

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 ("CI"); Letters from Cadwalader, Wickersham & Taft to Jonathan G. Katz, SEC, dated December 22, 2000 and January 4, 2001 ("Cadwalader 2"); Letter from Testa, Hurwitz & Thibault 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).