

bullet point

a note from Tannenbaum Helpert Syracuse & Hirschtritt LLP

SEC Approves Rule Change to NASD Hot Issues Rule¹

To: Clients of Tannenbaum Helpert Syracuse Hirschtritt LLP

Date: November 13, 2003

The Securities and Exchange Commission (the “SEC”) issued a release on October 24, 2003 approving the rule change proposed by the National Association of Securities Dealers, Inc. (the “NASD”) relating to restrictions on purchases and sales of initial public offerings of equity securities.² Currently, NASD Interpretative Material 2110-1, commonly known as the “Free-Riding and Withholding Interpretation” (the “Interpretation”) governs the restrictions on purchases and sales of initial public offerings (“IPOs”) which trade at a premium whenever secondary market trading begins (“hot issues”). The Interpretation has been substantially modified and will be replaced with new NASD Rule 2790 (the “New Rule”). Under the New Rule, an NASD member (“Member”) generally would be prohibited from selling any initial public offering of an equity security (“new issue”) to any account in which a restricted person has a beneficial interest. The NASD and the SEC believe that this rule furthers the appearance and reality of fairness in the IPO process and will strengthen investor confidence in the securities markets.

The NASD has stated that it will publish a Notice to Members within 60 days following this SEC approval, at which time the New Rule will go into effect. Once effective, there will be a three month transition period during which NASD Members may comply with either the Interpretation or the New Rule. Afterwards, NASD Members must fully comply with the provisions of the New Rule.

IPOs of Equity Securities Are Categorized as “New Issues”

The New Rule will only apply to “new issues” which is defined to mean any initial public offering of equity securities.³ The decision to adopt the new term of “new issue” was made after the NASD received comments suggesting that this approach is easier to understand compared to an earlier proposal whereby a security that is part of a public offering where the volume-weighted

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 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).

³ New Rule 2790(i)(10). In contrast, currently, the Interpretation applies to the majority of primary and secondary distributions of securities including, but not limited to, exchange offers, rights offerings, offerings made pursuant to a merger or acquisition, straight debt offerings, and SEC Rule 504 offerings.

price during the first five minutes of trading in the secondary market would be five percent or more above the public offering price. Furthermore, these commenters suggested that in practice, many firms would treat all IPOs as subject to the rule anyway because they would not be able to anticipate which offerings would trade at a premium in the secondary market.

As a consequence of adopting “new issue” as the standard to determine whether an equity security falls within the NASD’s proscriptions, the cancellation provision⁴ under the Interpretation has been eliminated as it is no longer necessary.⁵ When the New Rule goes into effect, presumably, NASD Members will have determined the status of all prospective purchasers prior to selling a new issue pursuant to the preconditions for sale provisions pursuant to new NASD Rule 2790(b).

The New Rule will not apply to secondary offerings, debt securities, restricted or exempt securities, offerings of a commodity pool operated by a commodity pool operator, rights offerings, exchange offers, offerings made pursuant to a merger or acquisition, investment grade asset-backed securities, convertible securities, preferred securities, investment company securities or offerings registered on Form F-6 that have a pre-existing market outside of the U.S.⁶ Also, the New Rule will not apply to purchases and sales pursuant to standby agreements.

Bright Line Test: One is Either a Restricted Person or a Non-Restricted Person

1. Restricted Person

The New Rule clearly defines “Restricted Person.” Under the New Rule, “Restricted Persons” include:

- Broker-dealers, their personnel (any officer, director, general partner, associated person or employee), their agents engaged in the investment banking or securities business and certain immediate family members of broker-dealers and personnel;
- Finders and fiduciaries with respect to the new issue;
- Portfolio managers, i.e., persons with authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment advisor or collective investment account⁷ and certain immediate family members of such persons;
- Persons listed or required to be listed in Schedules A, B or C of a Form BD unless their ownership code is less than 10%;

⁴ Under the Interpretation, if a Member sold an IPO to a restricted person or account that later was found to be a hot issue, the Member would not be considered to have violated the Interpretation if the Member cancelled the trade before the end of the first business day following the date on which secondary market trading commences for that issue and reallocates such security at the public offering price to a non-restricted person or account.

⁵ A commenter noted that many firms do not avail themselves to the current cancellation provision because of the administrative costs of tracking and canceling hot issue sales, the risks of noncompliance associated with selling hot issues to restricted persons and the ill will generated by having to cancel a customer’s allocation.

⁶ New Rule 2790(i)(10)(A)-(I).

⁷ New Rule 2790(i)(2) defines “collective investment account” as any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle that is engaged primarily in the purchase and/or sale of securities.

- Persons that directly or indirectly own 25% or more of a public reporting company listed or required to be listed on Schedule B of a Form BD (unless the company is listed on a national securities exchange) and certain of their immediate family members; and
- Affiliates of broker-dealers.

2. Exemptions from Restricted Person Status

The New Rule specifically excludes family investment vehicles⁸ and investment clubs⁹ from the definition of collective investment accounts. Therefore, a person who has authority to buy or sell securities on behalf of family investment vehicle or an investment club would not be a portfolio manager under the rule and therefore would not be restricted on that basis (although there may be other reasons such persons or other participants in the family investment vehicle or investment club may be restricted). Personnel and agents of a limited business broker-dealer that are identified as such on the Form BD are also specifically excluded from the definition of restricted person.

Furthermore, the New Rule's general prohibitions will not apply to the following classes of persons:

- Investment companies registered under the Investment Company Act of 1940;
- Common trust funds or similar funds that have investments from 1,000 or more accounts and does not limit beneficial interests principally to trust accounts of restricted persons;
- Insurance company general, separate or investment accounts, provided that the accounts are funded by premiums from 1,000 or more policyholders or that the insurance company has 1,000 or more policyholders and the insurance company does not limit the policyholders whose premiums are used to fund the account principally to restricted persons;
- An account whose beneficial interests of restricted persons do not exceed in the aggregate 10% of such account¹⁰;
- Publicly traded entities that are listed on a national securities exchange, are traded on Nasdaq National Market or are foreign issuers whose securities meet the quantitative designation criteria for listing on a national securities exchange or trading on the Nasdaq National Market;
- Foreign investment companies provided that such companies are listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority and no person owning more than 5% of the shares of the investment company is a restricted person;
- Employee Retirement Income Security Act (“ERISA”) plans that are qualified under Section 401(a) of the Internal Revenue Code and are not sponsored solely by a broker-dealer;
- State or municipal government benefit plans subject to state and/or municipal regulation;

⁸ New Rule 2790(i)(4) defines “family investment vehicle” as, a legal entity that is beneficially owned solely by immediate family members (parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children, and any other individual to whom the person provides material support. New Rule 2790(i)(5)).

⁹ New Rule 2790(i)(6) defines “investment club” as a group of friends, neighbors, business associates, or others that pool their money to invest in stock or other securities and are collectively responsible for making investment decisions.

¹⁰ This is the *de minimis* provision discussed herein.

- Tax exempt charitable organizations under Section 501(c)(3) of the Internal Revenue Code; and
- Church plans under Section 414(e) of the Internal Revenue Code.¹¹

Also, exempt are foreign employee benefit plans provided that the beneficial interest of restricted persons do not exceed in the aggregate 10% of such account.

Finally, “joint back office broker-dealers (“JBOs”)¹² are permitted to purchase new issues provided that so long as the beneficial interests of restricted persons do not exceed in the aggregate 10% of the fund. Accounts that are beneficially owned by restricted persons in excess of the 10% threshold may use carve-out procedures currently practiced under the Interpretations. Associated persons of JBOs are restricted persons under the New Rule.

3. Elimination of “Conditionally Restricted Person” Category

The NASD has eliminated the concept of “Conditionally Restricted Person” under the New Rule. Under the Interpretation, certain categories of restricted persons were able to participate in hot issues if the securities were sold to that person in accordance with their normal investment practice, the amount of securities sold was insubstantial and the NASD Member’s aggregate sales to these conditionally restricted persons were insubstantial and not disproportionate in amount as compared to sales to other members of the public. Under the New Rule, this concept of “Conditionally Restricted Persons” does not exist, and all persons are categorized as either restricted or non-restricted.

In connection with the elimination of the “Conditionally Restricted Person” concept, the NASD has introduced a 10% *de minimis* threshold for restricted person participation. Under the New Rule, restricted persons will be able to hold interests in a collective investment account that purchases new issues, so long as no more than 10% of the account’s beneficial owners are restricted persons. Accordingly, those persons that are conditionally restricted under the Interpretation will still be able to participate in new issues through ownership in a collective investment account. Moreover, the NASD will be permitting the continued use of carve-out provisions so that collective investment accounts in which restricted persons hold more than 10% of the beneficial ownership may still participate in new issues, but only up to 10% of the notional pro rata proceeds of the new issue. The NASD has pledged to provide a Notice to Members that will provide detailed guidance concerning the use of carve-out accounts.

Preconditions for Sale: Obtaining a Representation from the Beneficial Owner of the Account that It Is Eligible to Purchase New Issues

Under the New Rule, prior to selling a new issue to an account, a Member will be required to obtain a representation from the account holder or a person authorized to represent the beneficial owners of the account, that the account is eligible to purchase new issues in compliance with the rule. If an interest is held by a bank, broker-dealer, investment adviser or other conduit, prior to selling the new issue, the Member must 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

¹¹ New Rule 2790(c)(1)-(10).

¹² JBOs are hedge funds or their subsidiaries that have opted to become registered broker-dealers and share a back office with another registered broker-dealer.

and no Member may rely on a representation that they believe, or have reason to believe is not accurate.

The New Rule requires that the initial representation of restricted or unrestricted status must be by an affirmative statement¹³ from the account holder, authorized person or conduit, but thereafter, the Member may follow a negative consent procedure¹⁴ for annual verification that the initial representation remains valid. NASD Members will be required to retain a copy of all records and information relating to whether an account is eligible to purchase new issues for at least three years following a Member's last sale of a new issue to that account.

In contrast, under the Interpretation, prior to selling a hot issue to the account of any investment partnership or corporation, a Member was required to either review a current list of the names and business connections of all persons having any beneficial interest in the account so as to independently verify that no restricted person has a beneficial interest in the account or obtain a copy of a written representation from legal counsel or the account's independent certified public accountant stating that, after having conducted a specified level of due diligence, such counsel or accountant reasonably believes that no person with a beneficial interest in the account is a restricted person. In practice, hedge fund investors and other investment limited partnerships have had to furnish "hot issue opinion letters" from counsel in order to participate in hot issues. Also, under the Interpretation, a Member was required to maintain a current list (not more than 18 months old) of all of the names and business connections of all persons having a beneficial interest in the account or a copy of the current written representation.

Impact on Hedge Fund Managers

Under the New Rule, hedge fund managers are categorized as restricted persons. The NASD considered the possibility of allowing hedge fund managers unlimited participation in the benefits of new issues through the funds that they manage. Ultimately, the NASD concluded that because a hedge fund manager is in a position to direct business to a Member and may be willing to do so based on the size of its allocation of new issues, allowing hedge fund managers unlimited participation through their funds would further the appearance that an industry insider is receiving a disproportionate benefit from new issues and thus would likely undermine investor protection and the public interest.

Under the *de minimis* provision in the New Rule, a restricted person such as a hedge fund manager may participate in new issues through a collective investment account so long as their beneficial interest does not exceed in the aggregate 10% of such account. However, this does not preclude a hedge fund manager from holding more than a 10% interest in a hedge fund that he or she manages. Through the use of carve-out procedures, a fund may segregate the interests of restricted and non-restricted persons and direct the proceeds of the new issue investment in such a manner so that the hedge fund manager and other restricted persons receive an indirect, pro rata benefit that does not exceed 10% or their actual percentage interest in the fund, whichever is less. For example, if 30% of a hedge fund's partners are restricted persons and that fund invests \$100,000 for 10,000 shares of a new issue, no more than 1,000 shares or \$10,000 worth may be attributed in the aggregate to those restricted partners accounts. In contrast, if 7% of a hedge

¹³ An oral verification is not permitted.

¹⁴ Under a negative consent procedure, notices may be sent to the Members' customers asking if there has been a change in their restricted status. A Member will be permitted to rely on its existing information regarding a particular customer unless the customer affirmatively replied that his or her status has changed.

fund's partners are restricted persons, no more than 700 shares or \$7,000 worth may be attributed in the aggregate to those restricted partners accounts.

Under the New Rule, hedge fund managers will be required to represent to the brokers that they purchase new issues through, that the account is eligible to purchase new issues and is in compliance with the New Rule. This will require hedge fund managers to obtain the same type of information from their investors as was required under the Interpretation in order to determine the restricted status of each investor. As such, hedge fund subscription documents will continue to contain a questionnaire to determine an investor's eligibility to participate in new issues. Moreover, hedge funds will have to verify the eligibility status of their investors on an annual basis. However, hot issue opinion letters from legal counsel or an independent certified public accountant will no longer be required.

In the fund of funds context, it is anticipated that funds will still be required to "look through" their investors to ensure that no restricted persons are in the underlying fund, or that restricted persons participating in the underlying fund indirectly beneficially own no more than 10% of the fund or that appropriate carve-out mechanisms are in place to prevent the allocation of new issues to restricted persons beyond that allowed under the *de minimis* provision. The NASD will provide further guidance on this provision in a Notice to Members.

It is anticipated that the NASD will issue a Notice to Members on or before December 23, 2003 and the New Rule will go into effect at that time. Within three months thereafter, Members will be obligated to comply with the New Rule.

The full text of the Release is available at <http://www.sec.gov/rules/sro/34-48701.htm>

* * * * *

Please do not hesitate to contact us with comments or questions or for assistance with compliance with new Rule 2790.

Michael G. Tannenbaum
212 508 6701
tannenbaum@tanhelp.com

Ricardo W. Davidovich
212 508 6710
davidovich@tanhelp.com

Niamh H. Curry
212 5086725
curry@tanhelp.com

Ella D. Cohen
212 508 6775
cohen@tanhelp.com

Elisabeth H. Bedore
212 702 3147
bedore@tanhelp.com