

hot issue even though other employees are not required to do so.

In Amendment No. 2, the NASD provided additional detail to the proposed exemption for issuer-directed securities. Pursuant to Amendment No. 2, securities that the issuer specifically directed to persons such as employees, directors, and their friends and family would be exempt, even if such persons were restricted persons. The NASD stated that in recent years it has been presented with situations in which, for example, an employee of an issuer wanted to direct shares of a new issue to his or her parent, but was unable to do so because the parent was a restricted person (and not an employee or director of the issuer). The proposed rule, as revised by Amendment No. 2, would allow directed shares to be sold to the parent in this case.

One commenter recommended that all non-underwritten securities directed by the issuer should be exempt from the proposed rule.<sup>151</sup> The NASD believes, however, that a person who is otherwise restricted should not be allowed to purchase new issues pursuant to the issuer-directed security exemption unless such person (or a member of his or her immediate family) is an employee or director of the issuer, the issuer's parent, or a subsidiary of the issuer or the issuer's parent. In the NASD's view, a general exemption for all issuer-directed or all non-underwritten securities would be readily susceptible to abuse. The NASD also believes that the issuer-directed exemption should apply only when shares are in fact directed by the issuer; if a member firm asks or otherwise suggests that an issuer direct securities to a restricted person, the NASD does not believe that such securities should be exempt from the proposed rule. The NASD has stated that it would continue its practice of holding a managing underwriter responsible for ensuring that all securities in the public offering be distributed in accordance with the proposed rule.

Paragraph (d)(1) of the proposed rule would provide that, for purposes of the issuer-directed security exemption, a parent/subsidiary relationship is established if the parent had the right to vote, sell, or direct 50% or more of a class of voting security of the subsidiary. One commenter argued that a 10% ownership standard should apply instead.<sup>152</sup> The NASD believes that it is not uncommon for a member, through its merchant banking activities, to make

venture capital investments that constitute 10% or more of an issuer's capital. The NASD replied that, if it accepted this comment, all employees and directors of the member in such cases would be able to purchase the new issue. The NASD does not believe that exempting broker-dealer personnel by virtue of the broker-dealer's venture capital investments is consistent with the purposes of the proposed rule or the exemption for issuer-directed securities.<sup>153</sup>

One commenter<sup>154</sup> suggested that the scope of permissible purchasers under the issuer-directed exemption should be amended to conform with the permitted categories of offerees set forth in Rule 701 under the Securities Act of 1933.<sup>155</sup> The NASD determined not to act on this suggestion because it believes that the commenter's approach would be more difficult for members to implement.

Paragraph (d)(2) of the proposed rule would provide that the restrictions on the purchase and sale of new issues would not apply to securities that are part of a program sponsored by the issuer, or an affiliate of the issuer, that meets four criteria: (1) The program has at least 10,000 participants; (2) every participant is offered an opportunity to purchase an equivalent number of shares, or will receive a specified number of shares under a predetermined formula applied uniformly across all participants; (3) if not all participants receive shares under the program, the selection of the eligible participants is based on a random or other non-discretionary allocation method; and (4) the class of participants does not contain a disproportionate number of restricted persons. As proposed in Amendment No. 2, paragraph (d)(2) would have had a fifth criterion: that sales of the issuer-directed security not be made to participants who are managing underwriters or broker-dealers (or employees thereof) that are administering the program. One commenter welcomed an exemption for issuer-directed securities but argued that a requirement to investigate the facts about each of 10,000 participants

to prevent sales to persons listed in the fifth criterion would vitiate the relief granted.<sup>156</sup> The commenter added that relying on the large number of offerees as a basis for exemption would be consistent with the exemption for publicly traded entities, which is not dependent on any basis other than that a large number of persons would share the benefits of the new issue. The NASD agreed with the commenter and eliminated the fifth criterion.<sup>157</sup>

Another commenter<sup>158</sup> sought guidance on the meaning of the fourth criterion, which requires that "the class of participants does not contain a disproportionate number of restricted persons as compared to the investing public." In Amendment No. 5, the NASD stated that this condition is designed to ensure that a program is not directed to a group composed to a significant extent of restricted persons. The NASD also stated that, if an issuer has any questions about whether a specific program would qualify for this condition, the issuer should contact the NASD's Office of General Counsel for interpretative guidance.

## 6. Anti-Dilution Provisions

Paragraph (e) of the proposed rule would provide that the rule's basic prohibitions do not apply to an account in which a restricted person has a beneficial interest, if the account meets each of four criteria: (1) The account has held an equity ownership interest in the issuer for a period of one year prior to the effective date of the offering; (2) the sale of the new issue to the account does not increase the account's percentage equity ownership in the issuer above the ownership level as of three months prior to the filing of the registration statement in connection with the offering; (3) the sale of the new issue to the account does not include any special terms; and (4) the new issue purchased pursuant to this exemption is not sold or transferred for three months following the effective date of the offering. Paragraph (e) would supersede a similar provision in the Interpretation<sup>159</sup> and modify it slightly to allow an equity holder, for purposes of meeting the requirement that the interest in the issuer be held for one year, to count the period in which the

<sup>153</sup> The NASD notes that the proposed rule contains separate provisions that would permit venture capital investors to purchase new issues to avoid dilution in a public offering. See paragraph (e) of proposed NASD Rule 2790. The NASD believes that going beyond these protections for venture capital investors would be inconsistent with the purposes of the rule.

<sup>154</sup> See Sidley.

<sup>155</sup> 17 CFR 230.701 (providing an exemption from the registration provisions of the Securities Act for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation).

<sup>156</sup> See Fried 2.

<sup>157</sup> This commenter also noted that the exemption for issuer-directed securities, as proposed in Amendment No. 2, did not expressly permit an issuer to allocate its securities to employees and directors of sister companies, as described in the commentary to the proposed rule change. See Fried 2. The NASD has stated that this was an inadvertent omission and corrected the proposed rule text accordingly.

<sup>158</sup> See Testa 2.

<sup>159</sup> See NASD IM-2110-1(h).

<sup>151</sup> See MSDW.

<sup>152</sup> See Sullivan. But see MSDW (recommending a 50% threshold).