

dealer is consistent with the new rule's general aim of ensuring that public investors rather than securities industry insiders receive the benefit of new issues. The Commission also agrees with the NASD that an exemption for "limited business broker-dealers"—based solely on what the firm is authorized to do on its Form BD—is more transparent and easier to administer than the type of standard for exempted broker-dealers advocated by CBOE, which would require an analysis of the activities actually conducted by the broker-dealer.

The Commission also believes that the new rule's treatment of joint back office broker-dealers is consistent with the Act. Under the new rule, a JBO would be able to purchase new issues provided that the interests of restricted persons in the JBO do not exceed 10%, although associated persons of the JBO will be restricted persons. JBOs are hedge funds or hedge fund affiliates that often are active participants in the securities markets. The associated persons of JBOs may be in a position to direct future business to an NASD member, and the purchases by such industry insiders of an IPO could create the appearance that the offering was not truly "public."

Under the new rule, restricted person status will extend to any immediate family member of a person who is "directly restricted" by the new rule on account of his or her position in the industry (such as an employee of a broker-dealer). The restriction on immediate family members also will apply to persons who receive material support from a directly restricted person. The Commission believes that these provisions are appropriate to prevent evasion of the new rule while not unduly extending the rule's restrictions to persons who could not reasonably be viewed as an alter ego of a directly restricted person.

Similarly, the Commission believes that it is appropriate to extend restricted person status to owners and affiliates of a broker-dealer. In the absence of such a provision, the restriction on the broker-dealer could easily be evaded. The Commission believes that it is reasonable and consistent with the Act for the new rule to assign restricted person status to persons listed on Schedules A and B of a broker-dealer's Form BD. While Schedule A requires reporting of interests of 5% or more in the broker-dealer, the new rule will restrict only those persons appearing on Schedule A who hold interests of 10% or more. The Commission believes that the 10% threshold for ownership interests in a broker-dealer as a criterion for restricted person status is

appropriate because it is consistent with the 10% *de minimis* threshold established in the rule's general exemptions. Moreover, basing restricted person status on a 10% interest reported on Schedule A (for direct owners of the broker-dealer) will lessen the likelihood that an entity reported on Schedule B (for indirect owners) will be deemed a restricted person even if the indirect owner has only a small economic interest in the broker-dealer. The Commission believes that the ownership classifications employed by the new rule are reasonably based, are already understood by NASD members, and will facilitate administration of the rule.

The Commission also believes that the publicly traded entity exemption is reasonable and consistent with the Act. The proposed rule assumes that a publicly traded entity generally will have wide public ownership, thus reducing the likelihood that a large percentage of the entity's shareholders are restricted persons who would unfairly benefit from the entity's purchase of new issues. The Commission believes that this assumption is reasonable in light of the quantitative standards that companies must meet to list their securities on a national securities exchange or the Nasdaq Stock Market.<sup>176</sup> Although there may be some publicly traded companies of which restricted persons nevertheless constitute a significant percentage of the shareholders, the Commission believes the general exemption for publicly traded entities strikes an appropriate balance between carrying out the purposes of the rule and minimizing its administrative burdens.

The exemption for publicly traded entities will not cover broker-dealers themselves or affiliates of broker-dealers that are authorized to engage in the public offering of new issues (either as a selling group member or underwriter). A broker-dealer, although publicly traded, is likely to have a higher concentration of restricted persons amongst its ownership. Therefore, the Commission believes that it is reasonable for the NASD not to afford broker-dealers—or affiliates of broker-dealers that sell or underwrite new issues—the benefits of the publicly traded entity exemption. In the absence of such a provision, significant potential to evade the new rule would exist.

Finally, the Commission agrees with the NASD that participation in an

investment club, by itself, should not cause a person to be restricted under the new rule, and that the treatment of investment clubs and family investment vehicles under the new rule is consistent with the Act.

### *C. Elimination of Conditionally Restricted Person Status and New De Minimis Threshold*

The new rule will eliminate "conditionally restricted person" status and adopt a standard that will render all persons either restricted or non-restricted. The Commission agrees with the NASD that, in some cases, a person may purchase a hot issue pursuant to the Interpretation's "conditionally restricted person" exemption even when such purchase appears contrary to the principles underlying the Interpretation. The Commission believes that the proposed rule change will help eliminate such cases, and that the definition of "restricted person" in the new rule will be more transparent and easier to administer.

Although all persons under the rule will be either restricted or non-restricted, the NASD has acknowledged that accommodation must be made for some restricted person participation in collective investment accounts. The alternative—prohibiting all new issue purchases by a collective investment account if even a single restricted person is a participant—would be unrealistic. The NASD has proposed, therefore, a 10% *de minimis* limit for restricted person participation in a collective investment account. The Commission agrees with the NASD that the purposes of the rule generally are not implicated if a member sells a new issue to a collective investment account in which restricted persons have only a small interest. The investors who are non-restricted persons will still receive the majority of the new issue's proceeds, and the notional portion of such proceeds accruing to the restricted persons would be sufficiently small as to provide little incentive for them to direct future business to the member as compensation. The Commission, therefore, finds that the 10% threshold proposed by the NASD is reasonable and consistent with the Act.

Three commenters criticized the NASD's decision to consider hedge fund managers as restricted persons in all cases, even with respect to the funds for which they act as portfolio manager.<sup>177</sup> After carefully considering these comments, the Commission finds that they do not raise any issue that

<sup>176</sup> See, e.g., NASD Rule 4420(a)–(c) (requiring 1,100,000 publicly held shares for inclusion on the Nasdaq National Market); New York Stock Exchange Listed Company Manual Rule 102.01A (requiring 1,100,000 publicly held shares for listing on the NYSE).

<sup>177</sup> See MFA 3; Sidley 2; Willkie 3; Willkie 4. See also *infra* notes 35–36 and accompanying text.