

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 commenters³⁷ 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 through 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

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.

³⁷ See MFA 2; MFA 3; Sidley.

³⁸ See NASD IM-2110-1(g).