



# GlobalNote

## ANNUAL VERIFICATION OF INVESTORS' STATUS UNDER NEW ISSUE RULE<sup>1</sup>

**To:** Clients and Friends of Tannenbaum Helpern Syracuse & Hirschtritt LLP

**Date:** February 2007

### I. Introduction

On October 24, 2003, the U.S. Securities and Exchange Commission (the "SEC") approved proposed Rule 2790 of the National Association of Securities Dealers, Inc. (the "NASD") entitled *Restrictions on the Purchase and Sale of IPOs of Equity Securities* (the "Rule" or "Rule 2790").<sup>2</sup> Rule 2790 replaced the *Free-Riding and Withholding Interpretation* set forth in IM-2110-1 (the "Interpretation"). Rule 2790 generally prohibits NASD members or their associated persons ("Members") from selling a "new issue"<sup>3</sup> to any account in which a "restricted person" has a beneficial interest. The term "restricted person" includes most associated persons of a Member, most owners and affiliates of a broker/dealer, and certain other classes of persons.

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<sup>1</sup> This Memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects discussed herein. For further information see the firm's website: [www.thshlaw.com](http://www.thshlaw.com).

<sup>2</sup> SEC Order Approving Proposed Rule Change and Amendments Nos. 1 Through 4 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 5 Thereto by the NASD Relating to Restrictions on the Purchase and Sale of Initial Public Offerings of Equity Securities, 61 Fed. Reg. 62126 (October 31, 2003) (the "Approval Order") (Release No. 34-48701, File No. SR-NASD-99-60). See also Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the NASD to Interpret Two Provisions of New NASD Rule 2790 Relating to Initial Public Offerings (December 22, 2003) (Release No. 34-48973, File No. SR-NASD-2003-190).

<sup>3</sup> A "new issue" is an initial public offering of an equity security.

In December 2003, the NASD issued Notice to Members 03-79 (the “Notice”) which (i) set the effective date of compliance with the Rule for all Members and (ii) provided certain interpretive guidance relating thereto.<sup>4</sup> As explained in the Notice and discussed more fully below, Rule 2790 requires that Members, before selling a new issue to any account (i.e., fund or managed account), meet certain “preconditions for sale,” which generally require such Members to obtain a representation from the beneficial owner of the account that the account is eligible to purchase new issues in accordance with the Rule. While the NASD requires that the initial verification of an account’s status under the Rule be a positive affirmation from the beneficial owners of the account, thereafter, a person authorized to act on their behalf or a conduit is permitted by the NASD to allow Members to conduct annual verification of an account’s status through the use of negative consent letters.

These preconditions are important for hedge fund managers in particular because such managers have to make the required representations to Members on behalf of their funds. As a result, a hedge fund manager has to be sure that it has supporting representations from its fund’s investors who participate in new issues.

## **II. Preconditions for Sale**

Rule 2790 requires Members to obtain within the twelve months prior to a sale of a new issue to an account holder, either from the beneficial owners of the account or a person authorized to represent the beneficial owners of the account, an affirmative written statement that the account is eligible to purchase new issues in compliance with the Rule. Members are required to verify this status on an annual basis.

Section (b) of Rule 2790, “Preconditions for Sale,” specifically provides as follows:

*Before selling a new issue to any account, a member must in good faith have obtained within twelve months prior to such sale, a representation from:*

*(1) Beneficial Owners*

*the account holder(s), or a person authorized to represent the beneficial owners of the account, that the account is eligible to purchase new issues in compliance with this rule; or*

*(2) Conduits*

*a bank, foreign bank, broker/dealer, or investment adviser, or other conduit that all purchases of new issues are in compliance with this rule.*

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<sup>4</sup> NASD Notice to Members 03-79 (December 2003).

*A member may not rely upon any representation that it believes, or has reason to believe, is inaccurate. A member shall maintain a copy of all records and information relating to whether an account is eligible to purchase new issues in its files for at least three years following the member's last sale of a new issue to that account.*<sup>5</sup>

If an interest is held by a bank, broker-dealer, investment adviser or other conduit, prior to selling the new issue, the Member is required to obtain a representation from such conduit that all purchases of new issues are in compliance with the rule. All representations obtained from account holders, authorized persons or conduits must be within twelve months prior to such sale and no Member may rely on a representation that they believe, or have reason to believe is not accurate.<sup>6</sup>

### **III. Annual Verification of New Issue Eligibility Representations through Use of Negative Consent Letters**

The NASD requires the initial verification of an account's status under the Rule to be a positive affirmation from the beneficial owners, persons authorized to act on their behalf, or a conduit. However, as noted in the Approval Order, the NASD will permit Members to conduct the annual verification of an account's status through the use of negative consent letters. Thus, a Member may furnish a customer with account information on record used to determine that the account is eligible to purchase new issues and ask the customer to indicate whether anything has changed to make the account restricted. In the absence of any response from the customer, the Member may continue to deem the account as non-restricted. In addition, the NASD permits the use of electronic communications in accordance with the standards adopted by the SEC and the NASD for the use of such communications (*e.g.*, where appropriate notice has been provided and where necessary customer consent has been obtained). Lastly, however, the NASD will not permit Members to verify customer account information orally.<sup>7</sup>

A hedge fund manager should conduct an annual verification with respect to its fund's investors. The manager may utilize the negative consent procedure to send letters to its investors asking if there has been a change in their restricted status. Such negative consent letter should also include a new issue questionnaire to enable investors whose eligibility status has changed to provide the hedge fund manager with more current information.<sup>8</sup>

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<sup>5</sup> New Rule 2790(b).

<sup>6</sup> Approval Order, *supra* note 2, at 6.

<sup>7</sup> See Letter from Morgan Stanley Dean Witter to Jonathan G. Katz, SEC, dated March 17, 2000; Letter from Morgan Stanley Dean Witter to Secretary, SEC, dated January 31, 2001; Letter from Securities Industry Association to Jonathan G. Katz, SEC, dated February 18, 2000; Letter from Sullivan & Cromwell to Jonathan G. Katz, SEC, dated February 15, 2000.

<sup>8</sup> See Approval Order, *supra* note 2, at 6; see also Notice, *supra* note 2, at 842; see also Letter from Gary L. Goldsholle, Associate General Counsel, Regulatory Practice and Policy, NASD, Inc., to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated October 22, 2003, 10 (noting in response to inquiries of whether procedures for annual verifications of an investor's status require an

#### **IV. Master-Feeder Funds**

Under Rule 2790, a Member must only obtain a representation from a person authorized to represent the beneficial owners of the fund/account that purchases new issues directly from the Member (the “master fund”). Any person making such a representation would need to ascertain the status of investors in the feeder funds that invest in the master fund. Hedge fund managers of master funds should therefore send letters to the investors of the feeder funds which invest in such master fund inquiring as to whether the investors’ status has changed. If hedge fund manager of a master fund is unable to ascertain the status of investors in a feeder fund, the master fund must deem such feeder fund to be restricted and ensure that any profits from new issues are not allocated to that fund (or consider whether any exemption, such as the *de minimis* exemption, might apply to that feeder fund).<sup>9</sup>

While the Rule specifies that a Member must verify the status of the master fund annually, the Rule does not specify a time period during which a master fund may rely on information from a feeder fund. The NASD recognizes that logistical impracticalities may prevent all hedge fund managers of feeder funds from verifying information at the same time as the representative of the master fund. Thus, the NASD will allow the representative of a master fund to rely on information from any feeder fund that is no more than 12 months old. Similarly, the representative of a feeder fund that in turn receives investments from other feeder funds may also rely on information no more than 12 months old.<sup>10</sup>

In addition, if a feeder fund is beneficially owned in part by restricted persons and seeks to avail itself of the *de minimis* exemption, the person authorized to represent that fund should specify the percentage ownership by restricted persons. An authorized representative of a master fund that invests directly in new issues will be responsible for aggregating interests of restricted persons from the feeder funds to ensure that the aggregate ownership by restricted persons does not exceed the 10% threshold.<sup>11</sup>

#### **V. Funds-of-Funds**

In the context of a fund-of-funds, the role of the top-tier fund and the lower-tier funds are reversed. A portfolio fund in which a fund-of-funds invests is the “master fund” because it is the fund that purchases securities directly from broker-dealers, and the investing fund-of-funds is the “feeder fund” because it is the fund that allocates its capital to an underlying fund. It is the underlying fund that bears the responsibility to determine whether investors that invest into the fund, e.g. an investor fund, are restricted persons

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affirmative response, that the NASD intends to permit such verification to be conducted through the use of negative consent).

<sup>9</sup> See Notice, *supra* note 2, at 842.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 843.

and to aggregate ownership of such restricted persons. If the fund manager of a fund-of-funds is unable to represent to an underlying fund the status of its investors, then the fund-of-fund, i.e. the investor fund, will find itself to be deemed restricted.<sup>12</sup>

## **VI. Impact on Hedge Fund Managers**

Hedge fund managers who have not already done so in the past twelve months should send a negative consent letter to each current investor who is eligible to participate in new issues with an enclosed questionnaire asking whether anything has changed to affect such investor's eligibility since the completion of the subscription documents. Should anything have changed to affect such investor's eligibility, such investor should complete the enclosed questionnaire and return it to the fund, for purposes of determining whether such investor falls within the proscription of the Rule and is therefore precluded from participating in new issues. In the absence of an affirmative response from the investor, a hedge fund manager can rely on existing information as to the investor's eligibility to invest in new issues.

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Please do not hesitate to contact us with comments or questions or for assistance with drafting negative consent letters to be sent to investors and to comply with new NASD Rule 2790.

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<sup>12</sup> Tannenbaum Helpert Syracuse & Hirschtritt LLP memorandum, NASD Releases Notice to Members Regarding New Rule 2790 (Restrictions on the Purchase and Sales of IPOs of Equity Securities), (January 30, 2004) available at <http://www.thshlaw.com/Publications/BP.1.04.pdf>.