

dealer. While such affiliates would not specifically be included in the definition of "restricted person," paragraph (a)(1) of the proposed rule would provide that a member may not sell a new issue to any account in which a restricted person (such as an owner of a broker-dealer) "has a beneficial interest." The NASD has stated that an owner of a broker-dealer—whom the proposed rule would explicitly deem a restricted person "would be viewed as having a beneficial interest in an account held by a subsidiary (*i.e.*, a sister company of the broker-dealer).

Several commenters stated that applying the proposed rule to affiliates has no policy justification.<sup>101</sup> These commenters were concerned, in part, that many financial services firms, which currently may invest in hot issues under the Interpretation, would be prohibited from purchasing new issues under the proposed rule simply by the accident of having become affiliated with an NASD member firm in the wake of the Gramm-Leach-Bliley Act,<sup>102</sup> which repealed many restrictions on affiliation among banks, insurance companies, and securities firms.

The NASD believes, nevertheless, that broker-dealer affiliates should be restricted persons. The NASD contends that, if the rule failed to restrict an account in which a restricted person had a beneficial interest, the restricted person could evade the restriction by directing a subsidiary to purchase the new issue instead. However, to offer some relief to entities that could be affected by the restriction on broker-dealer affiliates, the NASD is establishing an exemption for any such affiliate (except another broker-dealer) that is publicly traded.<sup>103</sup>

**g. Family Members.** The proposed rule would restrict various persons based on their functions in the financial services industry. In addition, paragraph (i)(11)(D)(ii) would restrict certain other persons based on their relationship with persons who work in the financial services industry. The NASD believes that these collateral restrictions are necessary to prevent a "functionally" restricted person from circumventing the rule by purchasing new issues through the account of an immediate family member. Paragraph (i)(5) would define "immediate family member" to include a person's parents, mother-in-law or father-in-law, spouse, brother or

sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children, and any other individual to whom the person provides "material support." This provision is based on a provision in the Interpretation<sup>104</sup> but supplements the existing provision by adding a definition of "material support" in paragraph (i)(9): the direct or indirect provision of more than 25% of a person's income in the prior calendar year. Paragraph (i)(9) of the new rule would deem members of the immediate family living in the same household to be providing each other with material support.

The NASD originally proposed that "material support" would mean providing 10% of another's income. One commenter supported the addition of a bright-line definition of "material support" but recommended that the threshold be raised to 25%, as measured in the prior calendar year.<sup>105</sup> The NASD agreed and revised the proposed rule text accordingly. Another commenter argued that the definition of "material support" was over-inclusive, as it was not necessarily based on the economic reality of the situation.<sup>106</sup> The NASD believes, however, that the "material support" provisions as proposed are a reasonable means to prevent evasion of the rule, and that, without clear and straightforward standards for collateral restrictions on family members, the rule would become difficult to administer. The NASD stated in Amendment No. 2 that it will not evaluate "material support" issues on a case-by-case basis.

In addition, the proposed rule would modify the treatment of sales to members of the immediate family of an officer, director, general partner, employee, or agent of a member or other broker-dealer (collectively referred to as "associated persons"). Under the Interpretation, members of the immediate family of an associated person may not purchase hot issues from the firm employing the associated person.<sup>107</sup> The proposed rule would expand this prohibition to include affiliates of the firm employing the associated person. The NASD believes that this change is necessary to clarify that immediate family members of associated persons may use neither traditional nor online distribution

channels to circumvent the prohibitions on sales to them.

Finally, two commenters pointed out that the original proposal appeared to have instances of faulty drafting where family members should have been exempt from the proposed rule but were not.<sup>108</sup> The NASD agreed with these comments and revised the proposed rule text accordingly.

**h. Investment Clubs and Family Investment Vehicles.** Two commenters urged that the proposed rule not prohibit their investment clubs from purchasing IPOs.<sup>109</sup> In response, the NASD in Amendment No. 4 revised the definition of "collective investment account" in paragraph (i)(2) of the proposed rule to exclude "investment clubs" (as defined in paragraph (i)(6)) and "family investment vehicles" (as defined in paragraph (i)(4)). Therefore, a person who has authority to buy or sell securities on behalf of an investment club or a family investment vehicle would not be a portfolio manager under paragraph (i)(10)(D)(i) and, therefore, not be a restricted person on that basis. In addition, even if an investment club or family investment vehicle included persons who were otherwise restricted (*e.g.*, because they were associated persons of a broker-dealer), such entity could still purchase new issues if it qualified for the *de minimis* exemption of paragraph (c)(4).<sup>110</sup>

Finally, one commenter recommended that the definition of "family investment vehicle" be expanded to include long-term family employees.<sup>111</sup> In Amendment No. 5, the NASD stated that the commenter had not presented sufficient reason to exclude such persons and declined to make this change. Moreover, the NASD believes that permitting non-family persons into the exemption for family investment vehicles could open the exemption to abuse.

**i. Joint Back Office Broker-Dealers.** Certain hedge funds, or subsidiaries thereof, have opted to become registered broker-dealers. These entities are generally known as "joint back office broker-dealers" ("JBOs") because they share a back office with another registered broker-dealer. Under the Interpretation, hedge funds that are (or are affiliated with) JBOs are not, solely on such basis, precluded from

<sup>101</sup> See MSDW; Orrick; Rosenman; SIA; Sullivan; Willkie.

<sup>102</sup> Pub. L. No. 106-102, 113 Stat. 1338 (1999).

<sup>103</sup> See *infra* notes 127-136 and accompanying text.

<sup>104</sup> See NASD IM-2110-1(I)(2).

<sup>105</sup> See Schwab.

<sup>106</sup> See Fried 2 (hypothesizing that two cousins sharing an apartment would be deemed to materially support each other under the proposed rule, even though they might not in fact be materially supporting each other).

<sup>107</sup> See NASD IM-2110-1(b)(2)(B).

<sup>108</sup> See Sullivan; Testa.

<sup>109</sup> See Fu; Smith.

<sup>110</sup> One commenter stated that an earlier version of the proposed rule appeared to inadvertently exclude investment clubs and family partnerships from the *de minimis* exemption. See Sullivan. The NASD has clarified that such entities may qualify for the *de minimis* exemption.

<sup>111</sup> See Cadwalader 2.