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SEC Approves NASD's Rule on New Issues

The SEC has approved rule changes proposed by the NASD that govern restrictions on the purchase and sale of initial public offerings of equity securities. The SEC also approved, on an accelerated basis, an amendment to these rule changes. As a result, the NASD is adopting new NASD Rule 2790 (the "New Rule") to replace the current NASD Interpretative Material 2110-1, commonly known as the "Free-Riding and Withholding Interpretation" (the "Prior Rule").

The NASD has proposed a three-month transition period during which NASD members may comply with either the Prior Rule or the New Rule. The mandatory effective date for compliance with the New Rule is March 23, 2004.

I. What does the New Rule provide?

The New Rule, like the Prior Rule it replaces, is intended to protect the integrity of the public offering process by ensuring that: (i) NASD members ("Members") make bona fide public offerings of securities at the offering price; (ii) Members do not withhold securities in a public offering for their own benefit or use such securities to reward persons who are in a position to direct future business to Members; and (iii) industry insiders, including Members and their associated persons, do not take advantage of their "insider" position to purchase new issues for their own benefit at the expense of public customers.

Accordingly, the New Rule provides that (except as otherwise permitted under the New Rule):

- a Member (or an associated person thereof) may not sell a new issue to any private investment fund or account in which a restricted person has a beneficial interest (generally defined as any economic interest such as the right to share in gains or losses);[1]

- a Member (or an associated person thereof) may not purchase a new issue in any private investment fund or account in which such Member or associated person has a beneficial interest; and

- a Member may not continue to hold new issues acquired as an underwriter, selling group member or otherwise.

[1] The receipt of a management fee or performance-based fee for operating a private investment fund (including the *initial* receipt of tax deferred performance fees by a hedge fund) would not be considered a beneficial interest in the fund. However, the accumulation of these payments, if *subsequently* invested in the private investment fund (as a deferred fee arrangement or otherwise) would constitute a beneficial interest in the fund. Moreover, as noted in Section III. of this Memorandum, "portfolio managers" will be treated as "restricted persons" under the New Rule.

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II. What are the key differences between the New Rule and the Prior Rule?

A. The New Rule applies to all "New Issues"

The New Rule applies to all "new issues" as opposed to only "hot issues," which were previously defined under the Prior Rule as securities of a public offering that trade at a premium in the secondary market whenever such secondary market begins (and included convertible debt securities). A "new issue" is defined as any initial public offering of an "equity security" as defined in Section 3(a)(11) of the Securities Exchange Act of 1934 (the "Exchange Act"), including equity securities of non-U.S. issuers.

The offering of the following securities are *excluded* from the definition of "new issue":

- securities issued as part of a secondary offering;
- debt securities, including those that are not investment-grade. Offerings of securities of closed-end funds that invest solely in debt securities are also exempt pursuant to the exemption for offerings of securities of investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act");
- securities that are restricted under various provisions of the Securities Act of 1933 (the "Securities Act") namely, securities offered pursuant to Section 4(1), 4(2) or 4(6) of the Securities Act, Rule 144A, Rule 505 or 506 of Regulation D, and Rule 504 to the extent the securities are "restricted";
- "exempt securities," as defined in Section 3(a)(12) of the Exchange Act;
- securities of a commodity pool operated by a commodity pool operator, as defined in Section 1a(5) of the Commodity Exchange Act;
- rights offerings to existing shareholders, exchange offers, and offerings made pursuant to a merger or acquisition;
- investment-grade asset-backed securities;
- convertible securities;
- preferred securities;
- securities of an investment company registered under the Investment Company Act; and
- securities in ordinary share form or American Depositary Receipts ("ADRs") registered on Form F-6[2] that have a pre-existing market outside of the United States.

[2] The NASD notes that this exemption would apply only to initial offerings of ADRs that are not part of a global initial public offering.

B. The New Rule eliminates "conditionally restricted person" status

The "conditionally restricted person" status of the Prior Rule has been eliminated, which means that all persons will now be either restricted or non-restricted. Under the Prior Rule, a "conditionally restricted persons" could purchase "hot issue" securities from a Member if such purchase was consistent with their normal investment practice, the amount purchased was insubstantial and aggregate sales to "conditionally restricted" persons were insubstantial and not disproportionate to the public distribution.

C. The New Rule provides a 10% de minimis threshold

The New Rule provides a *de minimis* threshold pursuant to which restricted persons are permitted to hold interests in a private investment fund that purchases new issues if such persons account for no more than 10% of the fund's beneficial ownership. The Prior Rule sets forth carve-out procedures allowing a manager of a private investment fund who wishes to purchase initial public offerings for such fund to segregate the interests of restricted persons from non-restricted persons. Such carve-outs continue to be available under the New Rule. Therefore, a private investment fund in which restricted persons hold an interest of 10% or greater could continue to invest in new issues if such restricted persons received no more than 10% of the notional *pro rata* proceeds of the new issue.[3]

D. The New Rule requires a representation of eligibility

Under the New Rule, Members are no longer required to receive written opinions from an attorney or certified public accountant to a private investment fund relating to the eligibility of such fund to purchase "hot issues." Instead, the New Rule requires a Member to obtain within 12 months prior to a sale of a new issue to a private investment fund a representation from the investor(s), or a person authorized to represent the investor(s) in the fund, that the fund is eligible to purchase new issues in compliance with the New Rule. A Member may not rely upon any representation that it believes, or has reason to believe, is inaccurate.

The initial verification of a person's status under the New Rule must be a positive affirmation of non-restricted status, but annual verification of a person's status may be conducted though the use of negative consents.[4] The Member would 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 the Member's last sale of a new issue to that account.

III. How is a "restricted person" defined?

Under the New Rule, a Member or an associated person thereof may not sell a new issue to any private investment fund or account in which a restricted person has a beneficial interest, unless such sale qualifies for an enumerated exemption. In determining whether a person is a restricted person, a manager is required to "look through" to the persons who have the actual beneficial interests in the fund or account. If the manager "looks through" until each of the natural persons is reached and, along the way, encounters no beneficial owners who are restricted

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[3] No particular method to carve out the interests of restricted persons has been prescribed. The NASD has represented that it intends to offer detailed guidance concerning the use of carve-out accounts in a Notice to Members to be published after approval of the New Rule.

[4] The NASD allows the use of electronic communications for eligible customers but, consistent with the Rule 17a-3 under the Exchange Act, a Member would not be permitted to verify customer account information orally.

persons, the fund may purchase new issues. However, if the process of looking through reveals a "restricted person" — be it a natural person or a legal person — then the fund may be restricted.[5] The following are "restricted persons":

- *Broker-Dealers and their Personnel*: (i) Members and other broker-dealers; (ii) any officer, director, general partner, associated person, or employee of a Member or any other broker-dealer; and (iii) agents of a broker-dealer who are engaged in the investment banking or securities business. However, the personnel and agents of a "limited business broker-dealer" are specifically excluded from the definition of "restricted person". "Limited business broker-dealer" is defined as a broker-dealer whose authorization to engage in the securities business is limited solely to the purchase and sale of investment company/variable contracts securities and direct participation program securities.[6] This exemption applies only to persons associated with such a limited business broker-dealer, not to the limited business broker-dealer itself.

- *Finders and Fiduciaries*: Finders and fiduciaries of the managing underwriter are restricted persons only for those offerings for which they are acting in those capacities.[7]

- *Portfolio Managers*: Any person[8] who has authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account.

- *Owners of Broker-Dealers*: The New Rule bases ownership of a broker-dealer for purposes of the rule on whether the broker-dealer must report the ownership interest on Schedule A, B or C of Form BD.[9] A foreign entity disclosed on Schedule A or B of

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5 Once an account is deemed to be restricted, then the next step is to determine whether the account qualifies for an exemption.

6 A Member *may* look to the Form BD as evidence of a firm's status in determining whether it is a limited business broker-dealer, but *must* inquire further about whether the firm meets the conditions of a limited business broker-dealer.

7 In the case of a law firm or consulting firm, the restriction would apply only to those persons working on the particular offering.

8 In addition to natural persons, the definition of "portfolio manager" also encompasses non-natural persons (*e.g.*, an entity organized as a general partner, manager or investment advisor that has authority to buy and sell securities for any of the entities enumerated above).

9 Pursuant to Form BD, a broker-dealer must report entities that have interests at every level of its ownership structure that exceed designated percentages. However, once a public reporting company is reached, no ownership information further up the chain need be given. Only those public reporting companies that are reporting companies under Section 13 or 15(d) of the Exchange Act may avail themselves of this exclusion. The definition of "restricted person" picks up, among others, the following:

  - Any person or entity listed on Schedule A, which would cover persons or entities holding directly interests of 5% or more (as beneficial owners of voting securities of a corporation, as limited partners or as LLC members), and general partners and managing members, of a broker-dealer in corporate, partnership or LLC form, unless the ownership percentage in the broker-dealer is below 10%;

Form BD that is listed on a foreign exchange with an ownership interest in a broker-dealer is not a restricted person if that foreign entity were subject to Section 12 or 15(d) of the Exchange Act. The general restriction on owners of a broker-dealer does not extend to owners of a "limited business broker-dealer".

- *Affiliates of Broker-Dealers*: An owner of a broker-dealer — whom the New Rule explicitly deems a restricted person — would be viewed as having a beneficial interest in an account held by a subsidiary (*i.e.*, a sister company of the broker-dealer). To offer some relief to entities that could be affected by the restriction on broker-dealer affiliates, there is an exemption for any such affiliate (except another broker-dealer) that is publicly traded.

- *Immediate Family Members of Restricted Persons*: A person's 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 a "restricted person" provides "material support".[10] Under the New Rule, members of the immediate family of an "associated person"[11] and affiliates of the firm employing an "associated person" may not purchase new issues from the firm employing the "associated person".

IV. What exclusions are available under the New Rule?

The New Rule's general prohibitions do not apply to sales to or purchases from several classes of persons, whether directly or through private investment funds or accounts in which such persons have a beneficial interest. Certain of these classes of persons are briefly described below.

- Any person listed on Schedule B, which would cover, as to any direct owner listed in Schedule A in corporate, partnership or LLC form, a 25% direct or indirect beneficial owner of voting securities, a 25% direct or indirect limited partner or a 25% direct or indirect LLC member, or any general partner or elected managing member, of such direct owner (until a public reporting company is reached, at which point no further disclosure up the ownership chain is required), unless the ownership percentage in the direct owner is below 10%;

- Notwithstanding the rule that one need not look beyond a public company, a direct or indirect owner of 10% or more of a public reporting company disclosed on Schedule A, unless that public reporting company is listed on a stock exchange or traded on the Nasdaq National Market; and

- Notwithstanding the rule that one need not look beyond a public company, a direct or indirect owner of 25% or more of a public reporting company disclosed on Schedule B, unless that public reporting company is listed on a stock exchange or traded on the Nasdaq National Market.

[10] "Material support" is defined as the direct or indirect provision of more than 25% of a person's income in the prior calendar year. Members of the immediate family living in the same household are deemed to be providing each other with "material support".

[11] "Associated persons" is defined as members of the immediate family of an officer, director, general partner, employee, or agent of an Member or other broker-dealer.

- *Investment Clubs and Family Investment Vehicles*: The definition of "collective investment account" excludes "investment clubs" [12] and "family investment vehicles".[13] Therefore, a person who has authority to buy or sell securities on behalf of an investment club or a family investment vehicle would not be a portfolio manager and would not be a restricted person on that basis.

- *Investment Companies*: Sales of new issues to, or purchases by, an investment company registered under the Investment Company Act.

- *Common Trust Funds and Insurance Companies*: Sales of new issues to, or purchases by, certain trust funds and insurance company accounts, respectively, are exempt. To qualify for these exemptions, a trust fund would have to have investments from 1,000 or more accounts, and an insurance account would have to be funded by premiums from 1,000 or more policyholders (or, if a general account, the insurance company would have to have 1,000 or more policyholders). In addition, the fund or insurance account may not limit its participation principally to restricted persons.

- *Joint Back Office Broker-Dealers*: A hedge fund adviser that registers as a broker-dealer or that has a broker-dealer subsidiary could purchase new issues so long as the beneficial interests of restricted persons do not exceed in the aggregate 10% of the fund. The NASD has stated that the exemption for Joint Back Office Broker Dealers ("JBOs") does not extend to associated persons of a JBO.

- *Publicly Traded Entities*: Publicly traded entities (except broker-dealers and certain affiliates thereof) that are listed on a national securities exchange, are traded on the Nasdaq National Market, or are foreign issuers whose securities meet the quantitative designation criteria for listing on a national securities exchange or the Nasdaq National Market. This exemption does not apply to a publicly traded broker-dealer (or an affiliate) where the broker-dealer is authorized to engage in the public offering of new issues either as underwriter or as a selling group Member. The publicly traded entity exemption does not apply to securities traded on the Nasdaq SmallCap Market.[14]

- *Foreign Investment Companies*: "Foreign investment company" is defined as a fund company organized under the laws of a foreign jurisdiction (i) that is listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority and (ii) in which no person owning more than 5% of the shares of the investment company is a restricted person. Under the New Rule, a foreign investment company is no longer subject to the 100-investor limit in order to qualify for this exemption or the requirement that no more than 5% of its assets be invested in a particular hot issue.

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[12] "Investment club" is defined 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.

[13] "Family investment vehicle" is defined as a legal entity that is beneficially owned solely by immediate family members.

[14] The NASD represented that it would consider amending the publicly traded entity exemption if and when Nasdaq becomes a national securities exchange.

- *ERISA Plans*: Benefit plans established under the Employee Retirement Income Security Act ("ERISA") that are qualified under Section 401(a) of the Internal Revenue Code (the "Code"). An ERISA plan sponsored by a broker-dealer affiliate — although not a plan sponsored by the broker-dealer itself — may benefit from the exemption.

- *State and Municipal Government Benefit Plans*: There exists a general exemption for a state or municipal government plan that is subject to state and/or municipal regulation.

- *Tax-Exempt Charitable Organizations*: Sales of new issues to, and purchases by, tax exempt charities organized under Section 501(c)(3) of the Code are exempt.

- *Church Plans*: Church plans described in Section 414(e) of the Code are exempt.

V. Are there additional exemptions?

The New Rule provides for the following:

- an exemption for underwriters who, pursuant to an underwriting agreement, place a portion of a public offering in their investment accounts if they were unable to sell that portion to the public.

- an exemption similar to the "venture capital" exception under the Prior Rule if: the account has held an equity ownership interest in the issuer for a period of one year prior to the effective date of the offering; the sale of the new issue does not increase the account's percentage equity ownership in the issuer above the ownership level as of three months prior to the filing of the registration statement in connection with the offering; the sale of the new issue does not include any special terms; and the new issue purchased is not sold or transferred for three months following the effective date of the offering.

- an exemption for securities that are directed by the issuer to persons that are restricted under the rule. This exemption does not apply to persons who are broker/dealer personnel and finders and fiduciaries unless such persons, or a member of their immediate family, is an employee or director of the issuer, the issuer's parent, or a subsidiary of the issuer or the issuer's parent.[15] Unlike the Prior Rule, the issuer-directed exemption does not trigger a three-month lock-up.

- an exemption for securities distributed as part of a program sponsored by the issuer, or an affiliate of the issuer, that meets four conditions: (1) the opportunity to purchase a new issue under the program is offered to at least 10,000 participants; (2) every participant is offered an opportunity to purchase an equivalent number of shares or will receive a specified number of shares under a predetermined formula applied uniformly across all participants; (3) if not all participants receive shares under the program, the selection of the eligible participants is based on a random or other non-discretionary allocation method; and (4) the class of participants does not contain a disproportionate number of restricted persons.

[15] For purposes of this exemption, a parent/subsidiary relationship is established if the parent has the right to vote 50% or more of a class of voting security of the subsidiary, or has the power to sell or direct 50% or more of a class of voting security of the subsidiary.

- an exemption for new issues directed at eligible purchasers as part of a conversion offering (i.e., conversions by Sells and insurance companies from mutual to stock form) conducted in accordance with the standards of the governmental agency or instrumentality having authority to regulate such conversion offering.

VI. What steps should be taken in response to the New Rule?

Managers of private investment funds should commence the process of revising and circulating investor questionnaires that comply with the requirements of the New Rule to all existing and new investors. We will continue to monitor any new information provided by the SEC or the NASD regarding carve-out procedures. Such information may ultimately require amendments to the operative documents of private investment funds.

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The summary set forth herein is intended to be general in nature. This Memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this Memorandum should be directed to:

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