

**MEMO# 11557**

January 19, 2000

## **NASD PROPOSED RULE RELATING TO TRADING IN HOT EQUITY OFFERINGS**

1 Securities Exchange Act Release No. 42325 (January 10, 2000), 65 FR 2656 (January 18, 2000) ("Proposing Release"). 2 The current Interpretation defines a "hot issue" as any security that trades "at a premium" whenever secondary market trading begins. The NASD and the SEC have stated that any premium, no matter how small, makes an offering a hot issue. 1 [11557] January 19, 2000 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 3-00 EQUITY MARKETS ADVISORY COMMITTEE No. 3-00 INVESTMENT ADVISERS COMMITTEE No. 4-00 SEC RULES COMMITTEE No. 11-00 UNIT INVESTMENT TRUST COMMITTEE No. 3-00 RE: NASD PROPOSED RULE RELATING TO TRADING IN HOT EQUITY OFFERINGS

The National Association of Securities Dealers ("NASD"), through its wholly owned subsidiary NASD Regulation ("NASDR"), filed with the Securities and Exchange Commission a proposed rule change to establish a new rule, Rule 2790, relating to trading in hot equity offerings, to replace its Free-Riding and Withholding Interpretation, IM-2110-1 ("Interpretation").<sup>1</sup> The purpose of the proposed rule is to ensure that NASD members make a bona fide public offering of securities at the public offering price; ensure that members do not withhold securities in a public offering for their own benefit or use these securities to reward certain persons who are in a position to direct future business to the member; and ensure that industry "insiders," including members and their associated persons, do not take advantage of their "insider" position in the industry to purchase hot issues for their own benefit at the expense of public customers. The proposed rule change defines the term "hot issue" with reference to a threshold premium.<sup>2</sup> In particular, the proposed rule change defines a hot issue as any security that is part of a public offering if the volume weighted price during the first five minutes of trading in the secondary market is five percent or more above the public offering price. The Proposing Release states that NASDR recognizes that the selection of any threshold is to an extent arbitrary, and expects to receive comments on whether five percent is the correct premium. The proposed rule also would apply to equity offerings only. Specifically, the proposed rule incorporates the definition of "equity security," as the term is defined in Section 3(a)(11) of the Securities Exchange Act. The Interpretation has applied to equity and debt securities. The proposed rule also differs from the Interpretation in that it would apply to all secondary offerings. The Proposing Release states that in light of the decision to define a hot issue as requiring a 3 Conditionally restricted persons include, among other things, senior officers and directors of a bank, savings and loan institution, insurance company, investment company, investment advisory firm, or any other institutional type account, or any person in the securities department of any of the foregoing entities, or any other employee who may influence or whose activities directly or indirectly involve or are related to the function of buying or selling securities for any of the foregoing entities. Under the Interpretation, conditionally restricted persons can

purchase hot issues if: (1) the securities are sold to the customer in accordance with the customer's normal investment practice; (2) the amount of securities sold to any one such person is insubstantial; and (3) the member's aggregate sales to conditionally restricted persons is insubstantial and not disproportionate in amount as compared to sales to other members of the public. 2 five percent premium, NASDR believes that it is no longer appropriate to exclude all secondary offerings as a class. Another significant change in the proposed rule is the decision to eliminate the "conditionally restricted" person status and treat persons either as restricted or non-restricted.<sup>3</sup> At the same time, NASDR is revising the category of persons subject to the rule. NASDR does not believe that all senior officers and all employees in the securities department of the covered entities should be restricted. Instead, a more function-oriented approach is proposed by treating as restricted persons only those employees or other persons who supervise, or whose activities directly or indirectly involve or are related to, the buying or selling of securities for a bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account. Finally, the proposed rule would create an exemption from the rule for a collective investment account that is beneficially owned in part by restricted persons, provided that these restricted persons in the aggregate own less than five percent of the account. The five percent limit allows restricted persons who were previously only conditionally restricted, such as investment advisors and other investment and portfolio managers, to participate in hot issues to a limited extent. Investment companies registered under the Investment Company Act of 1940 are expressly exempt from the categories of persons to whom member firms would be prohibited from selling hot issue securities. The proposed rule also would exempt persons associated with "limited business broker/dealers" from the categories of restricted persons. A limited business broker-dealer includes a broker-dealer whose authorization to engage in the securities business is limited solely to the purchase or sale of investment company securities. Comments on this proposal are due to the SEC no later than February 8. If you have any comments you would like the Institute to consider including in a possible comment letter, please provide them to Ari Burstein by phone at (202) 371-5408, by fax at (202) 326-5839, or by e-mail at [aburstein@ici.org](mailto:aburstein@ici.org) no later than February 1. Ari Burstein Assistant Counsel Attachment