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a note from Tannenbaum Helpert Syracuse & Hirschtritt LLP

**NASD Releases Notice to Members Regarding New Rule 2790
(Restrictions on the Purchase and Sales of IPOs of Equity Securities)¹**

To: Clients of Tannenbaum Helpert Syracuse Hirschtritt LLP

Date: January 30, 2004

On December 23, 2003, the National Association of Securities Dealers, Inc. (the “NASD”) issued Notice to Members 03-79 regarding new NASD Conduct Rule 2790 (Restrictions on the Purchase and Sale of IPOs of Equity Securities) (“NASD Rule 2790”).² NASD Rule 2790 generally prohibits a NASD member from selling a “new issue” to any account in which a “restricted person” has a beneficial interest. Furthermore, before a NASD Member can sell a new issue to any account, the NASD Member must first satisfy certain “preconditions for sale” which generally require the NASD Member to obtain a representation from the beneficial owner of the account³ or a conduit⁴ that the purchaser is eligible to purchase new issues in accordance with NASD Rule 2790.

The purpose of NTM 03-79 is for the NASD to clarify certain points raised in the earlier SEC release whereby the SEC approved NASD Rule 2790. This memorandum highlights the key areas discussed in this Notice that was not discussed in the prior SEC release and examines the impact of NASD Rule 2790 on hedge fund managers.

Effective Date

NASD Rule 2790 became effective on December 23, 2003. From December 23, 2003 through March 22, 2004, a NASD Member may choose to comply with NASD Rule 2790 or with the provisions of the NASD’s Free Riding and Withholding Interpretation set forth in IM-2110-1 relating to the restrictions on the distributions of “hot issues” (the “Three-Month Transition Period”). **Effective March 23, 2004, all NASD Members and their associated persons must**

¹ 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 treated here.

² NASD Notice to Members 03-79 (December 2003) (“NTM 03-79”). See also Release No. 34-48701 “Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment Nos. 1 through 4 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 5 Thereto by the National Association of Securities Dealers, Inc. Relating to Restrictions on the Purchases and Sales of Initial Public Offerings of Equity Securities” (October 24, 2003) (“Release No. 34-48701”); THSH Memorandum, “SEC Approves Rule Change to NASD Hot Issues Rule” (November 13, 2003).

³ NASD Rule 2790(b)(1).

⁴ If an interest is held by a bank, foreign bank, broker-dealer, investment adviser, or other conduit, a NASD Member is required to obtain a representation from such a conduit that it is in compliance with NASD Rule 2790. NASD Rule 2790(b)(2).

comply with NASD Rule 2790. As such, any hedge fund manager that wishes to purchase new issues will also have to comply with NASD Rule 2790 starting on March 23, 2004.

Master-Feeder Structures

A. Master-Feeder Funds

In the context of master-feeder structures, a NASD Member must only obtain a representation from a person authorized to represent the beneficial owners of the top-tier fund (the “master fund”) that purchases new issues directly from the NASD Member. The representative of the master fund, however, bears the burden of having to ascertain the status of investors of any lower-tier funds (“feeder funds”) that invest in the master fund. Moreover, the representative of the master fund has the responsibility for aggregating interests of restricted persons from the feeder funds to ensure that the aggregate ownership by restricted persons does not exceed the 10 percent *de minimis* threshold. 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 the feeder fund should specify the aggregate ownership by restricted persons.

For purposes of determining the ownership level of restricted persons in a master fund, the interests of restricted persons in the feeder fund(s) is attributed to the master fund in an amount equal to the restricted persons’ interest in the feeder fund(s) times the master fund’s interest in the feeder fund(s). If the total interest of restricted persons exceeds the 10 percent threshold, then the master fund would not be eligible to use the *de minimis* exemption unless the master fund reduced the interest of restricted persons to below the ten percent threshold.

If the representative of the master fund is unable to ascertain the status of an investor 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 feeder fund.

NASD Rule 2790 does not specify the time period during which a master fund may rely on information from a feeder fund. According to the NASD, in light of the logistical impracticalities that may prevent all authorized representatives of feeder funds from verifying information at the same time as the representative of the master fund, the NASD is permitting the representative of a master fund to rely on information from any feeder funds that is no more than twelve (12) months old.

B. Fund-of-Funds

In the context of fund-of-funds, the roles 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 will be the underlying fund that bears the responsibility to determine whether investors that invest into the fund, e.g. an investor fund, are restricted persons and to aggregate ownership of such restricted persons. If an underlying fund finds itself exceeding the 10 percent threshold as a result of investor funds having an aggregate beneficial interest over 10 percent and such underlying fund wants to participate in new issues, then the underlying fund will have to undertake measures to ensure that the aggregate ownership of restricted persons is within the 10 percent *de minimis* exemption.

Carve-Out Procedures

Purchasers of new issues such as hedge funds may continue to implement carve-out procedures so that restricted persons may participate in the gains (or losses) attributable to new issues. Although Rule 2790 eliminates the specific “carve-out” procedures described in IM-2110-1, the NASD is permitting investors to continue to employ means of segregating interests of restricted persons. As such, investors may choose to adopt “separate accounts” similar to the provisions of IM-2110-1(g) or to maintain one account but adjust the capital accounts of restricted persons to remove any gains (or losses) attributable to new issues.

Journaling

The making of book entries between accounts, i.e. “journaling,” of non-restricted persons and restricted persons is permitted under NASD Rule 2790. The NASD believes that it would be appropriate for firms to allow restricted persons to share in the subsequent gains and losses from new issues provided that restricted persons purchase the new issue not at the initial public offer price but *at the prevailing market price* at the time their capital account reflects ownership of the security. Previously, the NASD did not view the Interpretation as permitting journaling of “hot issues” from one account to another.

Definition of New Issue

The term “new issues” is not limited to only domestic initial public offerings of equity securities. According to the NASD, new issues include non-U.S. initial public offerings.⁵ Accordingly, the prohibitions set forth in NASD Rule 2790(a) apply to NASD Members and their associated persons with respect to non-U.S. offerings. As such, hedge fund managers whose strategies include investing in non-U.S. initial public offerings should be cognizant of the provisions under NASD Rule 2790 and should be prepared to give a representation that they are in compliance with the rule to a NASD member that sells non-U.S. initial public offerings.

What Must a Hedge Fund Manager Do during the Three-Month Transition Period?

Since the portfolio manager of a collective investment vehicle, e.g. a hedge fund, is a restricted person and the portfolio manager and the fund’s investors who are restricted persons collectively may not participate in the gains (or losses) of new issues unless the fund satisfies the *de minimis* exemption, it is critical to know who among the fund’s investors are restricted persons. By knowing which investors are restricted persons and non-restricted persons prior to March 23, 2004, the fund manager should be able to implement measures to ensure that the beneficial ownership by restricted persons is within the 10 percent *de minimis* exemption so that the fund manager is in the position to be able to give a representation to a NASD Member that it is eligible to participate in new issues.⁶

⁵ NTM 03-79, note 13.

⁶ A collective investment account, e.g. a hedge fund, in which restricted persons hold more than a ten percent beneficial interest may continue to participate in the gains (or losses) of new issues provided that restricted persons do not receive more than ten percent of the notional *pro rata* proceeds of the new issue. See Release No. 34-48701. Fund managers of offshore funds should note that deferred management and performance fees that are accumulated and then subsequently invested in their hedge funds would constitute a beneficial interest in the collective investment account. See Release No. 34-48701.

Fund managers that manage a master-feeder structure should now start ascertaining the status of their investors in the feeder funds since the authorized person of the master fund bears the responsibility to represent that the master fund is able to purchase new issues based on the amount of beneficial ownership held by restricted persons at the feeder fund level. Note that if the fund manager of the master fund is unable to ascertain the status of investors in the feeder fund(s), then the master fund must deem the feeder fund(s) to be restricted and as such not allocate profits from new issues to the feeder fund(s). In light of the potential difficulties of ascertaining the status of beneficial owners at the feeder level, the fund manager of the master fund should determine who is restricted and who is non-restricted as soon as possible during this Three-Month Transition Period.

Fund managers that engage in a fund-of-fund strategy also have to start ascertaining the status of their investors. It is likely that an underlying fund in which a fund-of-funds invests in will be requesting its investor funds to represent whether such funds are restricted persons and their percentage of ownership by restricted persons so that the underlying fund can undertake the necessary measures to be within the 10 percent *de minimis* exemption. 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. As such, it is critical for a fund manager of a fund-of-funds to determine the status of its investors if such a fund manager wishes to participate in new issues purchased by its underlying funds.

During this Three-Month Transition Period, a fund manager should send a letter to current investors with an enclosed questionnaire whereby the investor affirmatively responds whether such an investor falls within one of the categories of being a restricted person.⁷ Moreover, a fund manager must revise its fund's offering documents to incorporate the new issue rule so that by March 23, 2004 the offering documents reflect current law.

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Please do not hesitate to contact us with comments or questions or for assistance with drafting questionnaires to be sent to investors and updating offering documents to comply with new NASD Rule 2790.

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⁷ Although NTM 03-79 states that it is permissible for a NASD Member to send a verification questionnaire to account holders via electronic delivery provided that the NASD Member complies with the SEC and NASD rules governing the use of electronic communications, it is likely that account holders such as a collective investment account can also avail itself to the use of electronic communications with respect to distributing questionnaires to investors. See NTM 03-79; Release No. 33-7288 (May 9, 1996). Note that after March 23, 2004, on an annual basis, hedge fund managers will have to annually verify the validity of their investors' representations.

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