

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,

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.

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.