or self-regulatory body, NASD Regulation is not confident that such regulation would prevent restricted persons from using foreign investment companies to circumvent the rule. The NASD continues to believe that is often difficult to assess the comparability of a foreign country's investment company statutes and regulations to those in the United States, particularly as it relates to the purposes of this rule, and believes, therefore, that it is necessary to impose certain conditions.

Colish and Sullivan suggested that NASD Regulation eliminate the fourth condition – a requirement that no person owning more than 5% of the foreign investment company is a restricted

[22] This is similar to a request made during the 1994 rulemaking when the exemption for foreign investment companies was first proposed.

person – because it is often difficult to ascertain the ownership of a foreign investment company. Despite these concerns, NASD Regulation believes that this requirement is necessary to avoid purchases of new issues by funds with concentrated ownership interests of restricted persons.

However, in response to concerns generally about the exemption for foreign investment companies, NASD Regulation has simplified the exemption by eliminating the 100 person requirement and the limitation on the size of the purchase in relation to the size of the investment company. The 100 person condition basically addressed the same concerns about concentration of ownership as condition (4) and, therefore, was eliminated. The limitation on the size of the purchase in relation to the size of the investment company appeared unnecessary and was potentially burdensome for members to calculate. Moreover, for very large funds, the limitation was meaningless inasmuch as 5% of their total assets would often exceed the size of the entire IPO. The other conditions are maintained.

(xiii) Minor or Technical Revisions

In addition to the changes discussed above, NASD Regulation made a number of minor or technical amendments in response to the comment letters.

Testa stated that the anti-dilution provisions, which were similar in scope to the venture capital provisions of paragraph (g) of the Interpretation, applied to natural persons only. Testa believed that entities as well as natural persons that have a prior equity ownership interest in an issuer, should be able to avail themselves of the anti-dilution provisions. The omission of entities in the anti-dilution provisions was inadvertent and has been changed. The anti-dilution provisions thus allow an entity or a natural person investing in such entity to retain the percentage equity ownership in the issuer at a level up to the ownership interest as of three months prior to the filing of the registration statement.

Testa also stated that, as a general matter, family members of a restricted person who receive "material support" from the restricted person should be treated similarly to the restricted person. Testa noted that the proposed rule change in some cases made an exemption for a restricted person to purchase new issues, but did not extend the exemption to the restricted person's immediate family members. NASD Regulation believes that an exemption for a restricted person also should be available to an immediate family member who is restricted under the rule, and it has amended the proposed rule change accordingly.

Several commenters, including Colish and Washington, stated that the use of the word "includes" in the definition of restricted person creates uncertainty by suggesting that the list is non-exclusive. NASD Regulation agrees and has removed the word "includes" from the definition of restricted person.

Schwab stated that the definition of restricted person should exclude consultants or contractors of a broker/dealer member who are not engaged in securities-related activities. Schwab stated that the policy concerns underlying the rule do not require restricting these individuals from participating in new issues. NASD Regulation agrees that consultants or contractors of a broker/dealer should not be restricted persons unless they are engaged in the investment banking or securities business. If, for example, Schwab hires a contractor or consultant to perform photocopying services or a compensation survey, it should not preclude such contractor or consultant from purchasing new issues. The definition of restricted person has been revised to exclude agents of a broker/dealer who are not engaged in the investment banking or securities business.

Schwab also supported the addition of a bright line definition of "material support" but believed that the 10% threshold for support is too low and recommended that a time frame be established for measuring support. NASD Regulation agrees and has revised the definition of "material support" to

providing more than 25% of a person's income in the current or prior calendar year. Separately, NASD Regulation recommends clarifying that members of the immediate family living in the same household will be deemed to be providing each other with material support. Using this language makes clear that the proposed rule change establishes a bright line test, and NASD Regulation will not evaluate material support issues on a case-by-case basis.

(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 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

The SEC received 24 comment letters. NASD Regulation's response to those comment letters is discussed above.

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