

**MEMO# 12942**

December 18, 2000

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

[12942] December 18, 2000 TO: SEC RULES COMMITTEE No. 133-00 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 34-00 EQUITY MARKETS ADVISORY COMMITTEE No. 63-00 UNIT INVESTMENT TRUST COMMITTEE No. 30-00 INVESTMENT ADVISERS COMMITTEE No. 25-00 RE: NASD AMENDS PROPOSED RULE CHANGE RELATING TO TRADING IN HOT EQUITY OFFERINGS The National Association of Securities Dealers ("NASD"), through its wholly owned subsidiary, NASD Regulation ("NASDR"), has filed with the Securities and Exchange Commission Amendment No. 2 to a proposed rule change to establish a new rule relating to the purchase and sale of initial equity public offerings.<sup>1</sup> The new rule would replace the current Free-Riding and Withholding Interpretation, IM-2110-1 ("Interpretation"). The amendment is in response to comments received on the original proposal.<sup>2</sup> Amendment No. 2 is attached and the most significant aspects of the amendment are summarized below. Comments on Amendment No. 2 are due to the SEC no later than December 26. Scope of Proposed Rule The original proposal defined the term "hot issue" with reference to a threshold premium. In particular, a hot issue would be defined 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. Based on comments received on the original proposal, NASDR has amended the proposed rule change to restrict the purchase and sale of all initial equity public offerings, not just those that open above a certain premium. The Proposing Release states that this approach is both easier to understand and avoids many of the complexities associated with canceling and reallocating the sale of an IPO to a non-restricted person in the event that an offering unexpectedly becomes a hot issue. As a result of 1 Securities Exchange Act Release No. 43627 (November 28, 2000), 65 FR 76316 (December 6, 2000) ("Proposing Release"). 2 See Memorandum to Closed-End Investment Company Committee No. 3-00, Equity Markets Advisory Committee No. 3-00, Investment Advisers Committee No. 4-00, and SEC Rules Committee No. 11-00, dated January 19, 2000. 2the proposal to apply the proposed rule change to all IPOs, NASDR also is proposing to exempt all secondary offerings. In addition, in order to address issues relating to an offering where there is insufficient investor demand, NASDR is proposing to add provisions to address circumstances where purchases by restricted persons are necessary for the successful completion of an offering. For example, the proposed rule change would exempt offerings of closed-end investment companies, as defined under Section 5(a)(2) of the Investment Company Act, from the scope of the rule. The Proposing Release states that applying the proposed rule change to closed-end funds does not further the purposes of the rule and may impair the ability of closed-end funds to obtain capital.<sup>3</sup> Finally, the proposed rule

change continues to expressly exempt investment companies registered under the Investment Company Act from the categories of persons to whom member firms would be prohibited from selling new issues. 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 and sale of investment company securities. Portfolio Managers The original proposal also recommended a more function-oriented approach in determining who would be considered restricted persons under the rule 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. In addition, the original proposal 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. In response to comments on the proposed rule change that the five percent figure was too low and that investors generally expect portfolio managers to make significant investments in accounts they manage to better align their interests with those of investors, Amendment No. 2 treats a portfolio manager and certain members of his or her immediate family as restricted persons, other than with respect to a beneficial interest in the bank, savings and loan institution, insurance company, investment company, investment adviser, or collective investment account, over which such person has investment authority. Amendment No. 2 therefore permits a portfolio manager to invest in IPOs through a fund he or she manages. Under Amendment No. 2, however, a portfolio manager may not purchase IPOs for his or her personal accounts. Ari Burstein Associate Counsel Attachment 3 The proposal also would exempt all debt securities, public offerings of investment grade asset-backed securities as defined in SEC Form S-3, convertible securities, and preferred securities from the rule’s coverage. 3Attachment (in .pdf format)