

holder had an interest in another company purchased by the issuer. The NASD has stated that this amendment is consistent with an NASD staff interpretative position.

One commenter questioned whether the NASD intended the anti-dilution provisions to apply only to natural persons, arguing that legal persons that have a prior equity ownership interest in an issuer also should be able to avail themselves of this exemption.¹⁶⁰ The NASD stated that the failure to extend the anti-dilution provisions to legal persons was inadvertent and revised the proposal accordingly.¹⁶¹

7. Stand-By Purchasers and Under-Subscribed Offerings

The NASD notes that the decision to apply the proposed rule to all new issues, not merely to hot issues, may create difficulties for offerings for which there is insufficient investor demand. Under the Interpretation, such offerings do not typically open at a premium and thus are not hot issues. With a rule that applies to all new issues, however, the rule should address circumstances in which purchases by restricted persons are necessary for the successful completion of an offering. Accordingly, paragraph (g) would provide that nothing in the rule would prohibit an underwriter, pursuant to an underwriting agreement, from placing a portion of a public offering in its investment account if it were unable to sell that portion to the public. In addition, paragraph (f) would provide that the prohibitions on the purchase and sale of new issues do not apply to purchases and sales made pursuant to a stand-by agreement that meets the following four conditions: (1) The stand-by agreement is disclosed in the prospectus; (2) the stand-by agreement is the subject of a formal written agreement; (3) the managing underwriter represents in writing that it is unable to find any other purchasers for the securities; and (4) securities sold pursuant to the stand-by agreement are subject to a three-month lock-up period. Paragraph (f) incorporates the existing exemption for stand-by purchases and sales found in the Interpretation.¹⁶²

Two commenters, although supporting the exemption relating to under-subscribed offerings, believed that it should be extended to permit an underwriter, in lieu of placing the

securities in its own investment account, to be able to sell such securities to one or more restricted persons.¹⁶³ One of these commenters stated that, if the objective of the proposed rule were to ensure a broad public distribution of securities for which there is significant demand, no regulatory objective would be furthered by restricting sales of offerings for which there is insufficient demand.¹⁶⁴ The NASD disagreed with these comments and stated that the provision was designed to ensure that the rule is consistent with an underwriter's contractual obligations to the issuer. The NASD believes that allowing an underwriter to sell a new issue to a restricted person if the issue turned "cold" would, in effect, reinstate the "hot issue" concept that the NASD is seeking to replace.

One commenter¹⁶⁵ asked for clarification that the proposed rule would not affect stabilization activities conducted under the Commission's Regulation M.¹⁶⁶ The NASD stated in Amendment No. 3 that the proposed rule would govern activities in connection with the distribution of new issues and would not have any effect on an underwriter's decision to engage in market stabilization activities, which occur after the security has commenced trading in the secondary market.

8. Exemptive Relief

The Interpretation contains a provision that allows the NASD staff to grant an exemption from any or all of the provisions of the Interpretation, if it determines that such exemption is consistent with the purposes of the Interpretation, the protection of investors, and the public interest.¹⁶⁷ Paragraph (h) would reincorporate the exemptive authority of the NASD staff into the new rule.

9. Definitions of Key Terms

a. *Beneficial Interest.* Paragraph (i)(1) of the proposed rule would define the term "beneficial interest" as any economic interest, such as the right to share in gains or losses. Consistent with a previously articulated NASD staff position,¹⁶⁸ the definition also would provide that the receipt of a

management fee or performance-based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity, would not be considered a beneficial interest in the account.

The term beneficial interest was defined in the original proposal as "any ownership or other direct financial interest." The NASD became aware that members found the reference to ownership, as distinct from a financial interest, unclear. The NASD believes that only those who profit from an account, rather than those legally own it, are of concern to the proposed rule and revised the proposal accordingly.

One commenter argued that the definition of "beneficial interest" should specifically exclude management or performance-based fees that are deferred for *bona fide* taxation reasons.¹⁶⁹ This commenter was concerned about the effect that deferred management or performance fees might have on a hedge fund manager's interest in a collective investment account that he or she managed. Another commenter noted that a portfolio manager might receive a management or performance-based fee for operating a hedge fund, the amount of which fees may be based on income from new issues.¹⁷⁰ This commenter asked the NASD to clarify whether these fees, if deferred for income tax purposes, would be deemed to create a beneficial interest in the fund held by the portfolio manager.

The NASD does not believe that it is appropriate to amend the definition of "beneficial interest" to expressly exclude performance-based allocations and deferred performance-based fees. In Amendment No. 5, the NASD counseled that the *initial* receipt of the fee would not constitute a beneficial interest in the collective investment account, because the definition of "beneficial interest" excludes "the receipt of a management or performance based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity."¹⁷¹ The NASD believes, however, that the accumulation of these payments, if *subsequently* invested in the collective investment account (as a deferred fee arrangement or otherwise) would constitute a beneficial interest in the account. The NASD believes that money invested in a collective investment account is part of a person's beneficial interest in that account even if the source of the money is a deferred fee arrangement. The NASD does not

¹⁶⁰ See Testa.

¹⁶¹ Subsequently, the same commenter noted several drafting errors with respect to the anti-dilution provisions as they appeared in Amendment No. 2. See Testa 2. The NASD subsequently made the necessary corrections.

¹⁶² See NASD IM-2110-1(e).

¹⁶³ See MSDW 2; Sullivan 2.

¹⁶⁴ See MSDW 2. This commenter also suggested imposing minimum capital contribution requirements for the stand-by provisions and extending the lock-up requirements from three months to one year. The NASD has stated that it does not believe that these additional requirements are necessary.

¹⁶⁵ See Testa 2.

¹⁶⁶ 17 CFR 242.100 *et seq.*

¹⁶⁷ See NASD IM-2110-1(a)(5).

¹⁶⁸ See NASD Notice to Members 97-5.

¹⁶⁹ See Rosenman.

¹⁷⁰ See Sidley 2.

¹⁷¹ See paragraph (i)(1) of proposed NASD Rule 2790.