

purchasing hot issues on behalf of their investors. The special provisions for JBOs arise from an exemption granted by the NASD staff responding to certain provisions of the 1998 amendments to the Interpretation. Those provisions had the effect of precluding hedge funds registered as JBOs (or with JBO subsidiaries) from purchasing hot issues even if investors in the funds were not restricted. The NASD staff determined that sales of hot issues to a hedge fund should be based on the status of the beneficial owners of the fund, not simply the fund's status as a broker-dealer.¹¹² The proposed rule seeks to codify this exemption.

The NASD continues to believe that the election by an investment fund to become (or be affiliated with) a JBO should not by itself preclude the purchase of new issues by investors in that fund who are not otherwise restricted persons. The original proposal provided that a collective investment account—including a JBO—could avail itself of the *de minimis* exemption and included a definition of “joint back office broker-dealer.” In Amendment No. 2, the NASD removed any explicit references to JBOs. The NASD stated that, as a result of its revisions to the definition of “beneficial interest” and “restricted person,” the conditions that gave rise to the need for the JBO exemption had been removed. By clarifying that “beneficial ownership” includes a financial interest, such as the right to share in gains or losses, the NASD believed it had clarified that a JBO's legal ownership of securities would not constitute a “beneficial interest” for purposes of the proposed rule. The NASD, therefore, concluded that a specific exemption for JBOs was no longer necessary.

In Amendment No. 4, the NASD restored a specific reference to JBOs in the *de minimis* exemption, now relocated to paragraph (c)(4) of the proposed rule, as well as a definition of “joint back office broker-dealer” in then paragraph (i)(7). Two commenters noted problems with the definition.¹¹³ Under the NASD's final proposal, the NASD devised an alternative manner of exempting purchases of new issues by JBOs. New paragraph (a)(4) would provide an exemption for “purchases by a broker/dealer (or owner of a broker/dealer), organized as an investment partnership, of a new issue at the public offering price, provided such purchases are credited to the capital accounts of its

partners in accordance with paragraph (c)(4).” This exemption would allow an investment partnership (e.g., a hedge fund) that registers as a broker-dealer or that has a broker-dealer subsidiary to purchase new issues on the same terms as other investment partnerships. This approach is consistent with the relief granted in the original exemptive letter. Under Amendment No. 5, a hedge fund that registers as a broker-dealer or that has a broker-dealer subsidiary could purchase new issues so long as the beneficial interests of restricted persons do not exceed in the aggregate 10% of the fund. Accounts that are beneficially owned by restricted persons in excess of the 10% threshold may use carve-out procedures to prevent the restricted persons from receiving more than 10% of the notional *pro rata* proceeds of a new issue.

One commenter argued that an entity that is a non-natural person should be disregarded for the purposes of determining who holds the beneficial interest in an account, and that the rule should look only to natural persons who may hold beneficial interests in that account.¹¹⁴ This commenter concluded, therefore, that there is no need for a specific exemption for JBOs. In Amendment No. 5, the NASD responded that the commenter was correct that, in determining whether a person is a restricted person, one should “look through” to the persons who have the actual beneficial interests in the account's gains and losses. If one can look through until each of the natural persons is reached and, along the way, encounters no beneficial owners who are restricted persons, the account may purchase new issues. However, if the process of looking through reveals a restricted person identified in paragraph (i)(11) of the proposed rule—be it a natural person or a legal person—then the account may be restricted. The next step in the analysis, according to the NASD, is to determine whether the account qualifies for an exemption under paragraph (c) of the rule. For this reason, the NASD provided an exemption for JBOs: In the absence of an exemption, a JBO would be restricted even if it were beneficially owned entirely by non-restricted persons.

The NASD has stated that the exemption for JBOs would not extend to associated persons of a JBO. Three commenters argued that associated persons of a JBO should not, solely by virtue of their association with the JBO, be restricted persons.¹¹⁵ The NASD explained in Amendment No. 4 that

election to become a JBO bestows certain benefits on the investment account, but also imposes certain obligations, including restrictions on the ability of associated persons to purchase new issues. The NASD further explained in Amendment No. 5 that the act of registering a collective investment account as a JBO should not taint the *investors*, who otherwise might not be restricted persons. However, the NASD does not believe that this necessitates excluding *associated persons* of the JBO from the definition of “restricted person.”

3. General Prohibitions

Paragraph (a)(1) of the proposed rule sets forth the basic prohibition that a member (or an associated person thereof) may not sell a new issue to an account in which a restricted person has a beneficial interest, except as otherwise permitted under the rule. Paragraph (a)(2) would provide that a member (or associated person thereof) may not purchase a new issue in any account in which such member or associated person has a beneficial interest, except as otherwise permitted under the rule. Paragraph (a)(3) would provide that a member may not continue to hold new issues acquired as an underwriter, selling group member, or otherwise, except as otherwise permitted under the rule.

One commenter stated that these provisions could be read to prohibit accommodation sales (*i.e.*, sales to another broker-dealer at the public offering price to enable that broker-dealer's customer to purchase the new issue at the public offering price) as well as purchases by and among members of the selling group while engaged in the distribution of a new issue.¹¹⁶ The NASD agreed that neither of these outcomes was intended and, in Amendment No. 3, added a new paragraph (a)(4) to the proposed rule to address these concerns. Paragraph (a)(4)(A) would allow sales or purchases from one member of the selling group¹¹⁷ to another member that are incidental to the distribution of a new issue to a non-restricted person at the public offering price. Paragraph (a)(4)(B) would allow sales or purchases by a broker-dealer of a new issue at the public offering price as an

¹¹⁶ See SIA.

¹¹⁷ The term “selling group” is defined in existing NASD Rule 0120(p). In Amendment No. 4, the NASD replaced the term “syndicate” with the term “selling group.” The NASD elected to use the more expansive term “selling group” because it did not believe that whether a broker-dealer has made a financial commitment to purchase securities in an IPO is relevant for purposes of the rule.

¹¹² See letter from Gary Goldsholle, NASD, to David Katz, Sidley & Austin, dated January 20, 1999.

¹¹³ See Sidley 2; Willkie 3.

¹¹⁴ See Sidley 2.

¹¹⁵ See Rosenman; Sidley 2; Willkie 3.