For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[15]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–27461 Filed 10–30–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48701; File No. SR–NASD–99–60]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment Nos. 1 Through 4 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 5 Thereto by the National Association of Securities Dealers, Inc. Relating to Restrictions on the Purchases and Sales of Initial Public Offerings of Equity Securities

October 24, 2003.

I. Introduction

On October 15, 1999, the National Association of Securities Dealers, Inc. (''NASD'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] a proposed rule change that would govern purchases and sales of ''hot equity'' offerings. On December 21, 1999, the NASD submitted Amendment No. 1 to the proposed rule change.[3] The proposed rule change and Amendment No. 1 were published for comment in the **Federal Register** on January 18, 2000.[4] On October 11, 2000, the NASD submitted Amendment No. 2 to the proposal[5] which, among other things, changed the subject of the proposed rule from ''hot issues'' to ''new issues.'' Amendment No. 2 was published for comment in the **Federal Register** on December 6, 2000.[6] The NASD submitted Amendment No. 3 to the proposal on March 20, 2001,[7] and Amendment No. 4 to the proposal on June 27, 2002.[8] The Commission published the proposal as revised by Amendment Nos. 3 and 4 in the **Federal Register** on December 10, 2002.[9] On October 23, 2003, the NASD submitted Amendment No. 5 to the proposal.[10] This notice and order approves the proposed rule change and Amendment Nos. 1 to 4 thereto, solicits comment on Amendment No. 5, and approves Amendment No. 5 on an accelerated basis.

II. Executive Summary

Currently, NASD Interpretative Material (''IM'') 2110–1, commonly known as the ''Free-Riding and Withholding Interpretation'' (''Interpretation''), governs the manner in which NASD members may distribute ''hot issues.'' The NASD has proposed to restructure and make substantive amendments to the Interpretation; the result would be codified as new NASD Rule 2790. The NASD has stated that the new rule, like the Interpretation it would replace, is designed to protect the integrity of the public offering process by ensuring that: (1) NASD members make *bona fide* public offerings of securities at the offering price; (2) members do not withhold securities in a public offering for their own benefit or use such securities to reward persons who are in a position to direct future business to members; and (3) industry insiders, including NASD members and their associated persons, do not take advantage of their ''insider'' position to purchase new issues for their own benefit at the expense of public customers. The NASD believes that the proposed rule is better designed to further the purposes of the Interpretation, while at the same time being easier to understand.

Under new NASD Rule 2790, an NASD member generally would be prohibited from selling a ''new issue'' to any account in which a ''restricted person'' had a beneficial interest. As discussed further below, the term ''restricted person'' would include most broker-dealers, most owners and affiliates of a broker-dealer, and certain other classes of person. The proposed rule would require a member, before selling a new issue to any account, to meet certain ''preconditions for sale.'' These preconditions generally would require the member to obtain a representation from the beneficial owner of the account that the account is eligible to purchase new issues in compliance with the rule. The rule would provide several general exemptions, the basic rationale of which is that sales to and purchases by entities that have numerous beneficial owners—and, therefore, are likely to have only a small percentage of restricted persons owners—are not the types of transactions the rule should proscribe. The details of proposed NASD Rule 2790 are discussed in Section IV below.

III. Procedural History and Comments Received

The proposal, as revised by Amendment No. 1, was published for comment in the **Federal Register** on January 18, 2000.[11] The Commission received 24 comments on the original notice.[12] In response to these comments,

[15] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Letter from Gary L. Goldsholle, NASD, to Katherine A. England, Division of Market Regulation, SEC, dated December 20, 1999 (''Amendment No. 1'').

[4] Securities Exchange Act Release No. 42325 (January 10, 2000), 65 FR 2656.

[5] *See* Letter from Alden S. Adkins, NASD, to Katherine A. England, Division of Market Regulation, SEC, dated October 10, 2000 (''Amendment No. 2'').

[6] Securities Exchange Act Release No. 43627 (November 28, 2000), 65 FR 76316.

[7] *See* Letter from Patrice M. Gliniecki, NASD, to Katherine A. England, Division of Market Regulation, SEC, dated March 20, 2001 (''Amendment No. 3'').

[8] *See* Letter from Gary L. Goldshalle, NASD, to Katherine A. England, Division of Market Regulation, SEC, dated June 27, 2002 (''Amendment No. 4'').

[9] *See* Securities Exchange Act Release No. 46942 (December 4, 2002), 67 FR 75889.

[10] *See* Letter from Gary L. Goldsholle, NASD, to Katherine A. England, Division of Market Regulation, SEC, dated October 22, 2003 (''Amendment No. 5'').

[11] *See supra* note 4.

[12] *See* 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 Sandra K. Smith to Jonathan G. Katz, SEC, dated February 1, 2000 (''Smith''); Letter from Driehaus Capital Management, Inc. to Jonathan G. Katz, SEC, dated February 4, 2000 (''Driehaus''); Letter from Cadwalader, Wickersham & Taft to Jonathan G. Katz, SEC, dated February 4, 2000 (''Cadwalader''); Letter from Fu Associates, Ltd. to Jonathan G. Katz, SEC, dated February 7, 2000 (''Fu''); 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 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 Northern Trust Global Advisors, Inc. to Jonathan G. Katz, SEC, dated February 13, 2000 (''Northern Trust''); 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 Securities Industry Association to Jonathan G. Katz, SEC, dated February 18, 2000 (''SIA''); Letter from Mayor, Day, Caldwell & Keeton, L.L.P. to SEC, dated March 8, 2000 (''Mayor Day''); Letter from Morgan Stanley Dean Witter to Jonathan G. Katz, SEC, dated March 17, 2000 (''MSDW''); 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''); Letter from Fried, Frank, Harris, Shriver & Jacobson to Jonathan G. Katz, SEC, dated May 9, 2000 (''Fried'').

the NASD submitted Amendment No. 2, which was published for comment in the **Federal Register** on December 6, 2000.[13] Between December 2000 and March 2001, the Commission received 14 comment letters on the proposed rule change.[14] The NASD reviewed the 14 comment letters and made various revisions to proposed NASD Rule 2790 in Amendment Nos. 3 and 4. After the NASD had filed Amendment No. 4 with the Commission, the Commission received two additional comment letters that, among other things, advocated publication of Amendment No. 4 in the **Federal Register**.[15] The proposal, as revised by Amendment Nos. 3 and 4, was published for comment in the **Federal Register** on December 10, 2002.[16] The Commission received four comments on the proposal after December 10, 2002,[17] and responded to those comments in Amendment No. 5. The proposed rule change, and the evolution of its various provisions through the five amendments, are described below.

[13] *See supra* note 6.

[14] *See* Letter from The Washington Group to Jonathan G. Katz, SEC, dated December 21, 2000 (''Washington 2''); Letter from Fried, Frank, Harris, Shriver & Jacobson to Jonathan G. Katz, SEC, dated December 22, 2000 (''Fried 2''); Letter from Capital International, Inc. to Jonathan G. Katz, SEC, dated December 22, 2000 (''CII''); Letters from Cadwalader, Wickersham & Taft to Jonathan G. Katz, SEC, dated December 22, 2000 and January 4, 2001 (''Cadwalader 2''); Letter from Testa, Hurwitz & Thibeault to Jonathan G. Katz, SEC, dated December 26, 2000 (''Testa 2''); Letter from Managed Funds Association to Jonathan G. Katz, SEC, dated December 26, 2000 (''MFA''); Letter from Mayor, Day, Caldwell & Keeton, L.L.P. to Jonathan G. Katz, SEC, dated December 26, 2000 (''Mayor Day 2''); Letter from Sullivan & Cromwell to Jonathan G. Katz, SEC, dated December 29, 2000 (''Sullivan 2''); Letter from Willkie Farr & Gallagher to Jonathan G. Katz, SEC, dated January 8, 2001 (''Willkie 2''); Letter from Securities Industry Association to Margaret H. McFarland, SEC, dated January 10, 2001 (''SIA 2''); Letter from Chicago Board Options Exchange to Jonathan G. Katz, SEC, dated January 12, 2001 (''CBOE 2''); Letter from Morgan Stanley Dean Witter to Secretary, SEC, dated January 31, 2001 (''MSDW 2''); Letter from The Washington Group to Laura S. Unger, SEC, dated March 27, 2001 (''Washington 3'').

[15] *See* Letter from Willkie Farr & Gallagher to SEC dated September 24, 2002 (''Willkie 3''); Letter from Managed Funds Association to SEC dated October 15, 2002 (''MFA 2'').

[16] *See supra* note 9.

[17] *See* Letter from Willkie Farr & Gallagher to Jonathan G. Katz, SEC, dated December 13, 2002 (''Willkie 4''); Letter from Managed Funds Association to Jonathan G. Katz, SEC, dated December 31, 2002 (''MFA 3''); Letter from Sidley Austin Brown & Wood to Jonathan G. Katz, SEC, dated January 9, 2003 (''Sidley 2''); Letter from Mayer Brown Rowe & Maw to Jonathan G. Katz, SEC, dated January 13, 2003 (''Mayer Brown'').

IV. Description of Proposal

A. Primary Differences Between NASD Rule 2790 and NASD IM–2110–1

1. ''New Issues'' Versus ''Hot Issues''

The Interpretation applies to any ''hot issue,'' defined as a public offering of a security that trades at a premium whenever secondary market trading begins.[18] The proposed rule, in contrast, would apply to any ''new issue,'' defined as an initial public offering of an equity security.[19] The initial proposal would have retained the concept of ''hot issues'' but revised the Interpretation's definition to provide a clearer standard for when an issue becomes ''hot'' (*i.e.*, when it trades at the required premium). The NASD initially proposed to define ''hot issue'' as a security that is part of a public offering where the volume-weighted price during the first five minutes of trading in the secondary market is 5% or more above the public offering price.

The proposed 5% threshold generated several comments. Three commenters supported the NASD's proposal for a clear and measurable standard for determining whether an issue becomes ''hot'' but believed that the 5% threshold was too low.[20] Several commenters questioned whether the methodology proposed by the NASD would be effective in identifying those offerings that should be subject to the proposed rule.[21]

Two commenters suggested an approach even more straightforward than a 5% threshold: prohibiting allocations of all IPOs to restricted persons.[22] One of these commenters noted a significant drawback to any definition that included a numerical threshold: prudent firms would have to treat all IPOs as subject to the rule because they would not be able to anticipate which offerings would trade through the threshold.[23] The second commenter agreed that, in practice, many firms would treat all IPOs as subject to the rule even if many of them were not hot issues.[24] The second commenter added that, although the Interpretation contains a cancellation provision, many firms do not avail themselves of it because of the administrative costs of tracking and canceling hot issue sales, the risks of noncompliance associated with selling hot issues to restricted persons, and the ill will generated by having to cancel a customer's allocation.

Based on these comments, the NASD in Amendment No. 2 revised the proposed rule to cover the purchase and sale of all initial equity public offerings, not just those that open above a designated premium. The NASD believes that this approach would be easier to understand and would avoid many of the complexities associated with the cancellation provision.

2. Elimination of Cancellation Provision

Currently, a member that sells a hot issue to a restricted person or account will not be considered to have violated the Interpretation if the member: (1) Cancels the trade before the end of the first business day following the date on which secondary market trading commences for that issue; and (2) reallocates such security at the public offering price to a non-restricted person or account.[25] This provision allows members to cancel trades in the event an issue unexpectedly becomes ''hot.'' With the decision to apply the proposed rule to all new issues, the NASD no longer believes that a cancellation provision is necessary. The NASD would expect members to determine the status of all prospective purchasers prior to selling a new issue.

3. Elimination of ''Conditionally Restricted Person'' Status

Another significant difference between the proposed rule and the Interpretation is the elimination of ''conditionally restricted person'' status and the decision to treat all persons as either restricted or non-restricted. Although the term ''conditionally restricted person'' is not used in the Interpretation, the concept generally includes: (1) Members of the immediate family of an associated person who are not supported directly or indirectly by the associated person; (2) finders in respect to the public offering; (3) any person acting in a fiduciary capacity to the managing underwriter (including accountants, attorneys, and consultants); and (4) senior officers and directors of a bank, savings and loan

[18] *See* NASD IM–2110–1(a)(1).

[19] *See* paragraph (i)(10) of proposed NASD Rule 2790. This provision would in turn define ''equity security'' to have the same meaning as in Section 3(a)(11) of the Act, 15 U.S.C. 78c(a)(11).

[20] *See* Driehaus; MSDW; Sullivan.

[21] *See* Colish (stating that the NASD should supply data to support the numerical thresholds chosen in the proposed rule); Driehaus (recommending use of a threshold based on a security's volume-weighted price on the first day, not just the first five minutes of trading or any other short period of time during the trading day); MSDW; NASAA; SIA (recommending a percentage based on the first half hour of trading that occurs away from the lead underwriter).

[22] *See* Schwab; SIA (arguing in the alternative for a higher threshold premium).

[23] *See* SIA.

[24] *See* Schwab.

[25] *See* NASD IM–2110–1(a)(3).

institution, insurance company, investment company, investment advisory firm, or any other institutional-type account, or any person in the securities department of any of the foregoing entities, or any other employee who may influence, or whose activities directly or indirectly involve or are related to, the function of buying or selling securities for any of the foregoing entities.[26] Under the Interpretation, a conditionally restricted person generally may purchase hot issues if: (1) The securities are sold to that person in accordance with the person's normal investment practice; (2) the amount of securities sold to such person is insubstantial; and (3) the member's aggregate sales to conditionally restricted persons is insubstantial and not disproportionate in amount as compared to sales to other members of the public.

Several commenters urged the NASD to retain the concept of conditionally restricted persons.[27] The NASD believes, however, that treating a person as conditionally restricted is, in many cases, contrary to the public interest: although certain conditionally restricted persons—such as investment advisers, hedge fund managers, and other investment managers—may have the requisite investment history to qualify for the exemption, they still may be in a position to direct future business to a member. The NASD does not believe that meeting the conditionally restricted person criteria alleviates these concerns. The NASD now prefers a bright-line approach and, therefore, has proposed to eliminate conditionally restricted person status. The NASD acknowledges that, by doing so, certain persons who may purchase hot issues under the Interpretation would be restricted persons under the new rule. However, the rule contains new provisions that would address some of their concerns.

4. Introduction of 10% *De Minimis* Threshold for Restricted Person Participation

The NASD has stated that some of the persons who previously benefited from conditionally restricted person status could instead benefit from a proposed *de minimis* threshold: restricted persons would be permitted to hold interests in a collective investment account that purchases new issues, provided that such persons account for no more than 10% of the account's beneficial ownership.

The NASD initially proposed a *de minimis* threshold of 5%. Several commenters urged the NASD to raise the threshold from 5% to 10% or more.[28] These commenters generally maintained that restricted persons should be permitted to hold interests in an account that purchases new issues, provided that they exercise no investment authority over the account.[29] The NASD responded that for many years it has received similar requests to establish what would in effect be a ''passive investor exemption.'' The NASD believes that such an exemption would allow persons who are not public investors to receive substantial allocations of new issues, which would be fundamentally at odds with the purposes of the rule. The NASD believes, moreover, that participation by restricted persons in an account might be known or inferred by an NASD member allocating a new issue and, thus, create a temptation for the member to reward that account in the hope of receiving future business. For these reasons, the NASD has declined to adopt a blanket exemption for passive investors.

Early commenters noted that investors generally expect a hedge fund manager to make significant investments in the fund to align the manager's interests with those of the investors; these commenters urged the NASD to raise the *de minimis* threshold to allow such arrangements.[30] However, rather than increase the initially proposed 5% threshold, the NASD in Amendment No. 2 proposed a limited exemption for portfolio managers: a person would not be restricted with respect to a collective investment account for which he or she acted as a portfolio manager.[31]

One commenter argued that this limited exemption for portfolio managers would not further the interests of the proposed rule because a portfolio manager who benefits from the purchase of new issues through an account that he or she manages would have far greater incentive and opportunity to direct future business to an NASD member than the restricted persons who were merely passive investors.[32] In Amendment No. 4, the NASD responded by reinstating portfolio managers as restricted persons in all cases, including with respect to accounts for which they act as portfolio manager, but raising the *de minimis* threshold to 10%. Under this new approach, an account managed by a portfolio manager would be permitted to invest in new issues, provided that the interest of all restricted persons in the account (including the portfolio manager) did not exceed 10%.[33] The NASD observed that this approach comported with earlier recommendations made by three commenters.[34]

Three commenters criticized this new approach and urged the NASD to return to its earlier proposal of a 5% *de minimis* threshold and deeming the portfolio manager as a non-restricted person with respect to the fund that he or she manages.[35] These commenters again emphasized their view that portfolio managers should be required, as one commenter put it, to ''eat their own cooking.''[36] They also argued that the new approach would put the manager of a collective investment account in competition with investors for ownership of interests in the account because the manager would wish to obtain the entire 10% for himself or herself. Further, the commenters stated that the revised approach would create an incentive for portfolio managers to cash out investors in their funds and manage their own money separately. Finally, the commenters argued that the NASD did not offer any public policy rationale or cite any instances of actual abuse that would support this revision.

In Amendment No. 5, the NASD declined to revise the *de minimis* exemption and the proposed treatment of portfolio managers in the manner suggested by the three commenters. The NASD believes that giving portfolio managers unrestricted access to new issues—if only through the funds that they manage—is inconsistent with the purposes of the proposed rule. The NASD stated that portfolio managers are in a position to direct substantial business to members and accordingly may seek to use this influence to obtain access to IPOs. The Interpretation,

[26] *See* NASD IM–2110–1(b)(5).

[27] *See* Mayor Day 2; MFA; Washington 2.

[28] *See* Cadwalader; MSDW; Ropes; Schulte; Sidley.

[29] *See* Cadwalader 2; Fried; Mayor; Ropes.

[30] *See* Cadwalader; Katten; Northern Trust; Schulte; Sullivan; Washington; Willkie.

[31] In any event, a portfolio manager would still be prohibited from purchasing new issues through a personal account.

[32] *See* Mayor 2.

[33] In Amendment No. 2, the NASD also proposed a requirement that no restricted person who had an interest in a collective investment account could receive through that account more than 100 shares of any new issue on a notional *pro rata* basis. This limit was designed to reduce the incentive for self-dealing and the appearance that restricted persons were receiving shares at the expense of public investors. However, in Amendment No. 4, the NASD eliminated the 100-share limitation to simplify application of the proposed rule. Thus, member firms would not need to track the interest of the largest restricted person or to perform calculations to determine on an offering-by-offering basis whether that person would receive more than 100 shares on a notional *pro rata* basis.

[34] *See* Katten; Rosenman; Schulte.

[35] *See* MFA 2; Sidley 2; Willkie 3; Willkie 4.

[36] Sidley 2.

recognizing this potential conflict, seeks to limit purchases of IPOs by these persons by treating them as ''conditionally restricted.'' Proposed NASD Rule 2790, in turn, seeks to limit IPO purchases by portfolio managers by treating them as restricted persons, subject to the 10% *de minimis* exemption. Furthermore, the NASD does not believe that the proposed rule would cause portfolio managers to cash out other investors in their funds and to manage their own money separately. The NASD expects that the fees received by portfolio managers for managing money far exceed the profits that they receive from greater participation in IPOs.

Finally, two commenters [37] asked whether the establishment of the *de minimis* exemption would eliminate carve-outs, which are contemplated by the Interpretation.[38] Such carve-out procedures allow a manager of an account who wishes to purchase IPOs for such account to segregate the interests of restricted persons from non-restricted persons. The NASD responded that carve-outs would continue to be available. Therefore, a collective investment account in which restricted persons held an interest of 10% or greater could continue to invest in new issues, provided that such restricted persons received no more than 10% of the notional *pro rata* proceeds of the new issue. Therefore, the NASD believes that the proposed rule would not prevent portfolio managers from continuing to pool their money and sharing the same investment risks with respect to every type of asset—except new issues.

In administering the procedures in the Interpretation, the NASD has recognized that accounts may employ a variety of methods to carve out the interests of restricted persons and that specifying a particular method could exclude other equally effective methods. The NASD has concluded, therefore, that the proposed rule should not prescribe a particular manner for carving out the interests of restricted persons. However, in Amendment No. 5 the NASD represented that it intends to offer detailed guidance concerning the use of carve-out accounts in a Notice to Members to be published after approval of the proposed rule change.

5. Preconditions for Sale

Under the proposed rule, a member would not be permitted to sell a new issue to an account until the member had met the rule's preconditions for sale. Paragraph (b) of the proposed rule would require a member to obtain a representation from the account holder(s), or a person authorized to represent the beneficial owner(s) of the account, that the account is eligible to purchase new issues in compliance with the rule. If an interest in the account were held by a bank, foreign bank, broker-dealer, investment adviser, or other conduit, the member would be required to obtain from that conduit a representation that all purchases of new issues would be in compliance with the rule.[39] Paragraph (b) also would provide that a member may not rely on a representation that it believes, or has reason to believe, is inaccurate. Furthermore, the member would be required to retain a copy of all records and information relating to whether an account is eligible to purchase new issues for at least three years following the member's last sale of a new issue to that account. Finally, paragraph (b) would require the member to obtain these representations within the 12 months prior to a sale of new issues to the account.[40]

Several commenters had reservations about the proposed preconditions for sale provisions.[41] One of these commenters believed that these provisions would impose significant and unnecessary administrative burdens on members, especially those that distribute shares to a large number of retail customers.[42] Another commenter feared that these provisions would require an annual mailing to all customers who might be interested in purchasing new issues and would prohibit the use of electronic communications.[43] These two commenters 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. A third commenter urged that NASD members be permitted to continue to qualify accounts orally and to maintain records of these oral representations.[44] Finally, various commenters suggested lengthening the verification period or allowing members to rely on ''negative consents.''[45]

In Amendment No. 5, the NASD reiterated that the initial verification of a person's status under the proposed rule must be a positive affirmation of non-restricted status, but that it intends to permit annual verification of a person's status to be conducted though the use of negative consents. The NASD noted that the Commission's new books and records rules allow a firm to furnish a customer with account information and ask that he or she verify that the information is correct. The NASD believes, therefore, that similar disclosure, confirming that an person is not a restricted person, would be appropriate. The NASD also would allow the use of electronic communications for eligible customers but, consistent with the Rule 17a-3 under the Act,[46] a member would not be permitted to verify customer account information orally.

Certain commenters questioned how the documentation requirement would apply given the possibility that a customer's status or percentage of ownership in an account may change over the course of a year.[47] One commenter stated that a member should not be in violation of the proposed rule if the member were unaware that an account is beneficially owned by a restricted person due to false information provided by the customer.[48] In response, the NASD revised paragraph (b) expressly to provide that a member may rely upon the information it receives from a customer unless it believes, or has reason to believe, that the information is inaccurate. Another commenter recommended that the proposed rule expressly state that a member may rely upon representations made by a person who the member ''reasonably believes'' is authorized to represent the beneficial owners of the account.[49] In Amendment

[37] *See* MFA 2; MFA 3; Sidley.

[38] *See* NASD IM–2110–1(g).

[39] One commenter expressed concern that the proposed rule, in the form presented in Amendment No. 2, would not adequately address sales to intermediaries such as domestic banks, foreign banks, broker-dealers, investment advisers, and other conduits that purchase new issues on behalf of their customers. *See* Sullivan 2. In response to these concerns, the NASD expanded the preconditions for sale provisions to address such conduits, as described above.

[40] The existing preconditions for sale provisions are scattered throughout the Interpretation. *See* NASD IM–2110–1(b)(2), (b)(5), (b)(7), and (f). The proposed rule change would revise and consolidate these various provisions into a single paragraph of the new rule.

[41] *See* Cadwalader; MSDW; Schwab; SIA.

[42] *See* Schwab.

[43] *See* MSDW.

[44] *See* SIA.

[45] Under a negative consent procedure, a broker-dealer member would send notices to its customers asking if there had been a change in their restricted status, and the broker-dealer would be permitted to rely on its existing information regarding a particular customer unless the customer affirmatively replied that his or her status had changed. *See* MSDW; MSDW 2; SIA; Sullivan.

[46] 17 CFR 240.17a-3.

[47] *See* Cadwalader; NASAA (suggesting a verification period significantly shorter than one year to reflect possible changes in ownership that could occur within that period); Ropes.

[48] *See* Schwab.

[49] *See* Fried.

No. 5, the NASD stated that members should use an appropriate level of diligence to determine whether an individual is authorized to represent the beneficial owners of the accounts, and that it is unnecessary to include the language suggested by this commenter.

Several commenters sought guidance on what type of information a member would be required to review to ascertain whether an account is beneficially owned by restricted persons, especially in the context of a fund-of-funds.[50] For example, one commenter urged the NASD to eliminate the need to ''look through'' multiple layers of investors to determine whether restricted persons are somewhere in the chain of ownership.[51] In Amendment No. 5, the NASD explained that a person authorized to represent the beneficial owners of the master fund (*i.e.*, the fund that purchases the new issues from the member directly) is required to represent that the fund is able to purchase new issues. The NASD expects that any such person, in making such representation, would ascertain the status of investors in the feeder funds (*i.e.*, funds that invest in the master fund). If the representative of the master fund is unable to ascertain the status of investors in a feeder fund, the master fund must deem such feeder fund to be restricted and ensure that the profits from new issues are not allocated to that fund (or consider whether any other exemption, such as the *de minimis* exemption, might apply to that feeder fund). Also in Amendment No. 5, the NASD stated that it would address this matter further in a Notice to Members following Commission approval of the proposed rule change.

B. Other Aspects of NASD Rule 2790

1. Securities Excluded From the Rule

a. *Securities Issued as Part of a Secondary Offering.* The proposed rule would not apply to secondary offerings, although the proposed rule does not contain a specific exemption for them. The exemption is implicit in the definition of ''new issue,'' which includes any *initial* public offering of an equity security.

The NASD initially proposed to subject a secondary offering to the new rule if it were ''hot'' (*i.e.*, it traded at a 5% premium). Allowing secondary issues to be considered hot issues would represent a reversal of the position taken by the NASD under the Interpretation,[52] and several commenters criticized this aspect of the original proposal.[53] These commenters questioned why the proposed rule should apply to secondary offerings if the NASD believed that most secondary offerings do not trade at a premium.[54] They also stated that, without a clear exemption for secondary issues, member firms generally would bar allocations of all secondary offerings to restricted persons out of concern that they could become hot.

With the decision to apply the proposed rule to new issues rather than hot issues, secondary offerings would not be subject to the rule. The NASD continues to believe that secondary offerings rarely if ever trade at a significant premium to the public offering price and agrees with the commenters that the negative consequences of applying the rule to secondary offerings would outweigh any benefits.

b. *Debt Securities.* Another significant difference between the proposed rule and the Interpretation is the treatment of debt securities. Originally, the Interpretation applied to equity and debt securities. However, as part of the 1998 amendments, the NASD exempted from the Interpretation most types of investment-grade debt and investment-grade asset-backed securities from the definition of ''hot issue.'' [55] The NASD is now going one step further and proposing to eliminate application of the rule to all debt securities, including those that are not investment-grade.[56]

One commenter recommended that the definition of ''new issue'' exclude offerings of securities of closed-end funds that invest solely in debt securities.[57] The commenter reasoned that, if offerings of debt securities were excluded, offerings of funds that invest solely in debt securities also should be excluded. In Amendment No. 4, the NASD stated that offerings of such funds would be exempt from the proposed rule pursuant to the exemption for offerings of securities of investment companies registered under the Investment Company Act of 1940.[58]

c. *Other Securities Exempt From NASD Rule 2790.* Paragraph (i)(10)(A) of the proposed rule would exclude from the definition of ''new issue'' offerings of securities that are restricted under various provisions of the Securities Act of 1933 [59] and the Securities Exchange Act of 1934.[60] Paragraph (i)(10)(B) would exclude offerings of ''exempt securities,'' as defined in Section 3(a)(12) of the Securities Exchange Act of 1934.[61]

Paragraph (i)(10)(C) would exclude from the definition of ''new issue'' offerings of securities of a commodity pool operated by a commodity pool operator, as defined in Section 1a(5) of the Commodity Exchange Act.[62] The original proposal did not contain such an exemption. Two commenters argued that offerings of securities of commodity pools should be excluded from the definition of ''new issue.''[63] The commenters noted that commodity pool securities, whether offered publicly or privately, generally do not trade in the secondary market, and that investors may redeem their interests from the issuer at net asset value at selected intervals, much like open-end mutual funds, which are exempt from the proposed rule. In addition, they stated that the offering process is similar to that for registered closed-end funds in that the commodity pool operator is generally seeking as large an infusion of capital as possible and that such offerings are rarely oversubscribed. In Amendment No. 3, the NASD agreed and added a new paragraph (C) to paragraph (i)(10) of the proposed rule.

Three commenters recommended that the term ''new issue'' not include rights offerings to existing shareholders, exchange offers, and offerings made pursuant to a merger or acquisition.[64]

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[50] *See* Cadwalader; Katten; Rosenman; Schulte; Sullivan.

[51] *See* Cadwalader.

[52] In 1998, the NASD amended the Interpretation to exempt secondary offerings of actively traded securities, based on its findings that few secondary offerings traded at a premium, and where there was a premium, it was generally very small. *See* Securities Exchange Act Release No. 40001 (May 18, 1998), 63 FR 28535, 28537 (May 26, 1998) (approving SR–NASD–97–95) (''1998 amendments'').

[53] *See* MSDW; Schwab; SIA; Sidley; Sullivan.

[54] *See*, *e.g.*, Schwab (''the remote possibility that an issue could trade at a premium would cause many member firms to prohibit allocations of any secondary issues to restricted customer accounts. As a practical matter, the Rule would exclude broad categories of investors from participating in secondary offerings. The negative consequences to both issuers and customers of such a broad exclusion outweigh any remote benefits associated with secondary offerings in the scope of the Rule'').

[55] *See* 1998 amendments, 63 FR at 28537.

[56] In Amendment No. 5, the NASD acknowledged that, under certain circumstances, the trading characteristics of junk debt more closely resemble that of the issuer's equity securities rather than its debt securities. However, the NASD believes that, for purposes of the new rule, the point in time at which the pricing and trading characteristics of a security are relevant are at the time of offering. The NASD continues to believe that, at the time of an offering, even junk debt will trade based primarily on interest rates and the creditworthiness of the issuer and, therefore, that the junk debt should not be treated in the same manner as equity securities under the proposed rule.

[57] *See* Schwab.

[58] *See infra* notes 70–72 and accompanying text.

[59] 15 U.S.C. 77a *et seq.*

[60] 15 U.S.C. 78a *et seq.*

[61] 15 U.S.C. 78c(a)(12).

[62] 7 U.S.C. 1a(5).

[63] *See* MFA; Cadwalader.

[64] *See* MSDW; SIA; Sullivan.

The NASD agreed, and this revision is reflected in paragraph (i)(10)(D) of the proposed rule.

Paragraph (i)(10)(E) would exclude offerings of investment-grade asset-backed securities from the definition of ''new issue.'' This provision would preserve an exemption in the Interpretation for financing-instrument-backed securities that are rated investment-grade.[65] In Amendment No. 5, the NASD explained that a separate exclusion for asset-backed securities was necessary even though the proposed rule already contains an exclusion for debt securities; certain types of asset-based securities may be considered equity rather than debt and therefore might not be covered by the proposed rule's implicit exemption for debt securities.

Paragraph (i)(10)(F) would exclude offerings of convertible securities. Under the literal terms of the Interpretation, debt securities that are convertible into common or preferred stock may be hot issues.[66] The NASD staff has exercised its exemptive authority[67] to exclude many convertible securities from the Interpretation. The NASD has now proposed to codify this exemption in the proposed rule.[68]

Paragraph (i)(10)(G) would exclude offerings of preferred securities. The NASD has stated that, in connection with the 1998 amendments, it considered—but deferred—an exemption for preferred securities.[69] However, the NASD is now proposing to exempt preferred securities because it believes, on balance, that these securities exhibit pricing and trading behavior more closely resembling that of debt rather than equity securities and, thus, should not be considered ''new issues.''

Paragraph (i)(10)(H) would exclude offerings of securities of an investment company registered under the Investment Company Act of 1940.[70] The NASD initially proposed to exclude only the securities of closed-end investment companies, as defined in Section 5(a)(2) of the Investment Company Act.[71] The NASD believes that these securities typically commence trading at the public offering price with little potential for trading at a premium because the fund's assets at the time of the offering are the capital it has previously raised. The NASD concluded, therefore, that deeming the securities of closed-end funds to be new issues would do little to further the purposes of the proposed rule. One commenter agreed with the NASD's decision to exempt offerings of securities of closed-end investment companies but questioned why the exemption did not extend to any type of investment company registered under the Investment Company Act of 1940.[72] The NASD agreed and revised paragraph (i)(10)(H) accordingly.

Paragraph (i)(10)(I) would exclude an offering of securities (in ordinary share form or American Depository Receipts (''ADRs'') registered on Form F–6) that have a pre-existing market outside the United States. One commenter suggested that the proposed rule should exclude an offering of securities of which the initial public offering price is based primarily on ''exogenous or market factors (such as, a rating by a nationally recognized statistical rating organization or the market price for a related security).''[73] The NASD believes that this suggestion is too broad. However, in the case of an ADR, the NASD agrees that application of the proposed rule is not necessary because the price of the offering will be constrained by the price of the shares in the underlying foreign market. Therefore, in Amendment No. 5, the NASD added new paragraph (i)(10)(I) to the proposed rule. The NASD notes that this exemption would apply only to initial offerings of ADRs that are not part of a global initial public offering.

d. *Miscellaneous Issues Regarding Scope of Term ''New Issue''.* One commenter[74] recommended that the definition of ''new issue'' expressly exempt offerings of securities made pursuant to Regulation S[75] under the Securities Act of 1933. The NASD does not believe that this commenter sufficiently demonstrated that this exemption would be consistent with the purposes of the proposed rule and has determined not to adopt it.

In Amendment No. 2, the definition of ''new issue'' proposed by the NASD included ''other securities distributions of any kind whatsoever, including securities that are specifically directed by the issuer on a non-underwritten basis.'' Several commenters noted that this language was surplusage and potentially misleading.[76] The NASD agreed and deleted this language from the definition.

One commenter recommended that the definition of ''new issue'' exclude any offering of securities for which, at the time of the offering, an organized trading market is not expected to develop.[77] In Amendment No. 5, the NASD responded that it was not necessary to draft a general exemption in the rule, and that offerings of this type might be candidates for specific exemptions granted by the NASD staff pursuant to their authority under paragraph (h) of the proposed rule.[78]

The same commenter[79] argued that the term ''initial public offering'' used in the definition of ''new issue'' should be construed to exclude any offering of securities made on a continuous basis (such as under a ''shelf'' registration statement pursuant to Rule 415 of Regulation C under the Securities Act of 1933[80]). In Amendment No. 5, the NASD agreed that such an offering would not be part of an ''initial public offering'' unless it were the first registered offering of the company's stock.

2. Restricted Persons

Paragraph (a)(1) of proposed NASD Rule 2790 would stipulate that a member or associated person thereof may not sell a new issue to any account in which a restricted person has a beneficial interest, unless such sale qualifies for an enumerated exemption. The scope of the term ''restricted person'' is discussed below.

a. *Broker-Dealers and Their Personnel.* Paragraph (i)(11)(A) of the proposed rule would define ''restricted person'' to include NASD members and other broker-dealers. Paragraph (i)(11)(B)(i) would extend the definition of ''restricted person'' to include any officer, director, general partner, associated person, or employee of a member or any other broker-dealer. Paragraph (i)(10)(B)(ii) would provide that agents of a broker-dealer are not considered restricted persons unless they are engaged in the investment banking or securities business.

[65] *See* NASD IM–2110–1(*l*)(1).

[66] *See id.*

[67] *See* NASD IM–2110–1(a)(5).

[68] One commenter recommended that the proposed rule not apply to debt securities that are convertible into ''actively traded'' equity securities. *See* MSDW. The NASD believes that, in view of the decision to exclude all secondary offerings, all convertible securities, not just those that are convertible into ''actively traded'' securities, should be excluded.

[69] *See* 1998 amendments, 63 FR at 28537.

[70] 15 U.S.C. 80a–1 *et seq.*

[71] 15 U.S.C. 80a–5(a)(2).

[72] *See* Cadwalader 2.

[73] Sidley 2.

[74] *See* Sullivan 2.

[75] 17 CFR 230.901 *et seq.*

[76] *See* MSDW 2 (arguing that non-underwritten securities should not be covered by the proposed rule since, by definition, NASD members would not be involved in the offering); Sullivan 2 (noting that this language would have the effect of including secondary offerings in the rule, even though the NASD's stated intent was to exempt secondary offerings); Willkie 2.

[77] *See* Sidley 2.

[78] *But see infra* note and accompanying text.

[79] *See id.*

[80] 17 CFR 230.415.

b. *Limited Business Broker-Dealers.* Paragraph (i)(11)(B) specifically would exclude from the definition of ''restricted person'' the personnel and agents of a ''limited business broker-dealer.'' Paragraph (i)(8) would define ''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. These provisions of the proposed rule would preserve an exemption for associated persons of a limited business broker-dealer under the Interpretation.[81] The NASD has emphasized, however, that this exemption would apply *only* to persons associated with such a limited business broker-dealer, not to the limited business broker-dealer itself.

Several commenters argued that the proposed definition of ''limited business broker-dealer'' is too narrow and should be expanded to include broker-dealers that do not have any involvement in the capital formation or equity underwriting business.[82] The NASD has determined, however, not to broaden the scope of this exemption. The NASD believes that even broker-dealers engaged solely in, for example, proprietary trading or merchant banking activities (or the associated persons of such firms) might enter into reciprocal arrangements with other members that could create improprieties that the proposed rule seeks to address. In addition, the NASD believes that a rule requiring members to determine whether a person is engaged in reciprocal arrangements with a broker-dealer would be difficult to administer and enforce and would eliminate the certainty sought by the proposed rule.

One commenter, the Chicago Board Options Exchange (''CBOE''), urged the NASD to revise the proposal to treat CBOE market makers and floor brokers as limited business broker-dealers. CBOE stated that these exchange members should not be considered ''industry insiders'' as they are not in a position to take advantage of their position to participate in IPOs for their own accounts at the expense of public customers. CBOE maintained, therefore, that treating these CBOE members as restricted persons would be unnecessary to accomplish the stated purposes of the rule. CBOE also argued that the proposal would put CBOE members at a competitive disadvantage relative to members of the futures exchanges: Although many futures products are economically similar to options, futures exchange members who trade them would not be restricted persons under the new rule. CBOE suggested alternate rule text that would allow a CBOE member to purchase new issues unless the underwriter of the IPO were an NASD member that executed stock transactions on behalf of the CBOE member.

In response to CBOE's comment, the NASD stated in Amendment No. 2 that the proposed rule should apply generally to all broker-dealers and their associated persons. The NASD believes that a rule requiring analysis of the activities of a particular broker-dealer would be more difficult rule to administer and enforce than a rule based on a firm's authorizations. The NASD recognizes that the Interpretation and the proposed rule make an exception for associated persons and owners of a broker-dealer that engages solely in the purchase and sale of investment company/variable contract securities and direct participation program securities. However, the NASD does not believe that the existence of this exemption for ''limited business broker-dealers'' necessitates additional exemptions.

With respect to the competitive issue between CBOE members and members of futures exchanges that trade financial derivatives, the NASD has acknowledged that futures exchange members would not—solely because of their status as such—be restricted persons under the proposed rule. However, the NASD believes that many futures exchange members would be subject to the proposed rule because of changes to the federal securities laws made by the Commodity Futures Modernization Act of 2000 (''CFMA'').[83] A futures exchange member that wishes to trade security futures products must register as a broker-dealer pursuant to Section 15(b)(11) of the Act, as amended by the CFMA.[84] In Amendment No. 5, the NASD clarified that the proposed rule would treat such futures exchange members the same as ''conventional'' broker-dealers.[85]

Finally, one commenter[86] recommended that the proposed rule include a provision that would allow an NASD member, in determining whether a firm is a limited business broker-dealer, to rely on the information contained in that firm's Form BD.[87] In completing the Form BD, a broker-dealer must list all lines of business that account for 1% or more of its annual revenue. In the initial proposal, the NASD stated that a member ''should look to the Form BD as well as any Restrictive Agreement'' to determine the activities of a broker-dealer. Upon further review, the NASD clarified in Amendment No. 3 that a member *may* look to the Form BD as evidence of a firm's status, but *must* inquire further about whether the firm meets the conditions of a limited business broker-dealer.

c. *Finders and Fiduciaries.* Paragraph (i)(11)(C) of the proposed rule would preserve a provision in the Interpretation that treats finders and fiduciaries of the managing underwriter as restricted persons. The NASD believes that finders and fiduciaries are industry insiders and, therefore, should be subject to the new rule. The NASD believes, moreover, that issuers must be prevented from circumventing the underwriting compensation limits of existing NASD Rule 2710 by offering finders or fiduciaries access to a new issue.[88] However, the NASD has proposed to treat finders and fiduciaries as restricted persons only for those offerings for which they are acting in those capacities. The NASD has added that, in the case of a law firm or consulting firm, the restriction would apply only to those persons working on the particular offering.

d. *Portfolio Managers.* The Interpretation prohibits the sale of hot issues ''to any senior officer of a bank, savings and loan institution, insurance company, investment company, investment advisory firm or any other institutional type account.''[89] These persons are restricted because their position allows them the opportunity to direct business to a member firm.

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[81] *See* NASD IM–2110–1(c).

[82] *See* Colish (suggesting that the definition of ''limited business broker-dealer'' also include broker-dealers that engage only in private placements); Fried (arguing that no broker-dealer should be a restricted person without some nexus to equity IPOs); Washington (suggesting that only broker-dealers that engage in an equity securities business should be restricted).

[83] Pub. L. No. 106–554, Appendix E, 114 Stat. 2763. The CFMA removed the prohibition on single-stock futures and set forth a regulatory scheme whereby entities that trade single-stock futures and other security futures products must register with both the Commission (under the Securities Exchange Act) and the Commodity Futures Trading Commission (under the Commodity Exchange Act).

[84] 15 U.S.C. 78o(b)(11).

[85] CBOE also recommended that members of that exchange who lease their seats and who are not engaged in a securities business not be considered restricted persons. In this matter, the NASD agreed and stated in Amendment No. 5 that it would not treat such persons as restricted persons under the new rule.

[86] *See* Fried 2.

[87] 17 CFR 249.501.

[88] NASD Rule 2710 defines the term ''underwriter and related persons'' to include ''financial consultants'' and ''finders.''

[89] NASD IM–2110–1(b)(4).

However, the NASD does not believe that all senior officers and employees of a securities department of one of these entities need be restricted. Therefore, the NASD devised a function-oriented approach that, in its original form, would have treated as a restricted person ''[a]ny employee or other person who supervises, or whose activities directly or indirectly involve or are related to, the buying or selling of securities'' for one of the listed entities.

In response to the original proposal, three commenters stated that they supported the functional approach but believed that the proposed rule language was too broad and could reach persons whose functions were purely ministerial.[90] These commenters suggested that only to persons who have authority to make investment decisions should be restricted. The NASD agreed and revised the proposed rule text accordingly in Amendment No. 2.[91] Accordingly, paragraph (i)(11)(D)(i) of the proposed rule would define a portfolio manager as 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.

One commenter sought clarification on whether an investment advisor organized as a non-natural person would be deemed a restricted person.[92] This commenter stated that the proposed rule treats certain employees of an investment advisor as restricted persons but is not clear whether the investment advisor itself is a restricted person. In Amendment No. 5, the NASD observed that the definition of ''portfolio manager'' in paragraph (i)(1)(D)(i) encompasses non-natural persons. Thus, an entity organized as an investment advisor that has authority to buy and sell securities for any of the entities enumerated above would be a portfolio manager for the purposes of the proposed rule and, as such, a restricted person.

Another commenter recommended excluding from the definition of ''portfolio manager'' a hedge fund manager of a fund with less than $200 million in assets.[93] The NASD believes that the reasons for treating hedge fund managers as restricted persons are not limited by the size of the assets under management, especially with amounts as significant as those proposed by the commenter. Therefore, the NASD declined to accept this recommendation.

Finally, one commenter requested that the proposed rule include an exemption for persons who, on a volunteer basis, make investment decisions on behalf of a tax-exempt charitable organization.[94] The NASD believes that the purposes of the rule may be implicated by persons who manage such organizations. The NASD, therefore, declined to accept this suggestion.

e. *Owners of Broker-Dealers.* In the view of the NASD, a prohibition on new issue purchases by a broker-dealer could be circumvented if the broker-dealer's owners were permitted to purchase the new issue. Therefore, the NASD has proposed to deem owners of a broker-dealer as restricted persons as well.

Under the original proposal, the term ''restricted person'' included any natural person (or member of the person's immediate family) who owned 10% or more, or contributed 10% or more of the capital, of a broker-dealer. Many of the commenters believed that this restriction was too broad and would be overly burdensome.[95] In Amendment No. 2, the NASD adopted a new approach that bases ownership of a broker-dealer for purposes of the rule on whether the broker-dealer must report the ownership interest on Form BD. The NASD favors this approach because it would not have to create new concepts of ownership for purposes of the rule: The Form BD reporting requirements are well understood by NASD members, who already maintain such information.

One commenter criticized this approach on the grounds that persons who might in fact have very little voting power or beneficial interest in the broker-dealer would be treated as restricted persons, which would not further the purposes of the rule.[96] A person must be reported on Form BD if it holds a designated percentage of ''a class of voting security'' of the reporting broker-dealer. The commenter noted that, depending on the broker-dealer's capital structure, a particular class of voting security might represent only a small portion of the firm's capital. Nevertheless, a person owning 10% or more of that class would be a restricted person under the proposed rule. The commenter recommended that the ownership interests reported in Schedules A and B of Form BD should be multiplied so that only the actual economic interest would be used to determine whether the person is restricted.

The NASD has determined not to accept the commenter's suggestion. In Amendment No. 4, the NASD stated that it seeks to aid members' compliance efforts by eliminating the need to perform calculations in determining ownership interests in a broker-dealer. In its experience, such calculations are often difficult and frequently raise interpretive issues with various ownership structures. The NASD deliberately sought to eliminate that level of complexity by referencing persons listed on Schedules A and B, noting that there are no special codes or identifiers on Schedule B to identify persons with only a small economic interest.

The same commenter also suggested an exemption from the proposed definition of ''restricted person'' for an entity disclosed on Schedule A or B of Form BD that is listed on a foreign exchange. Pursuant to Form BD, a broker-dealer must report entities that have interests at every level of its ownership structure that exceed designated percentages. However, once a public reporting company is reached, no ownership information further up the chain need be given.[97] Only those public reporting companies that are subject to Sections 12 or 15(d) of the Act[98] may avail themselves of this exclusion. The NASD has proposed to follow the Form BD in this regard; thus, a foreign entity with an ownership interest in a broker-dealer would not be a restricted person if that foreign entity were subject to Sections 12 or 15(d) of the Act.[99]

The general restriction on owners of a broker-dealer would not extend to owners of a limited business broker-dealer. One commenter recommended that, because *associated persons* of a limited business broker-dealer were not restricted, the *owners* of a limited business broker-dealer also should not be restricted.[100] The NASD agreed and revised the proposed rule text accordingly.

f. *Affiliates of Broker-Dealers.* The proposed rule would treat as restricted persons not only owners of a broker-dealer, but also affiliates of the broker-

[90] *See* Ropes; Schwab; Testa.

[91] However, one commenter suggested that a portfolio manager should be restricted based on whether this person ''exercises'' authority to make investment decisions, not whether such person is ''authorized'' to make investment decisions. See Fried. The NASD believes that the alternative standard proposed by this commenter is too narrow and has not made this change.

[92] *See* Katten.

[93] *See* Washington.

[94] *See* Schwab.

[95] *See* Colish; Orrick; SIA; Sidley; Willkie.

[96] *See* Fried 2.

[97] *See* Form BD, Schedule B, Instruction 3.

[98] 15 U.S.C. 78*l* and 78o.

[99] A foreign entity also might be eligible to purchase new issues pursuant to the proposed rule's exemption for publicly traded entities. *See infra* notes—and accompanying text.

[100] *See* Willkie 2.

dealer. While such affiliates would not specifically be included in the definition of ''restricted person,'' paragraph (a)(1) of the proposed rule would provide that a member may not sell a new issue to any account in which a restricted person (such as an owner of a broker-dealer) ''has a beneficial interest.'' The NASD has stated that an owner of a broker-dealer—whom the proposed rule would explicitly deem a restricted person ''would be viewed as having a beneficial interest in an account held by a subsidiary (*i.e.*, a sister company of the broker-dealer).

Several commenters stated that applying the proposed rule to affiliates has no policy justification.[101] These commenters were concerned, in part, that many financial services firms, which currently may invest in hot issues under the Interpretation, would be prohibited from purchasing new issues under the proposed rule simply by the accident of having become affiliated with an NASD member firm in the wake of the Gramm-Leach-Bliley Act,[102] which repealed many restrictions on affiliation among banks, insurance companies, and securities firms.

The NASD believes, nevertheless, that broker-dealer affiliates should be restricted persons. The NASD contends that, if the rule failed to restrict an account in which a restricted person had a beneficial interest, the restricted person could evade the restriction by directing a subsidiary to purchase the new issue instead. However, to offer some relief to entities that could be affected by the restriction on broker-dealer affiliates, the NASD is establishing an exemption for any such affiliate (except another broker-dealer) that is publicly traded.[103]

g. *Family Members.* The proposed rule would restrict various persons based on their functions in the financial services industry. In addition, paragraph (i)(11)(D)(ii) would restrict certain other persons based on their relationship with persons who work in the financial services industry. The NASD believes that these collateral restrictions are necessary to prevent a ''functionally'' restricted person from circumventing the rule by purchasing new issues through the account of an immediate family member. Paragraph (i)(5) would define ''immediate family member'' to include a person's parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children, and any other individual to whom the person provides ''material support.'' This provision is based on a provision in the Interpretation[104] but supplements the existing provision by adding a definition of ''material support'' in paragraph (i)(9): the direct or indirect provision of more than 25% of a person's income in the prior calendar year. Paragraph (i)(9) of the new rule would deem members of the immediate family living in the same household to be providing each other with material support.

The NASD originally proposed that ''material support'' would mean providing 10% of another's income. One commenter supported the addition of a bright-line definition of ''material support'' but recommended that the threshold be raised to 25%, as measured in the prior calendar year.[105] The NASD agreed and revised the proposed rule text accordingly. Another commenter argued that the definition of ''material support'' was over-inclusive, as it was not necessarily based on the economic reality of the situation.[106] The NASD believes, however, that the ''material support'' provisions as proposed are a reasonable means to prevent evasion of the rule, and that, without clear and straightforward standards for collateral restrictions on family members, the rule would become difficult to administer. The NASD stated in Amendment No. 2 that it will not evaluate ''material support'' issues on a case-by-case basis.

In addition, the proposed rule would modify the treatment of sales to members of the immediate family of an officer, director, general partner, employee, or agent of a member or other broker-dealer (collectively referred to as ''associated persons''). Under the Interpretation, members of the immediate family of an associated person may not purchase hot issues from the firm employing the associated person.[107] The proposed rule would expand this prohibition to include affiliates of the firm employing the associated person. The NASD believes that this change is necessary to clarify that immediate family members of associated persons may use neither traditional nor online distribution channels to circumvent the prohibitions on sales to them.

Finally, two commenters pointed out that the original proposal appeared to have instances of faulty drafting where family members should have been exempt from the proposed rule but were not.[108] The NASD agreed with these comments and revised the proposed rule text accordingly.

h. *Investment Clubs and Family Investment Vehicles.* Two commenters urged that the proposed rule not prohibit their investment clubs from purchasing IPOs.[109] In response, the NASD in Amendment No. 4 revised the definition of ''collective investment account'' in paragraph (i)(2) of the proposed rule to exclude ''investment clubs'' (as defined in paragraph (i)(6)) and ''family investment vehicles'' (as defined in paragraph (i)(4)). Therefore, a person who has authority to buy or sell securities on behalf of an investment club or a family investment vehicle would not be a portfolio manager under paragraph (i)(10)(D)(i) and, therefore, not be a restricted person on that basis. In addition, even if an investment club or family investment vehicle included persons who were otherwise restricted (*e.g.*, because they were associated persons of a broker-dealer), such entity could still purchase new issues if it qualified for the *de minimis* exemption of paragraph (c)(4).[110]

Finally, one commenter recommended that the definition of ''family investment vehicle'' be expanded to include long-term family employees.[111] In Amendment No. 5, the NASD stated that the commenter had not presented sufficient reason to exclude such persons and declined to make this change. Moreover, the NASD believes that permitting non-family persons into the exemption for family investment vehicles could open the exemption to abuse.

i. *Joint Back Office Broker-Dealers.* Certain hedge funds, or subsidiaries thereof, have opted to become registered broker-dealers. These entities are generally known as ''joint back office broker-dealers'' (''JBOs'') because they share a back office with another registered broker-dealer. Under the Interpretation, hedge funds that are (or are affiliated with) JBOs are not, solely on such basis, precluded from

[101] *See* MSDW; Orrick; Rosenman; SIA; Sullivan; Willkie.

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

[103] *See* infra notes 127–136 and accompanying text.

[104] *See* NASD IM–2110–1(*l*)(2).

[105] *See* Schwab.

[106] *See* Fried 2 (hypothesizing that two cousins sharing an apartment would be deemed to materially support each other under the proposed rule, even though they might not in fact be materially supporting each other).

[107] *See* NASD IM–2110–1(b)(2)(B).

[108] *See* Sullivan; Testa.

[109] *See* Fu; Smith.

[110] One commenter stated that an earlier version of the proposed rule appeared to inadvertently exclude investment clubs and family partnerships from the *de minimis* exemption. *See* Sullivan. The NASD has clarified that such entities may qualify for the *de minimis* exemption.

[111] *See* Cadwalader 2.

purchasing hot issues on behalf of their investors. The special provisions for JBOs arise from an exemption granted by the NASD staff responding to certain provisions of the 1998 amendments to the Interpretation. Those provisions had the effect of precluding hedge funds registered as JBOs (or with JBO subsidiaries) from purchasing hot issues even if investors in the funds were not restricted. The NASD staff determined that sales of hot issues to a hedge fund should be based on the status of the beneficial owners of the fund, not simply the fund's status as a broker-dealer.[112] The proposed rule seeks to codify this exemption.

The NASD continues to believe that the election by an investment fund to become (or be affiliated with) a JBO should not by itself preclude the purchase of new issues by investors in that fund who are not otherwise restricted persons. The original proposal provided that a collective investment account—including a JBO—could avail itself of the *de minimis* exemption and included a definition of ''joint back office broker-dealer.'' In Amendment No. 2, the NASD removed any explicit references to JBOs. The NASD stated that, as a result of its revisions to the definition of ''beneficial interest'' and ''restricted person,'' the conditions that gave rise to the need for the JBO exemption had been removed. By clarifying that ''beneficial ownership'' includes a financial interest, such as the right to share in gains or losses, the NASD believed it had clarified that a JBO's legal ownership of securities would not constitute a ''beneficial interest'' for purposes of the proposed rule. The NASD, therefore, concluded that a specific exemption for JBOs was no longer necessary.

In Amendment No. 4, the NASD restored a specific reference to JBOs in the *de minimis* exemption, now relocated to paragraph (c)(4) of the proposed rule, as well as a definition of ''joint back office broker-dealer'' in then paragraph (i)(7). Two commenters noted problems with the definition.[113] Under the NASD's final proposal, the NASD devised an alternative manner of exempting purchases of new issues by JBOs. New paragraph (a)(4) would provide an exemption for ''purchases by a broker/dealer (or owner of a broker/dealer), organized as a investment partnership, of a new issue at the public offering price, provided such purchases are credited to the capital accounts of its partners in accordance with paragraph (c)(4).'' This exemption would allow an investment partnership (*e.g.*, a hedge fund) that registers as a broker-dealer or that has a broker-dealer subsidiary to purchase new issues on the same terms as other investment partnerships. This approach is consistent with the relief granted in the original exemptive letter. Under Amendment No. 5, a hedge fund that registers as a broker-dealer or that has a broker-dealer subsidiary could purchase new issues so long as the beneficial interests of restricted persons do not exceed in the aggregate 10% of the fund. Accounts that are beneficially owned by restricted persons in excess of the 10% threshold may use carve-out procedures to prevent the restricted persons from receiving more than 10% of the notional *pro rata* proceeds of a new issue.

One commenter argued that an entity that is a non-natural person should be disregarded for the purposes of determining who holds the beneficial interest in an account, and that the rule should look only to natural persons who may hold beneficial interests in that account.[114] This commenter concluded, therefore, that there is no need for a specific exemption for JBOs. In Amendment No. 5, the NASD responded that the commenter was correct that, in determining whether a person is a restricted person, one should ''look through'' to the persons who have the actual beneficial interests in the account's gains and losses. If one can look through until each of the natural persons is reached and, along the way, encounters no beneficial owners who are restricted persons, the account may purchase new issues. However, if the process of looking through reveals a restricted person identified in paragraph (i)(11) of the proposed rule—be it a natural person or a legal person—then the account may be restricted. The next step in the analysis, according to the NASD, is to determine whether the account qualifies for an exemption under paragraph (c) of the rule. For this reason, the NASD provided an exemption for JBOs: In the absence of an exemption, a JBO would be restricted even if it were beneficially owned entirely by non-restricted persons.

The NASD has stated that the exemption for JBOs would not extend to associated persons of a JBO. Three commenters argued that associated persons of a JBO should not, solely by virtue of their association with the JBO, be restricted persons.[115] The NASD explained in Amendment No. 4 that election to become a JBO bestows certain benefits on the investment account, but also imposes certain obligations, including restrictions on the ability of associated persons to purchase new issues. The NASD further explained in Amendment No. 5 that the act of registering a collective investment account as a JBO should not taint the *investors,* who otherwise might not be restricted persons. However, the NASD does not believe that this necessitates excluding *associated persons* of the JBO from the definition of ''restricted person.''

3. General Prohibitions

Paragraph (a)(1) of the proposed rule sets forth the basic prohibition that a member (or an associated person thereof) may not sell a new issue to an account in which a restricted person has a beneficial interest, except as otherwise permitted under the rule. Paragraph (a)(2) would provide that a member (or associated person thereof) may not purchase a new issue in any account in which such member or associated person has a beneficial interest, except as otherwise permitted under the rule. Paragraph (a)(3) would provide that a member may not continue to hold new issues acquired as an underwriter, selling group member, or otherwise, except as otherwise permitted under the rule.

One commenter stated that these provisions could be read to prohibit accommodation sales (*i.e.*, sales to another broker-dealer at the public offering price to enable that broker-dealer's customer to purchase the new issue at the public offering price) as well as purchases by and among members of the selling group while engaged in the distribution of a new issue.[116] The NASD agreed that neither of these outcomes was intended and, in Amendment No. 3, added a new paragraph (a)(4) to the proposed rule to address these concerns. Paragraph (a)(4)(A) would allow sales or purchases from one member of the selling group [117] to another member that are incidental to the distribution of a new issue to a non-restricted person at the public offering price. Paragraph (a)(4)(B) would allow sales or purchases by a broker-dealer of a new issue at the public offering price as an

[112] *See* letter from Gary Goldsholle, NASD, to David Katz, Sidley & Austin, dated January 20, 1999.

[113] *See* Sidley 2; Willkie 3.

[114] *See* Sidley 2.

[115] *See* Rosenman; Sidley 2; Willkie 3.

[116] *See* SIA.

[117] The term ''selling group'' is defined in existing NASD Rule 0120(p). In Amendment No. 4, the NASD replaced the term ''syndicate'' with the term ''selling group.'' The NASD elected to use the more expansive term ''selling group'' because it did not believe that whether a broker-dealer has made a financial commitment to purchase securities in an IPO is relevant for purposes of the rule.

accommodation to a non-restricted person customer of the broker-dealer.

4. General Exemptions

Paragraph (c) states that the proposed rule's general prohibitions would not apply to sales to or purchases from several classes of persons, whether directly or through accounts in which such persons have a beneficial interest.[118] These classes of person are described below.

a. *Investment Companies.* Paragraph (c)(1) of the proposed rule states that sales of new issues to, or purchases by, an investment company registered under the Investment Company Act of 1940 [119] would not be subject to the rule. This provision would preserve an existing exemption in the Interpretation.[120]

b. *Common Trust Funds and Insurance Companies.* Paragraphs (c)(2) and (c)(3) would provide exemptions for sales of new issues to, or purchases by, certain trust funds and insurance company accounts, respectively. To qualify for these exemptions, a trust fund would have to have investments from 1,000 or more accounts, and an insurance account would have to be funded by premiums from 1,000 or more policyholders (or, if a general account, the insurance company would have to have 1,000 or more policyholders).[121] In addition, the fund or insurance account may not limit its participation principally to restricted persons.[122]

Under the original proposal, the exemption for general, separate, or investment accounts of insurance companies would apply only if the account ''has investments from'' 1,000 or more policyholders. One commenter recommended that the proposed rule use the term ''funded by'' policyholders instead of ''has investments from'' policyholders; an insurance company general account generally is owned by the insurance company itself, so the policyholders do not technically invest in or fund the account.[123] The NASD agreed and in Amendment No. 5 revised the proposed rule text accordingly.

One commenter suggested that the NASD delete the proposed requirement that an insurance company account be funded by premiums from 1,000 or more policyholders, reasoning that an account of any size would not pose a problem under the new rule so long as the policyholders were not, principally, restricted persons.[124] In Amendment No. 5, the NASD stated its intent to retain this numerical threshold because it provides further assurance that new issues purchased by an insurance company account are not targeted for restricted persons. The NASD added that, if an insurance company separate account has only a few policyholders (as suggested in the commenter's hypothetical), it would be appropriate for the insurance company to ascertain whether each of the individual policy holders was a restricted person.

The same commenter also recommended that the new rule specifically confirm that the insurance company account exemption is not limited to life insurance companies, but applies ''across all industries.'' [125] In Amendment No. 5, the NASD stated that paragraph (c)(3) of the proposed rule would apply to all types of insurance companies and that amending the exemption to apply ''across all industries'' could create unintended loopholes.

One commenter recommended that the proposed rule include a general exemption for mutual banks, in the same way that it would exempt mutual insurance companies.[126] In Amendment No. 5, the NASD noted that an exemption similar to the one for insurance company accounts is contained in paragraph (c)(2) of the proposed rule for bank common trust funds. The NASD does not, however, believe that the commenter has articulated a sufficient rationale for an exemption for mutual banks.

c. *Publicly Traded Entities.* Paragraph (c)(5) of the proposed rule would provide a general exemption for publicly traded entities (except broker-dealers and certain affiliates thereof) that are listed on a national securities exchange, are traded on the Nasdaq National Market, or are foreign issuers whose securities meet the quantitative designation criteria for listing on a national securities exchange or the Nasdaq National Market. These entities have broad public ownership and their securities may be purchased by any investor. The NASD believes that an exemption for publicly traded entities recognizes the practical limitations in attempting to identify every beneficial owner of a publicly traded entity and that the benefits of investments in new issues are, indirectly, shared by the public shareholders.

The original proposal would have exempted ''[a] publicly traded corporation [127] (other than an affiliate of a broker/dealer) listed on an exchange or The Nasdaq Stock Market, in which no person with a 10% or more ownership interest is a restricted person.'' Three commenters objected to the 10% proviso; they argued that the publicly traded entity exemption should resemble the exemption for registered investment companies and U.S. employee benefit plans in not requiring member firms to ''look through'' an entity to determine whether the beneficial owners were restricted persons.[128] The NASD agreed with these commenters and eliminated the ''look through'' provision.

As originally proposed, the publicly traded entity exemption did not extend to entities listed on a foreign exchange. One commenter stated that limiting the exemption to publicly traded entities listed on U.S. markets would unfairly discriminate against foreign companies.[129] A second commenter recommended an exemption for an initial equity offering in the United States by an issuer whose equity is publicly traded in another country.[130] In Amendment No. 3, the NASD expanded the proposed exemption to permit purchases of new issues by a publicly traded foreign entity so long as that entity meets the quantitative designation criteria for listing on a national securities exchange or the Nasdaq National Market.

The publicly traded entity exemption would not apply to a publicly traded broker-dealer or an affiliate of the broker-dealer where the broker-dealer is authorized to engage in the public offering of new issues either as underwriter or as a selling group member. Although the shareholders of such publicly traded entities would indirectly receive some of the benefit of

[118] Sullivan expressed concern that the general exemptions, in the form proposed in Amendment No. 2, applied only to the persons specified in the proposed rule and did not extend to the *accounts* of such persons. The NASD agreed that the general exemptions should clearly state that they apply to the specified persons as well as to the accounts of such persons, and revised the proposal accordingly.

[119] 15 U.S.C. 80a–1 *et seq.*

[120] *See* NASD IM–2110–1(f)(1).

[121] *See* paragraphs (c)(2)(A) and (c)(3)(A) of proposed NASD Rule 2790.

[122] *See* paragraphs (c)(2)(B) and (c)(3)(B) of proposed NASD Rule 2790.

[123] *See* Mayer Brown.

[124] *See* Sidley 2.

[125] *Id.*

[126] *See* Fried.

[127] One commenter pointed out that the text of the original proposal referred only to publicly traded *corporations* and suggested that the exemption be extended to legal persons other than corporations. *See* Rosenman. The NASD agreed and revised the proposed rule text accordingly.

[128] *See* Colish; Sidley; Sullivan (''because * * * publicly traded corporations are not likely to be used by restricted persons as vehicles for investments in hot issues, NASD members should be spared the administrative burden of confirming the restricted person ownership of customers that are publicly traded corporations'').

[129] *See* Sidley.

[130] *See* Fried 2.

IPO purchases, the NASD does not believe that allowing such purchases would be consistent with the purposes of the rule. The version of the publicly traded entity exemption proposed in Amendment No. 3 could have been construed to permit, for example, the holding company parent of a broker-dealer to purchase new issues, even if the broker-dealer engaged in a significant amount of investment banking business. The NASD stated that this was never the intent of the proposed exemption. Therefore, in Amendment No. 4, the NASD revised the public entity exemption to apply only to publicly traded entities that are not affiliated [131] with a broker-dealer engaged in the public offering of new issues.

The NASD believes that looking to whether a broker-dealer is authorized to engage in public offerings [132] excludes from the publicly traded entity exemption the ''full service'' broker-dealers and their parent companies that the rule is designed to reach. On the other hand, the proposed rule would allow purchases of new issues by the many publicly traded entities that have broker-dealer affiliates established for limited corporate purposes. The NASD believes that looking into whether a broker-dealer affiliate participates in offerings of new issues is one of many possible tests for determining the scope of the publicly traded entity exemption. The NASD stated that it also considered looking at the percent of profits or revenues a parent holding company derives from broker-dealer activities, but concluded that such information is often difficult to determine and frequently varies from year to year.[133]

One commenter argued that purchases by a private company also should be exempt from the proposed rule, if no more than 10% of its shareholders are restricted persons.[134] The NASD responded that a private company may avail itself of the *de minimis* exemption in paragraph (c)(4).

Finally, one commenter [135] pointed out that the Nasdaq Stock Market currently has an application pending with the Commission to become registered as a national securities exchange pursuant to Section 6 of the Act.[136] If that application is approved, securities traded in both the Nasdaq National Market and the Nasdaq SmallCap Market would be deemed to be traded on a national securities exchange. The commenter stated that the distinction set forth in paragraphs (c)(5)(A) and (B) between a security that is ''listed on a national securities exchange'' versus one that is ''traded on the Nasdaq National Market'' could create confusion as to whether securities traded on the Nasdaq SmallCap Market are exempt from the rule. In Amendment No. 5, the NASD stated that the publicly traded entity exemption does not apply to securities traded on the Nasdaq SmallCap Market. In addition, the NASD represented that it would consider amending the publicly traded entity exemption if and when Nasdaq becomes a national securities exchange.

d. *Foreign Investment Companies.* The Interpretation contains a general exemption for foreign investment companies.[137] A ''foreign investment company'' is defined as a fund company organized under the laws of a foreign jurisdiction that has certified that: (1) The fund 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.[138] Paragraph (c)(6) of the proposed rule would preserve this exemption, but reduce from four to two the number of criteria that a foreign fund would be required to meet. Under the proposed rule, the investment company must be listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority, and no person owning more than 5% of the shares of the investment company may be a restricted person.[139] However, as the NASD clarified in Amendment No. 5, a foreign investment company that failed to meet one or both of the criteria for the exemption in paragraph (c)(6) might still qualify for the *de minimis* exemption in paragraph (c)(4).

One commenter [140] suggested exempting any foreign investment company that is traded on a ''designated offshore securities market,'' as defined in Rule 902(b) under the Securities Act.[141] The NASD believes that such an exemption would be too broad and that the definition in Rule 902(b) is not related to the concerns underlying the proposed rule. Moreover, although noting that qualifying as a ''designated offshore securities market'' requires oversight by a governmental or self-regulatory body, the NASD is not confident that such regulation would prevent restricted persons from using foreign investment companies to circumvent the proposed rule. The NASD believes that, because it is difficult to compare foreign investment company laws to those in the United States, particularly as they relate to the purposes of the proposed rule, it is necessary to impose specific conditions on foreign investment companies to qualify for a general exemption.

In a second letter, the same commenter reiterated its recommendation that the proposed rule exempt foreign investment companies that are traded on a ''designated offshore securities market'' because managers of foreign investment companies might be unable to determine whether any 5%

[131] The NASD also stated in Amendment No. 4 that an ''affiliate'' for purposes of this provision would have the same meaning as in NASD Rules 2710 and 2720.

[132] Under NASD member admission rules, a broker-dealer that seeks authority to engage in public offerings must make that part of its membership application. If an existing NASD member that is not authorized to engage in public offerings seeks to do so in the future, such member must make an application under NASD Rule 1017. In Amendment No. 4, the NASD stated that it intends to look to whether a firm is authorized to engage in public offerings of new issues, and that the information on Form BD may help firms identify broker-dealers that are authorized to engage in public offerings. The NASD noted, however, that the information on Form BD will not be conclusive since Item 12 does not require an activity to be reported if it is less than 1% of annual revenue.

[133] In Amendment No. 5, the NASD offered the following example of how the publicly traded entity exemption would work in conjunction with the basic restriction on broker-dealers and their affiliates. Assume that a parent company is publicly traded and has a broker-dealer subsidiary that engages in public offerings. The publicly traded parent company would be restricted under paragraph (i)(11)(E) of the rule and would not qualify for the publicly traded entity exemption. All accounts in which such parent company had a beneficial interest (including entities in which the parent held an interest of 10% or more) also would be restricted persons, even if the business of the subsidiaries was wholly unrelated to the broker-dealer activities. Now assume that the publicly traded parent company has a broker-dealer subsidiary that does not engage in public offerings. The parent company would qualify for the publicly traded entity exemption in paragraph (c)(5) of the rule. The broker-dealer subsidiary would continue to be a restricted person, but the parent company and other non-restricted subsidiaries of the parent company would be eligible to purchase new issues.

[134] *See* Sullivan.

[135] *See* Sidley 2.

[136] 15 U.S.C. 78f.

[137] *See* NASD IM–2110–1(f)(1).

[138] *See* NASD IM–2110–1(l)(6).

[139] The NASD believes that condition (1) in the Interpretation—the 100-investor requirement—addresses the same concerns about concentration of ownership as condition (4). Therefore, the NASD has decided to eliminate the 100-investor requirement. In addition, the NASD believes that condition (3)—the limitation on the size of the purchase in relation to the size of the investment company—is unnecessary and potentially burdensome for members to calculate. The NASD has stated, moreover, that for very large funds the limitation is meaningless, inasmuch as 5% of their total assets would often exceed the size of the entire IPO. Therefore, the NASD has decided to eliminate condition (3).

[140] *See* MSDW.

[141] 17 CFR 230.902(b).

shareholder is a restricted person due to foreign privacy laws preventing them from obtaining the necessary ownership information.[142] Similarly, two other commenters suggested that the NASD eliminate the second requirement of the exemption—that no person owning more than 5% of the foreign investment company be a restricted person '' because of the difficulties in ascertaining the ownership of a foreign investment company.[143] Despite these concerns, the NASD believes that this requirement is necessary to prevent purchases of new issues by funds in which restricted persons have concentrated ownership interests.

e. *ERISA Plans.* Paragraph (c)(7) would provide a general exemption for benefit plans established under the Employee Retirement Income Security Act (''ERISA'') that are qualified under Section 401(a) of the Internal Revenue Code.[144] However, this exemption would not cover ERISA plans sponsored solely by a broker-dealer. The exemption as originally proposed also would have prevented an affiliate of a broker-dealer from using this exemption. Several commenters objected to this provision, arguing that they were unaware of any perceived or actual abuses to cause the NASD to narrow the exemption from the Interpretation.[145] The NASD agreed, and the final proposal would allow an ERISA plan sponsored by a broker-dealer affiliate—although not a plan sponsored by the broker-dealer itself—to benefit from the exemption.

f. *State and Municipal Government Benefits Plans.* Paragraph (c)(8) would provide a general exemption for a state or municipal government plan that is subject to state and/or municipal regulation.

g. *Tax-Exempt Charitable Organizations.* Paragraph (c)(9) would exempt sales of new issues to, and purchases by, tax exempt charities organized under Section 501(c)(3) of the Internal Revenue Code.[146] The NASD believes that new issue sales to charitable organizations are consistent with the purposes of the rule and foster a *bona fide* public distribution.

h. *Church Plans.* Paragraph (c)(10) would provide a general exemption for church plans described in Section 414(e) of the Internal Revenue Code.[147] As originally proposed, the rule included an exemption only for ERISA plans. One commenter stated that the same rationale for exempting ERISA plans also applied to church plans, and recommended that the NASD exempt such plans as well.[148] The NASD agreed and added the new paragraph (c)(10) in Amendment No. 3.

i. *Foreign Employee Benefits Plans.* The same commenter also recommended that the proposed rule include a general exemption for foreign governmental and foreign non-governmental employee benefits plans.[149] The commenter argued that foreign plan participants are not in a position to influence the investment decisions of the plan sponsor even if they might otherwise be restricted persons. The commenter further noted that a number of foreign benefits plans are sponsored by foreign subsidiaries of U.S. corporations, and that a restriction on foreign plans could have illogical results: A U.S.-based employee of a foreign firm might participate in a U.S. plan that is permitted to buy new issues, while an American co-worker based in a foreign country who invests in a foreign plan would not be allowed to participate through the foreign plan in new issue allocations.

In Amendment No. 3, the NASD stated that it had declined to adopt a blanket exemption for foreign employee benefit plans. Since that time, however, the NASD has granted an exemption from the Interpretation to a pension fund operated by the province of Québec. The NASD stated that it granted this exemption on the basis of the large number of plan participants and the small notional *pro rata* allocation of each of the fund's assets to any individual participant. Nevertheless, the NASD does not believe that a blanket exemption for foreign plans would be appropriate. In some cases, the NASD observed, foreign laws may permit benefit plans to allocate new issues only to certain plan participants, may provide for unequal distribution of profits from new issues, or may benefit a very narrow category of restricted person. The NASD stated that it also may be possible for a foreign benefits plan to be constructed as a means to circumvent the rule; for example, a shell corporation that consists entirely or principally of restricted persons could establish a benefits plan that would purchase new issues. The NASD stated in Amendment No. 4 that, as its staff becomes more familiar with various types of foreign investment plans, it may consider issuing additional guidance in this area.

Finally, the NASD has stated that a foreign employee benefits plan that did not receive a specific exemption from the NASD staff could purchase new issues if it qualified for the *de minimis* exemption in paragraph (c)(4).

5. Issuer-Directed Securities

The Interpretation provides that employees and directors of an issuer, a parent of an issuer, a subsidiary of an issuer, or any other entity that controls or is controlled by an issuer, may purchase securities that are part of a public offering that are specifically directed by the issuer to such persons.[150] The Interpretation extends this exemption to potential employees and directors who would result from an intended merger, acquisition, or other business combination. The Interpretation requires, however, that the securities acquired pursuant to the exemption be subject to a three-month lock-up period if a *bona fide* independent market for such securities does not exist.

Under its original proposal, the NASD would have revised the provisions on issuer-directed securities in to two principal ways. First, the scope of the exemption would have been extended to include employees and directors of sister companies. The NASD stated that such action would be consistent with the purposes of the rule and the existing exemption, as well as decisions of the NASD staff rendered pursuant to its exemptive authority. Second, the three-month lock-up period in the Interpretation would have been eliminated. The NASD believes that issuers should be free to set the conditions for sales of their own securities to their employees (or employees of affiliated companies) even if such employees are otherwise restricted persons. While an issuer may decide to impose a lock-up period, the NASD does not believe that such a period should be mandated by the proposed rule. The NASD has stated that eliminating the lock-up period would relieve members of having to investigate the status of employees and directors of the issuer and its affiliated companies, which was previously necessary solely to comply with the lock-up provision. This approach would allow all employees and directors of the issuer and affiliated companies to purchase securities of the issuer on equal terms. By contrast, under the Interpretation, an employee of an issuer who has a spouse in the securities industry must lock up a purchase of a

[142] *See* MSDW 2.

[143] *See* Colish; Sullivan.

[144] 29 U.S.C. 401(a).

[145] *See* MSDW; SIA; Sullivan.

[146] 29 U.S.C. 501(c)(3).

[147] 29 U.S.C. 414(e).

[148] *See* CII.

[149] *See id.*

[150] *See* NASD IM–2110–1(d).

hot issue even though other employees are not required to do so.

In Amendment No. 2, the NASD provided additional detail to the proposed exemption for issuer-directed securities. Pursuant to Amendment No. 2, securities that the issuer specifically directed to persons such as employees, directors, and their friends and family would be exempt, even if such persons were restricted persons. The NASD stated that in recent years it has been presented with situations in which, for example, an employee of an issuer wanted to direct shares of a new issue 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). The proposed rule, as revised by Amendment No. 2, would allow directed shares to be sold to the parent in this case.

One commenter recommended that all non-underwritten securities directed by the issuer should be exempt from the proposed rule.[151] The NASD believes, however, that a person who is otherwise restricted should not be allowed to purchase new issues pursuant to the issuer-directed security exemption 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 or the issuer's parent. In the NASD's view, a general exemption for all issuer-directed or all non-underwritten securities would be readily susceptible to abuse. The NASD 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, the NASD does not believe that such securities should be exempt from the proposed rule. The NASD has stated that it would continue its practice of holding a managing underwriter responsible for ensuring that all securities in the public offering be distributed in accordance with the proposed rule.

Paragraph (d)(1) of the proposed rule would provide that, for purposes of the issuer-directed security exemption, a parent/subsidiary relationship is established if the parent had the right to vote, sell, or direct 50% or more of a class of voting security of the subsidiary. One commenter argued that a 10% ownership standard should apply instead.[152] The NASD believes that it is not uncommon for a member, through its merchant banking activities, to make venture capital investments that constitute 10% or more of an issuer's capital. The NASD replied that, if it accepted this comment, all employees and directors of the member in such cases would be able to purchase the new issue. The NASD does not believe that exempting broker-dealer personnel by virtue of the broker-dealer's venture capital investments is consistent with the purposes of the proposed rule or the exemption for issuer-directed securities.[153]

One commenter[154] suggested that the scope of permissible purchasers under the issuer-directed exemption should be amended to conform with the permitted categories of offerees set forth in Rule 701 under the Securities Act of 1933.[155] The NASD determined not to act on this suggestion because it believes that the commenter's approach would be more difficult for members to implement.

Paragraph (d)(2) of the proposed rule would provide that the restrictions on the purchase and sale of new issues would not apply to securities that are part of a program sponsored by the issuer, or an affiliate of the issuer, that meets four criteria: (1) The program has at least 10,000 participants; (2) 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; (3) if not all participants receive shares under the program, the selection of the eligible participants is based on a random or other non-discretionary allocation method; and (4) the class of participants does not contain a disproportionate number of restricted persons. As proposed in Amendment No. 2, paragraph (d)(2) would have had a fifth criterion: that sales of the issuer-directed security not be made to participants who are managing underwriters or broker-dealers (or employees thereof) that are administering the program. One commenter welcomed an exemption for issuer-directed securities but argued that a requirement to investigate the facts about each of 10,000 participants to prevent sales to persons listed in the fifth criterion would vitiate the relief granted.[156] The commenter added that relying on the large number of offerees as a basis for exemption would be consistent with the exemption for publicly traded entities, which is not dependent on any basis other than that a large number of persons would share the benefits of the new issue. The NASD agreed with the commenter and eliminated the fifth criterion.[157]

Another commenter[158] sought guidance on the meaning of the fourth criterion, which requires that ''the class of participants does not contain a disproportionate number of restricted persons as compared to the investing public.'' In Amendment No. 5, the NASD stated that this condition is designed to ensure that a program is not directed to a group composed to a significant extent of restricted persons. The NASD also stated that, if an issuer has any questions about whether a specific program would qualify for this condition, the issuer should contact the NASD's Office of General Counsel for interpretative guidance.

6. Anti-Dilution Provisions

Paragraph (e) of the proposed rule would provide that the rule's basic prohibitions do not apply to an account in which a restricted person has a beneficial interest, if the account meets each of four criteria: (1) The account has held an equity ownership interest in the issuer for a period of one year prior to the effective date of the offering; (2) the sale of the new issue to the account does not increase the account'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 does not include any special terms; and (4) the new issue purchased pursuant to this exemption is not sold or transferred for three months following the effective date of the offering. Paragraph (e) would supersede a similar provision in the Interpretation[159] and modify it slightly to allow an equity holder, for purposes of meeting the requirement that the interest in the issuer be held for one year, to count the period in which the

[151] *See* MSDW.

[152] *See* Sullivan. *But see* MSDW (recommending a 50% threshold).

[153] The NASD notes that the proposed rule contains separate provisions that would permit venture capital investors to purchase new issues to avoid dilution in a public offering. *See* paragraph (e) of proposed NASD Rule 2790. The NASD believes that going beyond these protections for venture capital investors would be inconsistent with the purposes of the rule.

[154] *See* Sidley.

[155] 17 CFR 230.701 (providing an exemption from the registration provisions of the Securities Act for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation).

[156] *See* Fried 2.

[157] This commenter also noted that the exemption for issuer-directed securities, as proposed in Amendment No. 2, did not expressly permit an issuer to allocate its securities to employees and directors of sister companies, as described in the commentary to the proposed rule change. *See* Fried 2. The NASD has stated that this was an inadvertent omission and corrected the proposed rule text accordingly.

[158] *See* Testa 2.

[159] *See* NASD IM–2110–1(h).

holder had an interest in another company purchased by the issuer. The NASD has stated that this amendment is consistent with an NASD staff interpretative position.

One commenter questioned whether the NASD intended the anti-dilution provisions to apply only to natural persons, arguing that legal persons that have a prior equity ownership interest in an issuer also should be able to avail themselves of this exemption.[160] The NASD stated that the failure to extend the anti-dilution provisions to legal persons was inadvertent and revised the proposal accordingly.[161]

7. Stand-By Purchasers and Under-Subscribed Offerings

The NASD notes that the decision to apply the proposed rule to all new issues, not merely to hot issues, may create difficulties for offerings for which there is insufficient investor demand. Under the Interpretation, such offerings do not typically open at a premium and thus are not hot issues. With a rule that applies to all new issues, however, the rule should address circumstances in which purchases by restricted persons are necessary for the successful completion of an offering. Accordingly, paragraph (g) would provide that nothing in the rule would prohibit an underwriter, pursuant to an underwriting agreement, from placing a portion of a public offering in its investment account if it were unable to sell that portion to the public. In addition, paragraph (f) would provide that the prohibitions on the purchase and sale of new issues do not apply to purchases and sales made pursuant to a stand-by agreement that meets the following four 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 represents in writing that it is unable to find any other purchasers for the securities; and (4) securities sold pursuant to the stand-by agreement are subject to a three-month lock-up period. Paragraph (f) incorporates the existing exemption for stand-by purchases and sales found in the Interpretation.[162]

Two commenters, although supporting the exemption relating to under-subscribed offerings, believed that it should be extended to permit an underwriter, in lieu of placing the securities in its own investment account, to be able to sell such securities to one or more restricted persons.[163] One of these commenters stated that, if the objective of the proposed rule were to ensure a broad public distribution of securities for which there is significant demand, no regulatory objective would be furthered by restricting sales of offerings for which there is insufficient demand.[164] The NASD disagreed with these comments and stated that the provision was designed to ensure that the rule is consistent with an underwriter's contractual obligations to the issuer. The NASD believes that allowing an underwriter to sell a new issue to a restricted person if the issue turned ''cold'' would, in effect, reinstate the ''hot issue'' concept that the NASD is seeking to replace.

One commenter[165] asked for clarification that the proposed rule would not affect stabilization activities conducted under the Commission's Regulation M.[166] The NASD stated in Amendment No. 3 that the proposed rule would govern activities in connection with the distribution of new issues and would not have any effect on an underwriter's decision to engage in market stabilization activities, which occur after the security has commenced trading in the secondary market.

8. Exemptive Relief

The Interpretation contains a provision that allows the NASD staff to grant an exemption from any or all of the provisions of the Interpretation, if it determines that such exemption is consistent with the purposes of the Interpretation, the protection of investors, and the public interest.[167] Paragraph (h) would reincorporate the exemptive authority of the NASD staff into the new rule.

9. Definitions of Key Terms

a. *Beneficial Interest.* Paragraph (i)(1) of the proposed rule would define the term ''beneficial interest'' as any economic interest, such as the right to share in gains or losses. Consistent with a previously articulated NASD staff position,[168] the definition also would provide that the receipt of a management fee or performance-based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity, would not be considered a beneficial interest in the account.

The term beneficial interest was defined in the original proposal as ''any ownership or other direct financial interest.'' The NASD became aware that members found the reference to ownership, as distinct from a financial interest, unclear. The NASD believes that only those who profit from an account, rather than those legally own it, are of concern to the proposed rule and revised the proposal accordingly.

One commenter argued that the definition of ''beneficial interest'' should specifically exclude management or performance-based fees that are deferred for *bona fide* taxation reasons.[169] This commenter was concerned about the effect that deferred management or performance fees might have on a hedge fund manager's interest in a collective investment account that he or she managed. Another commenter noted that a portfolio manager might receive a management or performance-based fee for operating a hedge fund, the amount of which fees may be based on income from new issues.[170] This commenter asked the NASD to clarify whether these fees, if deferred for income tax purposes, would be deemed to create a beneficial interest in the fund held by the portfolio manager.

The NASD does not believe that it is appropriate to amend the definition of ''beneficial interest'' to expressly exclude performance-based allocations and deferred performance-based fees. In Amendment No. 5, the NASD counseled that the *initial* receipt of the fee would not constitute a beneficial interest in the collective investment account, because the definition of ''beneficial interest'' excludes ''the receipt of a management or performance based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity.''[171] The NASD believes, however, that the accumulation of these payments, if *subsequently* invested in the collective investment account (as a deferred fee arrangement or otherwise) would constitute a beneficial interest in the account. The NASD believes that money invested in a collective investment account is part of a person's beneficial interest in that account even if the source of the money is a deferred fee arrangement. The NASD does not

[160] *See* Testa.

[161] Subsequently, the same commenter noted several drafting errors with respect to the anti-dilution provisions as they appeared in Amendment No. 2. *See* Testa 2. The NASD subsequently made the necessary corrections.

[162] *See* NASD IM–2110–1(e).

[163] *See* MSDW 2; Sullivan 2.

[164] *See* MSDW 2. This commenter also suggested imposing minimum capital contribution requirements for the stand-by provisions and extending the lock-up requirements from three months to one year. The NASD has stated that it does not believe that these additional requirements are necessary.

[165] *See* Testa 2.

[166] 17 CFR 242.100 *et seq.*

[167] *See* NASD IM–2110–1(a)(5).

[168] *See* NASD Notice to Members 97–5.

[169] *See* Rosenman.

[170] *See* Sidley 2.

[171] *See* paragraph (i)(1) of proposed NASD Rule 2790.

believe that a decision to defer recognition of earnings for income tax purposes should alter the analysis of whether a person has a beneficial interest in a collective investment account.

b. *Collective Investment Account.* Paragraph (i)(2) would define ''collective investment account'' as any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle that is engaged primarily in the purchase and/or sale of securities. The original proposal defined ''collective investment account'' as any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle that manages assets of other persons. One commenter pointed out that a hedge fund or other investment partnership typically engages in the purchase and sale of securities for its proprietary account, and that these entities do not necessarily manage the assets of others.[172] This commenter recommended, therefore, that the NASD remove the phrase ''that manages the assets of other persons'' from the definition. The NASD agreed and revised the proposed definition accordingly.

C. Transition Period

Three commenters urged the NASD to allow entities that would be subject to the proposed rule a transition period before coming into full compliance with it.[173] The NASD believes that a transition period would be reasonable and has proposed a three-month period during which members could comply with either the Interpretation or the new rule. This three-month period would begin upon the NASD's publication of a Notice to Members announcing any Commission final action on the proposed rule change. The NASD stated in Amendment No. 5 that it would publish this Notice to Members no later than 60 days following a Commission approval.

V. Discussion

After carefully considering the proposal and all the comments received, the Commission finds that the proposal, as amended, is consistent with the requirements of the Act and the regulations thereunder applicable to a national securities association. In particular, the Commission believes that the proposal is consistent with Sections 15A(b)(6) and 15A(b)(9) of the Act.[174] Section 15A(b)(6) requires, among other things, that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest. Section 15A(b)(6) also provides that the rules of an association may not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Section 15A(b)(9) provides that the rules of an association may not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

The Commission finds that the proposal will protect investors and is in the public interest. The Commission believes that the proposal is a reasonable means of furthering the NASD's stated aims of ensuring that: (1) NASD members make a *bona fide* public offering of securities at the public offering price; (2) members do not withhold securities in a public offering for their own benefit or use such securities to reward certain persons who are in a position to direct future business to the member; and (3) industry insiders, including NASD members and their associated persons, do not take advantage of their ''insider'' position to purchase new issues for their own benefit at the expense of public customers.

The proposal is to a large extent a reorganization of the existing provisions of NASD IM–2110–1. The Commission has previously opined on many of these provisions and found them to be consistent with the Act.[175] Furthermore, the Commission believes that the proposal furthers the purposes of the Act by making the rule easier to understand and administer. With respect to provisions of new NASD Rule 2790 that were not present in the Interpretation, the Commission finds that they also are consistent with the Act. The most significant of these new provisions are discussed below.

A. Offerings Covered by NASD Rule 2790

The Commission believes that it is reasonable for the new rule to apply to ''new issues'' rather than ''hot issues.'' Under the Interpretation, restrictions are not triggered unless an issue becomes ''hot'' (*i.e.*, it trades at a premium over the offering price). The Commission believes that NASD members generally will find it simpler to treat all new issues in the same manner. The Commission also believes it reasonable to eliminate the cancellation provision; its primary rationale no longer exists because all new issues are subject to the rule from the moment that they are initially offered to the public, not later when they become ''hot.'' Eliminating the cancellation provision will enhance compliance with the new rule by encouraging NASD members to identify all potential restricted persons prior to a new issue.

B. Restricted Persons

The Commission believes that the scope of the term ''restricted person'' in the new rule is reasonable and consistent with the Act. As under the Interpretation, broker-dealers and their associated persons will be restricted. The Commission finds that it is consistent with the Act for the NASD to restrict its members from purchasing new issues from or selling new issues to other broker-dealers. The acquisition by such persons of new issues could give the appearance that an initial public offering was not in fact truly ''public.'' The Commission also believes it is appropriate for the NASD to extend the restriction to agents of a broker-dealer who are engaged in the investment banking or securities business.

Under the new rule, as under the Interpretation, ''limited business broker-dealers'' (*i.e.*, broker-dealers that are authorized to engage only the purchase and sale of investment company/variable contracts securities and direct participation program securities) will not be considered restricted persons. The Commission believes that this provision is consistent with the Act because it exempts only a small class of broker-dealers that, due to the nature of their business, are unlikely to benefit unfairly from the purchase of a new issue.

The Commission has carefully considered CBOE's comment letter and finds that the NASD's decision not to expand the concept of limited business broker-dealers to include CBOE market makers and floor brokers (and their associated persons) is reasonable. CBOE argued that ''options market makers and floor brokers perform specialized, limited functions and should not be considered representative of the typical broker-dealer population.'' However, the NASD's determination not to make additional exemptions for CBOE members and other types of broker-

[172] *See* Sidley.

[173] *See* Ropes (suggesting 90 days); Schulte (six months); Sullivan 2 (90 days).

[174] 15 U.S.C. 78o–3(b)(6) and (9).

[175] *See, e.g.,* Securities Exchange Act Release No. 40001 (May 18, 1998), 63 FR 28535 (May 26, 1998) (SR–NASD–97–95) (approving various revisions to NASD IM–2110–1); Securities Exchange Act Release No. 35059 (December 7, 1994), 59 FR 64455 (December 14, 1994) (SR–NASD–94–15) (same).

dealer is consistent with the new rule's general aim of ensuring that public investors rather than securities industry insiders receive the benefit of new issues. The Commission also agrees with the NASD that an exemption for ''limited business broker-dealers''—based solely on what the firm is authorized to do on its Form BD—is more transparent and easier to administer than the type of standard for exempted broker-dealers advocated by CBOE, which would require an analysis of the activities actually conducted by the broker-dealer.

The Commission also believes that the new rule's treatment of joint back office broker-dealers is consistent with the Act. Under the new rule, a JBO would be able to purchase new issues provided that the interests of restricted persons in the JBO do not exceed 10%, although associated persons of the JBO will be restricted persons. JBOs are hedge funds or hedge fund affiliates that often are active participants in the securities markets. The associated persons of JBOs may be in a position to direct future business to an NASD member, and the purchases by such industry insiders of an IPO could create the appearance that the offering was not truly ''public.''

Under the new rule, restricted person status will extend to any immediate family member of a person who is ''directly restricted'' by the new rule on account of his or her position in the industry (such as an employee of a broker-dealer). The restriction on immediate family members also will apply to persons who receive material support from a directly restricted person. The Commission believes that these provisions are appropriate to prevent evasion of the new rule while not unduly extending the rule's restrictions to persons who could not reasonably be viewed as an alter ego of a directly restricted person.

Similarly, the Commission believes that it is appropriate to extend restricted person status to owners and affiliates of a broker-dealer. In the absence of such a provision, the restriction on the broker-dealer could easily be evaded. The Commission believes that it is reasonable and consistent with the Act for the new rule to assign restricted person status to persons listed on Schedules A and B of a broker-dealer's Form BD. While Schedule A requires reporting of interests of 5% or more in the broker-dealer, the new rule will restrict only those persons appearing on Schedule A who hold interests of 10% or more. The Commission believes that the 10% threshold for ownership interests in a broker-dealer as a criterion for restricted person status is appropriate because it is consistent with the 10% *de minimis* threshold established in the rule's general exemptions. Moreover, basing restricted person status on a 10% interest reported on Schedule A (for direct owners of the broker-dealer) will lessen the likelihood that an entity reported on Schedule B (for indirect owners) will be deemed a restricted person even if the indirect owner has only a small economic interest in the broker-dealer. The Commission believes that the ownership classifications employed by the new rule are reasonably based, are already understood by NASD members, and will facilitate administration of the rule.

The Commission also believes that the publicly traded entity exemption is reasonable and consistent with the Act. The proposed rule assumes that a publicly traded entity generally will have wide public ownership, thus reducing the likelihood that a large percentage of the entity's shareholders are restricted persons who would unfairly benefit from the entity's purchase of new issues. The Commission believes that this assumption is reasonable in light of the quantitative standards that companies must meet to list their securities on a national securities exchange or the Nasdaq Stock Market.[176] Although there may be some publicly traded companies of which restricted persons nevertheless constitute a significant percentage of the shareholders, the Commission believes the general exemption for publicly traded entities strikes an appropriate balance between carrying out the purposes of the rule and minimizing its administrative burdens.

The exemption for publicly traded entities will not cover broker-dealers themselves or affiliates of broker-dealers that are authorized to engage in the public offering of new issues (either as a selling group member or underwriter). A broker-dealer, although publicly traded, is likely to have a higher concentration of restricted persons amongst its ownership. Therefore, the Commission believes that it is reasonable for the NASD not to afford broker-dealers—or affiliates of broker-dealers that sell or underwrite new issues—the benefits of the publicly traded entity exemption. In the absence of such a provision, significant potential to evade the new rule would exist.

Finally, the Commission agrees with the NASD that participation in an investment club, by itself, should not cause a person to be restricted under the new rule, and that the treatment of investment clubs and family investment vehicles under the new rule is consistent with the Act.

C. Elimination of Conditionally Restricted Person Status and New De Minimis Threshold

The new rule will eliminate ''conditionally restricted person'' status and adopt a standard that will render all persons either restricted or non-restricted. The Commission agrees with the NASD that, in some cases, a person may purchase a hot issue pursuant to the Interpretation's ''conditionally restricted person'' exemption even when such purchase appears contrary to the principles underlying the Interpretation. The Commission believes that the proposed rule change will help eliminate such cases, and that the definition of ''restricted person'' in the new rule will be more transparent and easier to administer.

Although all persons under the rule will be either restricted or non-restricted, the NASD has acknowledged that accommodation must be made for some restricted person participation in collective investment accounts. The alternative—prohibiting all new issue purchases by a collective investment account if even a single restricted person is a participant—would be unrealistic. The NASD has proposed, therefore, a 10% *de minimis* limit for restricted person participation in a collective investment account. The Commission agrees with the NASD that the purposes of the rule generally are not implicated if a member sells a new issue to a collective investment account in which restricted persons have only a small interest. The investors who are non-restricted persons will still receive the majority of the new issue's proceeds, and the notional portion of such proceeds accruing to the restricted persons would be sufficiently small as to provide little incentive for them to direct future business to the member as compensation. The Commission, therefore, finds that that the 10% threshold proposed by the NASD is reasonable and consistent with the Act.

Three commenters criticized the NASD's decision to consider hedge fund managers as restricted persons in all cases, even with respect to the funds for which they act as portfolio manager.[177] After carefully considering these comments, the Commission finds that they do not raise any issue that

[176] *See, e.g.*, NASD Rule 4420(a)–(c) (requiring 1,100,000 publicly held shares for inclusion on the Nasdaq National Market); New York Stock Exchange Listed Company Manual Rule 102.01A (requiring 1,100,000 publicly held shares for listing on the NYSE).

[177] *See* MFA 3; Sidley 2; Willkie 3; Willkie 4. *See also infra* notes 35–36 and accompanying text.

precludes approval of the NASD's proposal. The Commission acknowledges that it is reasonable for hedge fund investors to seek to align the interests of hedge fund managers with their own. Contrary to the view taken by these commenters, however, the new rule will not significantly impede that effort. NASD Rule 2790 does not prohibit a hedge fund manager from holding an interest of greater than 10% in a hedge fund that he or she manages because of the availability of the carve-out procedures. These carve-out procedures, which exist under the Interpretation and will be carried over in the new rule, allow the fund to segregate the interests of restricted from non-restricted persons and to direct the proceeds of the fund's investments accordingly. Thus, the rule merely prohibits such a fund from purchasing new issues in a manner that allows the hedge fund manager (and other restricted persons) to receive from such purchases an indirect, *pro rata* benefit that exceeds the lesser of 10% or their actual percentage interest in the fund. NASD Rule 2790 places no restrictions on the ability of a hedge fund—whatever its ownership structure—to purchase any other type of asset. The investors will still be able to align the interests of hedge fund managers with their own with respect to every type of investment opportunity other than new issues. The Commission believes that the potential adverse consequences of preventing the alignment of investor and manager interests with respect to this class of investment are minimal.

By contrast, allowing hedge fund managers unlimited participation in the benefits of new issues through the funds that they manage would be much more likely to compromise investor protection and the public interest. A portfolio manager is in a position to direct business to a member and might be willing to do so in return for having received new issues. The larger a hedge fund manager's interest in the fund, the greater the manager's notional *pro rata* benefit from any particular investment made by the fund and the greater the incentive for the member to sell new issues to that fund in hopes of receiving future business. Furthermore, allowing a portfolio manager to have unlimited participation in a hedge fund that purchases new issues would further the appearance that an industry insider was receiving a disproportionate benefit from new issues. The Commission believes that the proposed rule furthers the appearance, as well as the reality, of fairness in the IPO process and thus will strengthen investor confidence in the securities markets.

The Commission concludes that deeming hedge fund managers and other portfolio managers as restricted persons, subject to the 10% *de minimis* exemption for collective investment accounts, represents a reasonable balance between the principles underlying the new rule and consideration of the structure of the hedge fund industry.

D. Other Provisions

The Commission finds that the preconditions for sale provisions strike a reasonable balance between, on the one hand, ensuring that accounts to which NASD members sell new issues are in fact eligible and, on the other hand, minimizing the administrative burdens on both members and their customers. Specifically, the Commission believes that 12 months is a reasonable time frame within which members should update eligibility information. The Commission also believes that the NASD's proposed use of negative consent procedures is reasonable and consistent with the Act.

With respect to the anti-dilution provisions of the proposed rule, the Commission believes that the acquisition of new issues by restricted persons for the purpose of preventing their existing interests from being diluted does not run counter to either the purposes of the rule or the provisions of the Act. The Commission also believes that the holding period requirements of the anti-dilution provisions are a reasonable means to prevent abuse of these provisions.

The Commission finds that the provisions of the new rule relating to stand-by purchasers and under-subscribed offerings are consistent with the Act. These provisions are a reasonable means to facilitate the distribution of new issues and, although allowing restricted persons to hold beneficial interests in new issues in some circumstances, do not run counter to the purposes of the new rule.

Finally, the Commission believes that it is reasonable for paragraph (h) of new NASD Rule 2790 to allow NASD staff to exempt any person, security, or transaction from the rule, to the extent that such exemption would be consistent with the purposes of the rule, the protection of investors, and the public interest. However, the Commission reminds the NASD that exemptions of general applicability that would impose substantive binding requirements should be done through the notice-and-comment rulemaking process prescribed by Rule 19b–4 under the Act.[178] The only circumstance in which exemptive authority of the NASD should be exercised without employing this process is where the circumstances are truly unique. In most instances, the circumstances involved are so common that the same exemption would in fact be granted to all other similarly situated persons and thus must be handled through the notice-and-comment rulemaking process.[179]

E. Effective Date

The Commission believes that it is reasonable and consistent with the Act to allow NASD members the transition period specified above [180] in which to adjust their compliance programs to accommodate the new rule. The Commission notes that it has approved similar transition periods in previous cases.[181] Accordingly, the proposed rule change will take effect upon the issuance by the NASD of a Notice to Members discussing the new rule, and the NASD has represented that it will publish this Notice to Members no later than 60 days following Commission approval. NASD members may comply with either the Interpretation or new NASD Rule 2790 for three months following publication of the Notice to Members.

F. Accelerated Approval

Pursuant to Section 19(b)(2) of the Act,[182] the Commission finds good cause for approving the proposal, as revised by Amendment No. 5, prior to the thirtieth day after the date of publication of notice of the amended proposal in the **Federal Register**. The Commission believes that Amendment No. 5 does not materially alter the operation of the rule and is intended only to respond to comments and to make certain technical corrections pointed out by certain of the commenters. Accordingly, the Commission is accelerating approval of the proposal, as amended.

G. Impact on Efficiency, Competition, and Capital Formation

In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital

[178] 17 CFR 240.19b–4.

[179] *See* letter to T. Grant Callery, NASD, from Annette L. Nazareth, Division of Market Regulation, SEC, dated March 27, 2003.

[180] *See supra* note and accompanying text.

[181] *See, e.g.*, Securities Exchange Act Release No. 44499 (June 29, 2001), 66 FR 35819, 35822 (July 9, 2001) (SR–NASD–2001–14) (allowing Nasdaq issuers a short period of time to comply with either the old or newly approved listing standards).

[182] 15 U.S.C. 78s(b)(2).

formation.[183] The Commission believes that the proposed rule change will further these aims by helping to ensure public confidence in the IPO process and, thereby, encouraging investment in new issues. The Commission also believes that the proposal will enhance efficiency, competition, and capital formation by streamlining the Interpretation, making it simpler to administer, and reducing the compliance costs of affected persons.

H. Additional Rulemaking Related to IPO Distribution

In a separate filing (SR–NASD–2003–140), the NASD has addressed other issues relating to the IPO distribution process. Specifically, the NASD in SR–NASD–2003–140 is proposing to prohibit ''*quid pro quo* allocations'' (*i.e.*, offering or threatening to withhold allocations of IPO shares as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by an NASD member) and ''spinning'' (*i.e.*, allocating IPO shares to officers or directors of a company in hopes of winning future investment banking business from that company). In approving this filing (SR–NASD–99–60), the Commission is making no findings and expressing no opinion on the proposals set forth in SR–NASD–2003–140.

VI. Amendment No. 5

Below are the provisions of proposed NASD Rule 2790 that were changed by Amendment No. 5. The base text is that proposed in Amendment No. 4. Text added by Amendment No. 5 is italicized; deleted text is in brackets.

* * * * *

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.

(4) Nothing in this paragraph (a) shall prohibit:

(A) sales or purchases from one member of the selling group to another member of the selling group that are incidental to the distribution of a new issue to a non-restricted person at the public offering price; [or]

(B) sales or purchases by a broker/dealer of a new issue at the public offering price as part of an accommodation to a non-restricted person customer of the broker/dealer*; or*

(C) purchases by a broker/dealer (or owner of a broker/dealer), organized as an investment partnership, of a new issue at the public offering price, provided such purchases are credited to the capital accounts of its partners in accordance with paragraph (c)(4).

(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:

(1) Beneficial Owners

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; or

(2) Conduits

a bank, foreign bank, broker/dealer, or investment adviser, or other conduit that all purchases of new issues are 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 the following accounts or persons, whether directly or through accounts in which such persons have a beneficial interest:

(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 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] *is funded by premiums from 1,000 or more policyholders, or, if a general account, the insurance company has* 1,000 or more policyholders; and

(B) The insurance company does not limit [beneficial interests in] the [account] *policyholders whose premiums are used to fund the account principally to restricted persons, or, if a general account, the insurance company does not limit its policyholders* principally to restricted persons;

(4) An account [or joint back office broker/dealer (''JBO'')]if the beneficial interests of restricted persons do not exceed in the aggregate 10% of such account[or JBO];

(5) A publicly traded entity (other than a broker/dealer or an affiliate of a broker/dealer where such broker/dealer is authorized to engage in the public offering of new issues either as a selling group member or underwriter) that:

(A) Is listed on a national securities exchange;

(B) Is traded on the Nasdaq National Market; or

(C) Is a foreign issuer whose securities meet the quantitative designation criteria for listing on a national securities exchange or trading on the Nasdaq National Market;

(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;

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

(10) A church plan under Section 414(e) 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 to persons that are restricted under the rule; provided, however, that securities directed by an issuer may not be sold to or purchased by an account in which any restricted person specified in subparagraphs (i)(1*0*[1])(B) or (i)(1*0*[1])(C) of this rule has a beneficial interest, unless such person, or a

[183] *See* 15 U.S.C. 78c(f).

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 or the issuer's parent. Also, for purposes of this paragraph (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 security 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; and

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

(3) Are directed to eligible purchasers who are otherwise restricted under the rule 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 account 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 account'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 paragraph (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, or other fees for acting in a fiduciary capacity, 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 that is engaged primarily in the purchase and/or sale of securities. A ''collective investment account'' does not include a ''family investment vehicle'' or an ''investment club.''

(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 investment vehicle'' means a legal entity that is beneficially owned solely by 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) [''Joint Back Office Broker/Dealer'' means any domestic or foreign private investment fund that has elected to register as a broker/dealer solely to take advantage of the margin treatment afforded under Section 220.7 of Regulation T of the Federal Reserve. The activities of a joint back office broker/dealer must not require that it register as a broker/dealer under Section 15(a) of the Act.]

([8]*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.

([9]*8*) ''Material support'' means directly or indirectly providing more than 25% of a person's income in the prior calendar year. Members of the immediate family living in the same household are deemed to be providing each other with material support.

([10]*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. 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 144A or Rule 505 or Rule 506 adopted thereunder;

(B) Offerings of exempted securities as defined in Section 3(a)(12) of the Act, and rules promulgated thereunder;

(C) Offerings of securities of a commodity pool operated by a commodity pool operator as defined under Section 1a(5) of the Commodity Exchange Act;

(D) Rights offerings, exchange offers, or offerings made pursuant to a merger or acquisition;

(E) Offerings of investment grade asset-backed securities;

(F) Offerings of convertible securities;

(G) Offerings of preferred securities; [and]

(H) Offerings of an investment company registered under the Investment Company Act of 1940; *and*

(I) Offerings of securities (in ordinary share form or ADRs registered on Form F–6) that have a pre-existing market outside of the United States.

([11]*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);

(ii) 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; or

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

(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.

(ii) An immediate family member of a person specified in subparagraph (D)(i) that materially supports, or receives material support from, such person.

(E) Persons Owning a Broker/Dealer

(i) Any person listed, or required to be listed, in Schedule A of a Form BD (other than with respect to a limited business broker/dealer), except persons identified by an ownership code of less than 10%;

(ii) Any person listed, or required to be listed, in Schedule B of a Form BD (other than with respect to a limited business broker/dealer), except persons whose listing on Schedule B relates to an ownership interest in a person listed on Schedule A identified by an ownership code 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, or required to be listed, in 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, or other than with respect to a limited business broker/dealer);

(v) Any person that directly or indirectly owns 25% or more of a public reporting company listed, or required to be listed, in 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, or other than with respect to a limited business broker/dealer).

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

* * * * *

VII. Solicitation of Comments on Amendment No. 5

Interested persons are invited to submit written data, views, and arguments on Amendment No. 5, including whether the amendment is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. 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 File No. SR–NASD–99–60 and should be submitted by November 21, 2003.

VIII. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[184] that the proposal (SR–NASD–99–60) and Amendment Nos. 1 to 4 thereto are approved, and that Amendment No. 5 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[185]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–27463 Filed 10–30–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48700; File No. SR–PCX–2003–35]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Pacific Exchange, Inc. To Amend Its Corporate Governance and Disclosure Policies

October 24, 2003.

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 July 14, 2003, the Pacific Exchange, Inc. (''PCX'' or ''Exchange'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On October 14, 2003, the Exchange filed an amendment to the proposal.[3] The Commission is publishing this notice to solicit comments on the proposed rule

[184] *Id.*

[185] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* letter from Steven B. Matlin, Senior Counsel, PCX, to Nancy J. Sanow, Assistant Director, Division of Market Regulation, Commission, dated October 8, 2003 (''Amendment No.1''). In Amendment No.1, the Exchange made changes to proposed rule text in PCX Rule 5.3(k)(5)(B)(ii)(a).