

b. *Limited Business Broker-Dealers.* Paragraph (i)(11)(B) specifically would exclude from the definition of “restricted person” the personnel and agents of a “limited business broker-dealer.” Paragraph (i)(8) would define “limited business broker-dealer” as a broker-dealer whose authorization to engage in the securities business is limited solely to the purchase and sale of investment company/variable contracts securities and direct participation program securities. These provisions of the proposed rule would preserve an exemption for associated persons of a limited business broker-dealer under the Interpretation.⁸¹ The NASD has emphasized, however, that this exemption would apply *only* to persons associated with such a limited business broker-dealer, not to the limited business broker-dealer itself.

Several commenters argued that the proposed definition of “limited business broker-dealer” is too narrow and should be expanded to include broker-dealers that do not have any involvement in the capital formation or equity underwriting business.⁸² The NASD has determined, however, not to broaden the scope of this exemption. The NASD believes that even broker-dealers engaged solely in, for example, proprietary trading or merchant banking activities (or the associated persons of such firms) might enter into reciprocal arrangements with other members that could create improprieties that the proposed rule seeks to address. In addition, the NASD believes that a rule requiring members to determine whether a person is engaged in reciprocal arrangements with a broker-dealer would be difficult to administer and enforce and would eliminate the certainty sought by the proposed rule.

One commenter, the Chicago Board Options Exchange (“CBOE”), urged the NASD to revise the proposal to treat CBOE market makers and floor brokers as limited business broker-dealers. CBOE stated that these exchange members should not be considered “industry insiders” as they are not in a position to take advantage of their position to participate in IPOs for their own accounts at the expense of public customers. CBOE maintained, therefore, that treating these CBOE members as restricted persons would be unnecessary

to accomplish the stated purposes of the rule. CBOE also argued that the proposal would put CBOE members at a competitive disadvantage relative to members of the futures exchanges: Although many futures products are economically similar to options, futures exchange members who trade them would not be restricted persons under the new rule. CBOE suggested alternate rule text that would allow a CBOE member to purchase new issues unless the underwriter of the IPO were an NASD member that executed stock transactions on behalf of the CBOE member.

In response to CBOE’s comment, the NASD stated in Amendment No. 2 that the proposed rule should apply generally to all broker-dealers and their associated persons. The NASD believes that a rule requiring analysis of the activities of a particular broker-dealer would be more difficult rule to administer and enforce than a rule based on a firm’s authorizations. The NASD recognizes that the Interpretation and the proposed rule make an exception for associated persons and owners of a broker-dealer that engages solely in the purchase and sale of investment company/variable contract securities and direct participation program securities. However, the NASD does not believe that the existence of this exemption for “limited business broker-dealers” necessitates additional exemptions.

With respect to the competitive issue between CBOE members and members of futures exchanges that trade financial derivatives, the NASD has acknowledged that futures exchange members would not—solely because of their status as such—be restricted persons under the proposed rule. However, the NASD believes that many futures exchange members would be subject to the proposed rule because of changes to the federal securities laws made by the Commodity Futures Modernization Act of 2000 (“CFMA”).⁸³ A futures exchange member that wishes to trade security futures products must register as a broker-dealer pursuant to Section 15(b)(11) of the Act, as amended by the CFMA.⁸⁴ In Amendment No. 5, the NASD clarified that the proposed rule would treat such futures exchange

members the same as “conventional” broker-dealers.⁸⁵

Finally, one commenter⁸⁶ recommended that the proposed rule include a provision that would allow an NASD member, in determining whether a firm is a limited business broker-dealer, to rely on the information contained in that firm’s Form BD.⁸⁷ In completing the Form BD, a broker-dealer must list all lines of business that account for 1% or more of its annual revenue. In the initial proposal, the NASD stated that a member “should look to the Form BD as well as any Restrictive Agreement” to determine the activities of a broker-dealer. Upon further review, the NASD clarified in Amendment No. 3 that a member *may* look to the Form BD as evidence of a firm’s status, but *must* inquire further about whether the firm meets the conditions of a limited business broker-dealer.

c. *Finders and Fiduciaries.* Paragraph (i)(11)(C) of the proposed rule would preserve a provision in the Interpretation that treats finders and fiduciaries of the managing underwriter as restricted persons. The NASD believes that finders and fiduciaries are industry insiders and, therefore, should be subject to the new rule. The NASD believes, moreover, that issuers must be prevented from circumventing the underwriting compensation limits of existing NASD Rule 2710 by offering finders or fiduciaries access to a new issue.⁸⁸ However, the NASD has proposed to treat finders and fiduciaries as restricted persons only for those offerings for which they are acting in those capacities. The NASD has added that, in the case of a law firm or consulting firm, the restriction would apply only to those persons working on the particular offering.

d. *Portfolio Managers.* The Interpretation prohibits the sale of hot issues “to any senior officer of a bank, savings and loan institution, insurance company, investment company, investment advisory firm or any other institutional type account.”⁸⁹ These persons are restricted because their position allows them the opportunity to direct business to a member firm.

⁸⁵ CBOE also recommended that members of that exchange who lease their seats and who are not engaged in a securities business not be considered restricted persons. In this matter, the NASD agreed and stated in Amendment No. 5 that it would not treat such persons as restricted persons under the new rule.

⁸⁶ See Fried 2.

⁸⁷ 17 CFR 249.501.

⁸⁸ NASD Rule 2710 defines the term “underwriter and related persons” to include “financial consultants” and “finders.”

⁸⁹ NASD IM-2110-1(b)(4).

⁸¹ See NASD IM-2110-1(c).

⁸² See Colish (suggesting that the definition of “limited business broker-dealer” also include broker-dealers that engage only in private placements); Fried (arguing that no broker-dealer should be a restricted person without some nexus to equity IPOs); Washington (suggesting that only broker-dealers that engage in an equity securities business should be restricted).

⁸³ Pub. L. No. 106-554, Appendix E, 114 Stat. 2763. The CFMA removed the prohibition on single-stock futures and set forth a regulatory scheme whereby entities that trade single-stock futures and other security futures products must register with both the Commission (under the Securities Exchange Act) and the Commodity Futures Trading Commission (under the Commodity Exchange Act).

⁸⁴ 15 U.S.C. 78o(b)(11).