

No. 5, the NASD stated that members should use an appropriate level of diligence to determine whether an individual is authorized to represent the beneficial owners of the accounts, and that it is unnecessary to include the language suggested by this commenter.

Several commenters sought guidance on what type of information a member would be required to review to ascertain whether an account is beneficially owned by restricted persons, especially in the context of a fund-of-funds.⁵⁰ For example, one commenter urged the NASD to eliminate the need to "look through" multiple layers of investors to determine whether restricted persons are somewhere in the chain of ownership.⁵¹ In Amendment No. 5, the NASD explained that a person authorized to represent the beneficial owners of the master fund (*i.e.*, the fund that purchases the new issues from the member directly) is required to represent that the fund is able to purchase new issues. The NASD expects that any such person, in making such representation, would ascertain the status of investors in the feeder funds (*i.e.*, funds that invest in the master fund). If the representative of the master fund is unable to ascertain the status of investors in a feeder fund, the master fund must deem such feeder fund to be restricted and ensure that the profits from new issues are not allocated to that fund (or consider whether any other exemption, such as the *de minimis* exemption, might apply to that feeder fund). Also in Amendment No. 5, the NASD stated that it would address this matter further in a Notice to Members following Commission approval of the proposed rule change.

B. Other Aspects of NASD Rule 2790

1. Securities Excluded From the Rule

a. *Securities Issued as Part of a Secondary Offering.* The proposed rule would not apply to secondary offerings, although the proposed rule does not contain a specific exemption for them. The exemption is implicit in the definition of "new issue," which includes any *initial* public offering of an equity security.

The NASD initially proposed to subject a secondary offering to the new rule if it were "hot" (*i.e.*, it traded at a 5% premium). Allowing secondary issues to be considered hot issues would represent a reversal of the position taken by the NASD under the Interpretation,⁵²

and several commenters criticized this aspect of the original proposal.⁵³ These commenters questioned why the proposed rule should apply to secondary offerings if the NASD believed that most secondary offerings do not trade at a premium.⁵⁴ They also stated that, without a clear exemption for secondary issues, member firms generally would bar allocations of all secondary offerings to restricted persons out of concern that they could become hot.

With the decision to apply the proposed rule to new issues rather than hot issues, secondary offerings would not be subject to the rule. The NASD continues to believe that secondary offerings rarely if ever trade at a significant premium to the public offering price and agrees with the commenters that the negative consequences of applying the rule to secondary offerings would outweigh any benefits.

b. *Debt Securities.* Another significant difference between the proposed rule and the Interpretation is the treatment of debt securities. Originally, the Interpretation applied to equity and debt securities. However, as part of the 1998 amendments, the NASD exempted from the Interpretation most types of investment-grade debt and investment-grade asset-backed securities from the definition of "hot issue."⁵⁵ The NASD is now going one step further and proposing to eliminate application of the rule to all debt securities, including those that are not investment-grade.⁵⁶

securities, based on its findings that few secondary offerings traded at a premium, and where there was a premium, it was generally very small. See Securities Exchange Act Release No. 40001 (May 18, 1998), 63 FR 28535, 28537 (May 26, 1998) (approving SR-NASD-97-95) ("1998 amendments").

⁵³ See MSDW; Schwab; SIA; Sidley; Sullivan.

⁵⁴ See, e.g., Schwab ("the remote possibility that an issue could trade at a premium would cause many member firms to prohibit allocations of any secondary issues to restricted customer accounts. As a practical matter, the Rule would exclude broad categories of investors from participating in secondary offerings. The negative consequences to both issuers and customers of such a broad exclusion outweigh any remote benefits associated with secondary offerings in the scope of the Rule").

⁵⁵ See 1998 amendments, 63 FR at 28537.

⁵⁶ In Amendment No. 5, the NASD acknowledged that, under certain circumstances, the trading characteristics of junk debt more closely resemble that of the issuer's equity securities rather than its debt securities. However, the NASD believes that, for purposes of the new rule, the point in time at which the pricing and trading characteristics of a security are relevant are at the time of offering. The NASD continues to believe that, at the time of an offering, even junk debt will trade based primarily on interest rates and the creditworthiness of the issuer and, therefore, that the junk debt should not be treated in the same manner as equity securities under the proposed rule.

One commenter recommended that the definition of "new issue" exclude offerings of securities of closed-end funds that invest solely in debt securities.⁵⁷ The commenter reasoned that, if offerings of debt securities were excluded, offerings of funds that invest solely in debt securities also should be excluded. In Amendment No. 4, the NASD stated that offerings of such funds would be exempt from the proposed rule pursuant to the exemption for offerings of securities of investment companies registered under the Investment Company Act of 1940.⁵⁸

c. *Other Securities Exempt From NASD Rule 2790.* Paragraph (i)(10)(A) of the proposed rule would exclude from the definition of "new issue" offerings of securities that are restricted under various provisions of the Securities Act of 1933⁵⁹ and the Securities Exchange Act of 1934.⁶⁰ Paragraph (i)(10)(B) would exclude offerings of "exempt securities," as defined in Section 3(a)(12) of the Securities Exchange Act of 1934.⁶¹

Paragraph (i)(10)(C) would exclude from the definition of "new issue" offerings of securities of a commodity pool operated by a commodity pool operator, as defined in Section 1a(5) of the Commodity Exchange Act.⁶² The original proposal did not contain such an exemption. Two commenters argued that offerings of securities of commodity pools should be excluded from the definition of "new issue."⁶³ The commenters noted that commodity pool securities, whether offered publicly or privately, generally do not trade in the secondary market, and that investors may redeem their interests from the issuer at net asset value at selected intervals, much like open-end mutual funds, which are exempt from the proposed rule. In addition, they stated that the offering process is similar to that for registered closed-end funds in that the commodity pool operator is generally seeking as large an infusion of capital as possible and that such offerings are rarely oversubscribed. In Amendment No. 3, the NASD agreed and added a new paragraph (C) to paragraph (i)(10) of the proposed rule.

Three commenters recommended that the term "new issue" not include rights offerings to existing shareholders, exchange offers, and offerings made pursuant to a merger or acquisition.⁶⁴

⁵⁷ See Schwab.

⁵⁸ See *infra* notes 70–72 and accompanying text.

⁵⁹ 15 U.S.C. 77a *et seq.*

⁶⁰ 15 U.S.C. 78a *et seq.*

⁶¹ 15 U.S.C. 78c(a)(12).

⁶² 7 U.S.C. 1a(5).

⁶³ See MFA; Cadwalader.

⁶⁴ See MSDW; SIA; Sullivan.

⁵⁰ See Cadwalader; Katten; Rosenman; Schulte; Sullivan.

⁵¹ See Cadwalader.

⁵² In 1998, the NASD amended the Interpretation to exempt secondary offerings of actively traded