February 18, 2000

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Re: Securities Exchange Act Release No. 34-42325; File No. SR-NASD-99-60; Proposed Rule 2790; Trading in Hot Equity Offerings

Dear Mr. Katz:

The Self-Regulation and Supervisory Practices Committee and the Syndicate Committee (the "Committees") of the Securities Industry Association ("SIA")[1] appreciate the opportunity to comment on NASD Regulation's ("NASDR") proposed Rule 2790, which would govern allocations of "hot issues" and replace the Free-Riding and Withholding Interpretation under NASD Rule 2110.[2] According to the Release, the proposed new Rule is an effort to focus and streamline the Interpretation. Indeed, NASDR believes that the proposed Rule is more carefully targeted toward the purposes of the Interpretation and, at the same time, is significantly easier for the membership and the investing public to understand and follow. The Committees applaud NASDR for attempting to streamline the Interpretation. Certain of the changes, however, may make the Rule more difficult to administer than the current Interpretation and are inconsistent with the objectives stated above.

I. Introduction

The proposed Rule would differ from the existing Interpretation in several respects. Among other things, a formula would determine whether an offering is a "hot issue," which triggers application of the Rule. All public offerings as well as all secondary offerings of equity securities would be subject to the Rule and debt offerings would be excluded. The category of conditionally restricted persons would be eliminated, and the category of restricted persons would be expanded. Affiliates of a broker-dealer would be restricted persons under the proposed Rule and that term would be more clearly articulated. Finally, broker-dealers would be required to maintain "documentary evidence" in the form of a written, current certification from all public customers regarding their restricted person status.

SIA previously has noted the expensive internal procedures that firms must employ to demonstrate compliance with the Interpretation. Since its adoption and through various amendments over the years, the Interpretation has become highly complex, and time-consuming and costly to administer. We have consistently urged the NASD to consider refinements that result in a more workable Interpretation.[3] Because of the complexity of the Interpretation and questions regarding its application, we believe that full compliance is often compromised. Due to the dynamic nature of the capital markets process, a rule that is easily understood and simple to administer is critical. Therefore, we welcome NASDR's efforts to streamline and simplify the Interpretation.

Nevertheless, few, if any, of the proposed provisions minimize the complexity of the Interpretation. Ideally, the Committees would favor a straightforward rule that requires a broker-dealer to make a bona fide public offering of all securities issuances.[4] NASDR could review the allocation in the examination process, and firms would have to justify their allocation or be cited for violation of the Rule. As proposed, however, the Rule remains overinclusive and burdensome to administer. At a minimum, the Committees believe NASDR should consider the modifications discussed below.

II. Preconditions for Sale

A. The Requirement to Obtain Documentary Evidence from Every Account is Burdensome and Costly

Perhaps the most troubling aspect of the proposed Rule is the provision that requires, as a precondition for sale, that the broker-dealer "must have *obtained* within the previous 12 months *documentary evidence"* from the account holder certifying that no restricted person has a beneficial interest in the account. Additionally, the proposed Rule states that "a member may rely upon the *written representation* furnished by the customer. . ." This provision, on its face, requires salespersons to obtain *written documentation, once a year*, from *each account* that purchases new issues as to its status as a restricted person. This goes above and beyond the documentary requirements that currently exist under the Interpretation. The proposed Rule sweeps in the whole category of public, non-restricted investors who currently are not required to produce any written documentary evidence. Under the existing Interpretation, written documentation needs to be obtained only from investment partnerships and corporations, as well as from all broker-dealers and foreign banks. We believe that this new requirement is unintentional because the goal of the proposed Rule is to streamline the Interpretation and make the documentation requirements less burdensome, not moreso.

The Committees are very concerned about the written documentation requirement because it is much more burdensome than what currently is required. The difficulty in obtaining such documentation is obvious. Firms would have to request the required documentation through mailings and otherwise of *all* accounts rather than a small sub-category of accounts. There will be a significant incremental expense associated with this effort as well as with the costs associated with the accompanying compliance function (*i.e.*, monitoring to be sure that all accounts have provided the documentation prior to every new-issue allocation). If new issues are allocated to nonrestricted parties, but these parties have not provided sufficient or timely documentation, the NASD can seek fines and censure under such circumstances. The result will likely be many more technical violations under the Rule because firms will have difficulty obtaining the required written representations from all accounts. The Committees believe that the NASD intended the proposed Rule to provide a stronger framework to prohibit the sale of hot issues to restricted individuals, not to create technical violations that bear no relation to this important goal. Given the potential for technical violations, firms will have no choice but to limit retail accounts from purchasing hot issues.

The Committees believe firms should be permitted to rely on the reasonable means they use to comply with the current Interpretation. Firms generally rely on oral representations from public customers that they are not restricted persons and such representations are documented internally. This information typically is collected in the account opening process and updated as part of a firm's know-your-customer and suitability obligations, or in other account updating efforts. We would vigorously assert that there are no patterns of abuse in this connection that would require the NASD's dramatic shift in the approach to determining restricted person status. The Committees respectfully request that member firms be permitted to continue to qualify accounts orally and to maintain records of those oral representations.

B. <u>Type of Documentary Evidence is Significantly Improved</u>

The requirements as to what *type* of documentary evidence is needed under the proposed Rule (*i.e.*, any written evidence from the account holder or a person authorized to represent the purchaser) is a significant improvement over current requirements. Indeed, the proposed Rule eliminates the myriad means members must use to demonstrate that they have not sold hot issues to restricted persons. However, as discussed above, extending the written documentation requirements to all accounts is a significant additional burden. Therefore, we respectfully request that the <u>new</u> documentation requirement be applied only to the current universe of accounts requiring documentation (*e.g.*, investment partnerships and corporations, all domestic and foreign broker-dealers, and domestic banks and other conduits). There should continue to be no documentation requirements for public, non-restricted investors, registered investment companies, non-broker-dealer sponsored ERISA accounts, and accounts of non-financial corporations, etc.

Furthermore, the Committees believe the NASD should explore an automated means of updating certain account information regarding restricted person status. CommScan owns and operates a communications system and provides software applications that connect the broker-dealer and regulatory organizations involved in the offering process. The NASD engaged CommScan to develop the NASDesk/Compliance Desk software system to facilitate electronic communication among lead managers, syndicate members, and NASD's Corporate Financing Department. Under a no-action letter from the SEC,[5] CommScan has established a website on which it posts Qualified Institutional Buyers ("QIB") for purposes of Rule 144A . The Commission has agreed that sellers may rely on the QIB list as a method for establishing a reasonable belief that a prospective purchaser is a QIB, provided that the information on the list is current according to standards set out in the letter. The Committees believe the CommScan website could be expanded to include a site where certain accounts can post assurance that no restricted person will receive hot issues in contravention of the Rule.

C. Renewal Process Should Be Effected Every Three Years Rather than Annually

With respect to the renewal process, a letter to customers acknowledging their status based on existing firm records, which requests a response only if the information is no longer correct (*e.g.*, negative consent), should satisfy the requirement that restricted status information be updated. Such a negative consent letter should be required to be sent to the customer at least once every thirty-six months as a fail-safe measure backing up ordinary due diligence (*e.g.*, suitability and know-your-customer obligations) which is on-going. The thirty-six month time frame would be consistent with the updating requirement for account information in the SEC's revised books and records rules (not yet published).

Additionally, with respect to non-broker-dealer sponsored ERISA accounts, registered investment companies, insurance company portfolios, and other institutional investors, no renewal process should be required because the non-restricted status does not change over time. We respectfully request that, with regard to the renewal process, member firms be allowed to update the firm's records by negative consent letters every three years, and that for the above-referenced large institutional accounts, no renewal process be required.

III. Definition of "Hot Issue"

For purposes of the new Rule, an offering would be defined as a "hot issue" if, within the first five minutes of trading, the volume weighted price of the security is five percent or more above the offering price. The existing Interpretation, on the other hand, defines a hot issue as any security that trades at a premium. Most firms, as a practical matter, have been treating all initial public offerings as hot issues and have been withholding allocation of such issues to restricted persons. The threshold premium as proposed would not enable firms to alter this practice. From a compliance perspective, firms cannot be in a position of having to anticipate which offerings will trade through the threshold premium during the first five minutes of trading and, as a result, firms will continue to treat all initial public offerings as hot issues. The Committees believe that modifications are necessary to assure that the issues captured by the proposed formula are those which actually have a substantial and/or immediate secondary market premium, consistent with the intent of the Rule. We therefore urge NASDR to consider the alternatives discussed below.

First, the 5% threshold is too low and should be raised substantially. In the opinion of the Committees, the 5% threshold does not effectively distinguish between offerings for which there is substantial excess investor demand and offerings that are satiated by the initial public offering supply. A primary reason for this is the recent surge in electronic trading with market participants speculating on a sharp rise in initial public offering share prices during the first day of trading. The placement of market orders to buy on the open exerts extreme upward pressure on share prices by market participants who have no interest in a company's business prospects. These are not investors being deprived of stock in the initial public offering. Rather, they are speculators hoping to profit from flipping the stock during frenzied trading.[6] If the number of hot issues that NASDR selects for review and submission of a hot issue questionnaire significantly increases under the new Rule, then any potential benefits firms may have obtained through the threshold calculation are likely to be lost. The unintended result of establishing a threshold that is too low will be that firms, as they are doing now, will simply preclude restricted persons from participating in all initial public offerings.

Second, we question the practicality of basing the calculation on the first five minutes of trading. While we agree that volume weighted price is a calculation that can be performed by any member or investor with access to trade data, we believe that this time period is just too short. We appreciate the need to make a determination quickly but note that it takes some time for an issue to find its true trading level. Issues often trade at a premium within the first five minutes of trading – on very low volume – but level out shortly thereafter. The Committees therefore suggest that NASDR calculate the percentage based on the first half hour of trading and only on trading that occurs away from the lead underwriter. This will further reduce the chance that trading will be manipulated, particularly in Nasdaq SmallCap and Bulletin Board issues where there may be a small public float or the lead underwriter may be dominating the trading.

Despite the perceived ease of calculation,[7] the Committees believe that Syndicate Managers and Compliance personnel have come to rely heavily on the regulatory certainty provided to firms by the Compliance Desk service currently administered by NASDR. No matter how straightforward the calculation, it will never be an appropriate replacement for the staff determination that currently is being provided. Thus, we urge the NASD to continue to provide this valuable regulatory service.

While the proposed definition of hot issue provides greater clarity than the current Interpretation, many members of these Committees believe the NASD should adopt a more straightforward approach. These members believe that the NASD should prohibit the allocation of all initial public offerings to restricted persons, at least until all public demand is satisfied.

IV. Scope of the Rule

In addition to initial and secondary offerings, the proposed Rule defines public offering to include exchange offers, rights offerings, offerings made pursuant to a merger or acquisition, and other securities distributions of any kind whatsoever. With respect to rights offerings, the Committees fail to see how restricting existing owners from participating in such offers jeopardizes the integrity of the public offering process. The abuse that the Rule was designed to prevent, *i.e.*, enabling industry members to profit in the offering process by withholding securities in a public offering for their own benefit and selling to the public at a higher price, is simply not possible in an exchange or rights offering. In fact, if these offerings are included, existing investors may actually suffer harm through the dilution of their shares. The NASDR has acknowledged this in a series of exemption letters.[8]

Additionally, proposed Rule 2790 would apply to all initial and secondary public offerings of equity securities (including convertible debt offerings and other offerings with an equity component) that are "hot issues." All non-convertible debt securities would be exempted from the Rule. The Committees strongly agree with NASDR that debt offerings do not raise the same issues as equity offerings and support this aspect of the proposal. The Committees, however, strongly disagree that secondary equity offerings should be covered.

Although NASDR believes that, in practice, most secondary offerings will continue to be exempt under the proposed Rule, once again, firms cannot be in the position of having to anticipate which secondary offerings will be subject to the Rule. As a result, firms will treat all secondary offerings as hot notwithstanding that few secondary offerings trade at a premium and, those that do often do so because they have been priced at a discount to encourage participation.[9] The supply and demand issues that generally surround an initial public offering are far less pronounced in the context of secondary offerings. When an issue is already trading on an established market and historical bases for pricing exist, there is less opportunity for abuse. Including issues of this type would not further the purposes of the proposed Rule. In fact, secondary offerings of actively-traded issues currently are exempt from the Interpretation, and we are not aware of any abuses in connection with such offerings that would cause NASDR now to subject them to the new Rule. At a minimum, the Committees strongly urge NASDR to use the definition of "actively-traded security" under Securities Exchange Act Regulation M to exempt many secondary offerings, which is the exclusion provided under the current Interpretation.

V. Definition of Restricted Person

The proposed Rule purports to simplify the categories of "restricted persons" to whom sales of hot issues are prohibited and to more precisely target those persons to whom the Rule applies. Restricted person under the proposed Rule would include, among others, any employee or other person who supervises, or whose activities directly or indirectly involve or are related to, the buying and selling of securities for a bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account.[10] In contrast to the current Interpretation, NASDR is employing a more function-oriented approach to limit the employees in the securities departments of the covered entities that would be restricted.

Despite the attempt to more carefully target those subject to the Rule, the number of entities covered by the proposed Rule will increase significantly if NASDR defines restricted person to include affiliates of a broker-dealer. The definition of restricted person is overbroad and essentially contradicts the intent of the Rule to better target those with investment discretion for restricted person status, rather than targeting the firm in its entirety. Many firms have asset management affiliates that manage discretionary accounts as well as accounts for unaffiliated persons. We strongly suggest that to the extent that affiliates of broker-dealers become restricted persons under the Rule, the Rule more clearly exempts certain classes of accounts maintained by broker-dealer affiliates. Affiliation clearly does not dictate the ability to engage in reciprocal arrangements between industry members in the allocation of public offerings. Within a firm, Chinese Walls are used in many contexts to separate those employees with access to confidential or nonpublic information from others that, because of their function in the firm, should not have such access to such information. This is an accepted practice with respect to various regulated entities and could readily be used.

The current Interpretation covers natural persons who are associated with a broker-dealer and certain persons who have contributed capital to a broker-dealer, but not other affiliates such as related corporations. The result of the proposed Rule, the Committees note, will be to apply the proscriptions in the Rule to many important institutional investors, including certain banks, bank holding companies, investment advisors, and other industrial companies. Given the recent repeal of the Glass-

Steagall Act, this new prohibition will have a significant impact that appears to have been overlooked.

Certainly, reciprocal arrangements between industry members in the allocation of public offerings must be prevented, but the proposed Rule continues to prevent participation in the capital markets by an ever-growing segment of the population that has no interest in or power to engage in reciprocal arrangements. A rule targeted to conduct which has the purpose or effect of creating reciprocal arrangements, rather than one which seeks to prevent them based on complex definitions of status in the industry, would better serve the capital markets and would be more fair to industry members, their relatives, and other market participants.

The proposed Rule also would significantly narrow the existing exclusion for employee benefit plans by restricting sales of hot issues to any employee benefit plan qualified under ERISA that is sponsored by a broker-dealer affiliate. The current Interpretation only restricts sales of hot issues to employee benefit plans sponsored by member firms and sponsored by entities engaged in financial services activities unless such plan permits participation by a broad class of participants and the plan is not designed primarily for the benefit of restricted parties. Sales to other employee benefit plans are not restricted under the existing Interpretation. However, with the exception of government employee plans, Section (e)(5) of proposed Rule 2790 only exempts employee benefit plans qualified under ERISA "provided that the plan sponsor is not a member or an affiliate." As a result, an employee benefit plan sponsored by any entity which controls, is controlled by or is under common control with an NASD member, even if such plan permits broad participation and was not designed primarily for the benefit of restricted persons, would not be able to purchase hot issues. This approach is inconsistent with the current Interpretation pursuant to which a plan is not deemed a restricted person merely because it is affiliated with a member, and would exclude a large number of participants in existing and future plans sponsored by financial services companies from participating in hot issues.

The Committees are not aware of any perceived or actual abuses involving employee benefit plans that would make it in the public interest to narrow the exclusion for such plans under the current Interpretation. Employee benefit plans are already subject to stringent regulation under the provisions of ERISA. ERISA imposes a "prudent man standard of care" on plan fiduciaries in administering the plan, one of the highest standards imposed by law. A plan fiduciary must act solely in the interest of plan participants and beneficiaries, and has a duty to diversify the investments of the plan. Furthermore, a fiduciary breaches its fiduciary duty to plan participants if it engages in self-dealing or other actions not in the best interest of participants, including conduct that is inconsistent with the policies underlying the proposed Rule. These standards also require that there be a Chinese Wall between a plan fiduciary and an affiliated member firm.

Accordingly, the Committees respectfully request that the proposed Rule be modified to maintain the current restrictions on sales of hot issues to employee benefit plans, which preclude from purchasing hot issues only those employee benefit plans sponsored by member firms or sponsored by financial services companies that do not permit participation by a broad class of participants, or are designed primarily for the benefit of restricted parties.

VI. Conclusion

The Committees applaud NASDR for attempting to minimize the complexity and scope of the Free-Riding and Withholding Interpretation. While we believe some of the proposed changes will make the Rule easier to understand, the Committees believe NASDR could go further without jeopardizing the objectives of the Interpretation and the proposed Rule. Despite the efforts to streamline, the proposed Rule remains a complex web of definitions which is potentially overinclusive and burdensome to administer. We hope that our comments are useful in fashioning a final Rule that can be easily understood and effectively administered. We note, too, that if the Rule is adopted, the hot issue questionnaire will need to be modified and the Committees would be happy to work with you on that process.[11]

Thank you for the opportunity to comment on the proposed Rule. If you have any questions or would like to discuss our comments further, you can contact the undersigned or Judith Poppalardo, Staff Advisor to the Self-Regulation and Supervisory Practices Committee, at 202-296-9410.

Sincerely,

Christopher R. Franke	John C.Burch, Jr.
Chairman	Chairman
Self-Regulation and Supervisory Committee	Syndicate

Practices Committee

CC: Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Katherine A. England, Assistant Director, Division of Market Regulation
Joseph P. Corcoran, Division of Market Regulation
Alden S. Adkins, Senior Vice President and General Counsel, NASDR
Gary L. Goldscholle, Assistant General Counsel, NASDR
Joseph E. Price, Director, Corporate Financing, NASDR