

**Securities Industry Association**

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July 25, 1997

Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

Re: NASD Regulation Notice To Members 97-30

Dear Ms. Conley:

The Securities Industry Association's ("SIA")¹ Self-Regulation and Supervisory Practices and Capital Markets Committees (the "Committees") appreciate this opportunity to comment on the proposed amendments to the Free-Riding and Withholding Interpretation set forth in IM-2110-1 (the "Interpretation") outlined in the above-captioned Notice To Members ("Notice"). In the Notice, NASD Regulation, Inc. ("NASDR") requests comment on specific amendments and solicits comment on how the Free-Riding and Withholding Interpretation could be revised and streamlined.

The Committees appreciate NASDR's efforts to simplify the Interpretation and make it easier to follow. Administration of the Interpretation in its current form is extremely burdensome for brokerage firms and their customers. We reiterate concerns that SIA has previously expressed regarding the expensive internal procedures firms must employ to demonstrate compliance with the Interpretation.² Consequently, we welcome refinements that will result in a more workable Interpretation.

In general, we believe that certain of the proposed changes are a step in that direction, but we believe that the Interpretation could be streamlined even further. Since its adoption in 1970 and through various amendments over the past quarter century, the Interpretation has been pulled and stretched beyond its original purpose. It no longer merely is a restriction simply against "free-riding and withholding," but rather has become a set of provisions that tries to circumscribe a host of potential abuses related to possible conflicts of interest and opportunities for self-dealing in the offering process, such as using securities to reward persons who are in a position to direct future business to the member. Although the NASD has conducted two reviews of the Interpretation during the last several years, the changes that have resulted are relatively minor.

The multi-faceted use of the Interpretation has several negative effects. First, the Interpretation has become highly complex, and time-consuming and costly to administer.³ In many cases, its provisions not only are burdensome, but also are difficult to interpret and apply in practice. Also,

because of the complexity of the rule and the questions regarding interpretation, full compliance with the rule may be compromised. Finally, in their efforts to diligently comply with the Interpretation, firms may err on the side of excluding any investor that arguably comes close to the definition from participating in offerings. If the Interpretation were more focused on its original purpose and scope, firms and customers may be more likely to satisfy its elements.

As an overall matter, therefore, we believe that NASDR should consider narrowing the scope of the Interpretation to ensuring that members make a bona fide public distribution of "hot issue" securities and do not withhold such securities for their own benefit. Other potential conflicts are already addressed in other interpretations of what constitutes "just and equitable principles of trade," or in other NASDR regulations or securities laws.

Consistent with this overall view, our comments on the specific amendments are set out below.

NASDR is proposing that the Interpretation be modified so that, with two exceptions, all equity owners or contributors to capital would be considered "restricted persons." The Interpretation would exempt purchases by passive investors who own or have contributed 10 percent or less of the firm's equity or capital and who purchase from a member other than the member in which they maintain the ownership interest, provided that the member in which they maintain an ownership interest is not in a position to direct issues to the owner or contributor. The Interpretation also would exempt purchases by persons who passively own 10 percent or less of the shares of broker-dealers that are traded on an exchange or NASDAQ.

The Committees do not necessarily object to NASDR's proposed definition of "restricted person" on its face, though we do not share the view that there is widespread confusion. However, the Committees believe that, in the interest of streamlining regulation, single definitions should be used for multiple and consistent purposes whenever possible. Instead of creating a new category of "restricted person," which itself could cause confusion and require interpretation, NASDR should incorporate an existing and widely-understood standard and use the term "affiliate" as defined in NASD Rule 2720 (b)(1). This would incorporate the built-in exemptions contained in the Interpretation. In addition, the term "affiliate" is broader in scope than NASDR's proposed definition of restricted person because it captures entities controlled by or under common control with a member. The Committees note that NASD Rule 2720 (b)(1) creates a presumption that a 10 percent ownership interest creates an affiliation, but permits that presumption to be rebutted upon appropriate facts and circumstances. The Committees believe that the flexibility provided by a rebuttable presumption would be appropriate to deal with situations where, despite a passive ownership interest of over 10 percent, the restricted person has no ability to control the allocation of a hot issue.

NASDR proposes to delete offerings of rated investment grade debt from the Interpretation on the ground that investment grade debt does not raise the same issues that are posed by equities under the Interpretation. The exception would apply to "non-convertible debt securities rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories."

The Committees generally agree with the acknowledgment that investment grade fixed income securities have different characteristics and pose different issues than equity securities. Investment grade fixed income securities are priced and traded primarily on the basis of yield.

The yield that a potential investor requires to invest in a rated fixed income instrument is a function of market interest rate movements. Equity securities, on the other hand, are priced and traded on the basis of market demand linked to factors intrinsic or specific to the security. Unlike investors in equity securities who seek a security of a particular issuer, investors in investment grade fixed income securities generally seek securities of a certain credit quality, maturity and at a given spread above a benchmark Treasury security having a comparable maturity. Investment grade fixed income securities of comparable credit quality and maturity are fungible, thus negating an underlying policy concern (*i.e.*, a particular issue being in great demand) that may have caused the adoption of the Interpretation in the first place.

The Committees believe that it is appropriate to treat investment grade fixed income securities differently than equity securities for purposes of the Interpretation. Although there has been evidence of abuse in connection with offerings of equity securities, NASDR has not identified instances of abuse in the fixed income market.

While the Committees generally agree with the NASDR's proposal, we would extend the exemption even further. We recommend that the exemption apply to all "investment grade securities that trade primarily on the basis of yield and credit quality" rather than to the more narrow threshold of "non-convertible debt securities rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories." The latter definition would not include numerous securities that trade based on interest rate movements rather than excessive demand for a particular security. Asset-backed securities, for instance, trade primarily on the basis of yield and credit quality, yet technically could be structured as an equity interest in a trust or similar vehicle. Numerous preferred stocks and newer forms of capital securities (*e.g.*, Trust Preferreds, MIPS, etc.), which trade primarily based on their yield and credit quality, would similarly be excluded from the benefits of the exemption if the NASDR does not change the definition along the lines we propose.

Limiting the exemption to non-convertible debt securities would also omit certain types of debt securities that are convertible into securities other than common stock (*e.g.*, securities convertible into preferred stock or another class of debt). The prices for such securities generally fluctuate based on interest rate movements and not excess demand for securities of a particular issuer. For the foregoing reasons, we believe that investment grade securities should be exempt if they are priced and traded primarily on the basis of yield and credit quality.

NASDR believes that it is important to provide express authority to grant exemptions in individual cases, and is proposing to amend the Interpretation for this purpose.

The Committees support this grant of exemptive authority because it will provide NASDR with the ability to carve out exceptions where individuals can demonstrate that the Interpretation should not apply, such as where a passive investor of over 10 percent has no ability to control the allocation of a hot issue as noted above.

Purchases of shares of investment companies registered under the Investment Company Act of 1940 ("1940 Act") are exempt from the restrictions of the Interpretation. NASDR is proposing to extend this exemption to the purchase of shares of foreign entities that are similar to U.S. investment companies. Specifically, NASDR is proposing to allow members to allocate shares to a foreign mutual fund if the fund provides written certification from a U.S. attorney or accountant

stating that: (1) the fund has 100 or more shareholders; (2) the fund is publicly offered; (3) no more than 5 percent of the fund's securities assets are invested in the securities of any one issuer; (4) any person owning more than 5 percent of the shares of the fund is not a restricted person as defined in subparagraphs (b)(1) through (b)(4) of the Interpretation; and (5) the fund is properly registered or authorized to do business in the foreign jurisdiction.

The Committees believe that it is unfair to require a foreign fund to obtain the necessary attestations from a U.S. attorney or accountant. This imposes undue burdens and costs on the buy side and limits the ability of such entities to engage fairly in global markets. If the goal is to create a level playing field for U.S. and foreign mutual funds, the exemption should apply to the foreign equivalent of U.S. registered investment companies without the need for written certification. Whether a foreign fund is the equivalent of a U.S. registered fund should be determined by the firm allocating the shares based on the criteria that NASDR proposes.

NASDR determined that secondary offerings should continue to be subject to the Interpretation, because it found that a relatively high percentage of secondary offerings trade at a premium.

The Committees strongly believe that the Interpretation should not apply to secondary offerings. Although the statistical information provided by NASDR indicates that approximately 33 percent of secondary offerings trade at a premium, in the experience of the members of the Committees, and as NASDR acknowledges, the premium generally is small. Indeed, focusing solely on premium does not take into account overall market movements and commissions, either of which could make a secondary offering appear to trade at a premium. Moreover, the supply and demand issues that generally surround an initial public offering are far less pronounced, and there is less opportunity for abuse, when an issue is already trading on an established market and historical bases for pricing exist. In fact, pricing of secondary offerings often is dictated by what the expected institutional demand for that security will be. Unless the issue is being offered at a substantial discount, which is rare, there is seldom an opportunity for abuse. Therefore, the Committees believe that the prohibitions should not apply to secondary offerings. In the alternative, because the vast majority of secondary offerings involve widely-held, seasoned issues, we believe that NASDR should exempt offerings of liquid issues at appropriate thresholds from the Interpretation.

With respect to accounts for qualified plans under the Employment Retirement Income Security Act (Qualified ERISA Plans), NASDR proposes that "any plan sponsored by a broker-dealer would be deemed per se restricted."

The Committees agree that a qualified ERISA plan sponsored by a broker-dealer should be restricted, but only insofar as it relates to a plan's transactions with the broker-dealer sponsoring that plan. The Interpretation should not prohibit a broker-dealer's ERISA plan from purchasing securities in a hot issue so long as the sponsoring broker-dealer is not also an underwriter of the securities. We wholeheartedly agree that a broker-dealer's ERISA plan's purchase of a hot issue underwritten by that same broker-dealer would be a conflict of interest and that such participation should not be permitted under the Interpretation.

NASDR requests comment on the appropriate nature and scope of the issuer-directed share exemption.

The Committees strongly support the clarification that all employees and directors of an issuer

should be allowed to purchase securities of the issuer, regardless of the employees' and directors' status as restricted persons. There have been numerous instances where a company is offering securities in a hot issue and employees and directors have been unable to participate and purchase shares at the initial public offering price, simply because of a tenuous affiliation with a restricted person. These employees and directors feel they are being unfairly excluded for reasons beyond their control which are in no way related to their status as employees or directors. We believe that these exclusions are unfair and contrary to the spirit of the 1994 amendments. Employees and directors should be able to purchase securities in the companies with which they are affiliated, without regard to whether the securities are part of a hot issue.

Miscellaneous

The Committees believe, particularly if the Interpretation will continue to apply to secondary offerings, that it is critical for NASDR to declare an issue "hot" as early as possible on the day trading commences so that firms can halt trading as appropriate rather than break trades after the fact. While we appreciate the reasons for not articulating the standards that determine when an issue is "hot," it would be helpful if NASDR could articulate publicly at least a minimum threshold below which market participants would have certainty that an issue will be "hot." Despite the ability to break trades, the reality is that, if notification occurs late in the day, purchasers may already have acted to their detriment by selling shares that had been allocated to them. Early notification and minimum thresholds will minimize this problem and add certainty to the process for both underwriters and investors.

Finally, NASDR should take this opportunity to clarify application of the Interpretation to multi-tranche off-shore offerings that are done simultaneously in the U.S. and abroad. We understand that the Interpretation applies to registered offerings in the United States but not to U.S. transactions exempt from registration under *Rule 144A*. It would be helpful if NASDR would clarify the applicability of the Interpretation in the event of a registered U.S. offering conducted simultaneously with an off-shore offering that is exempt from registration under *Regulation S*. Specifically, we request that NASDR confirm in such case that the Interpretation does not apply to the off-shore Regulation S offering in much the same way that it does not apply to Rule 144A transactions in the United States.

Thank you for the opportunity to comment on the proposed amendments to the Interpretation. If you have questions or would like to discuss our comments further, please contact the undersigned or Judith Poppalardo, staff advisor to the Self-Regulation and Supervisory Practices Committee, at 202-296-9410, or Mark Egert, staff advisor to the Capital Markets Committee, at 212-608-1500.

Sincerely,

R.Gerald Baker Ralph L. Pellecchio
Chairman Chairman
Self-Regulation and Supervisory Capital Markets Committee
Practices Committee

cc: Craig Landauer

Footnotes

1 The Securities Industry Association ("SIA") is the trade association representing the business interests of about 760 securities firms in North America. Its members include securities organizations of virtually all types - investment banks, brokers, dealers, and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for 90% of securities firm revenue in the United States.

2 See letter to Mr. Stephen D. Hickman, Corporate Secretary, NASD, from Mark T. Commander, Chairman, Self-Regulation and Supervisory Practices Committee, dated October 22, 1993, and letter to Mr. Robert I. Kleinberg, Governor, NASD, from Allen B. Holeman, Chairman, Self-Regulation and Supervisory Practices Committee, dated November 6, 1992.

3 Since 1996 when the NASD started monitoring compliance electronically, the increase in the number of Hot Issue Questionnaires has required many firms to devote even more resources to this area.