

SEC APPROVES NEW NASD HOT ISSUE RULE

On October 24, 2003, the Securities and Exchange Commission (the “SEC”) approved NASD Rule 2790, which will replace the current Free-Riding and Withholding Interpretation¹ (the “Prior Rule”) and generally prohibit the offer and sale by NASD member broker-dealers (“Members”) of New Issue Securities² to any account in which a “Restricted Person” has a beneficial interest. Rule 2790 defines “Restricted Persons” to include most broker-dealers, employees, owners and affiliates of broker-dealers, other classes of persons including Portfolio Managers,³ and immediate family members that materially support, or receive material support from, such Restricted Persons.

Rule 2790 will take effect upon the issuance by the NASD of a Notice to Members discussing Rule 2790, which is expected to occur not later than December 23, 2003. Members may comply with either the Prior Rule or Rule 2790 during the three-month period following publication of the Notice to Members, after which compliance with Rule 2790 will be mandatory.

Rule 2790 makes the following significant changes to the regulation of offers and sales of New Issue Securities:

1. The restrictions of Rule 2790 will apply to all initial public offerings (“IPOs”) of most equity securities, whether or not they immediately trade at a premium in the

¹ SEC Release No. 34-48701 (October 24, 2003), <http://www.sec.gov/rules/sro/34-48701.htm>. The prior NASD Interpretation, commonly known as the “Hot Issue” Rule, is found in the NASD Manual at IM-2110-1.

² NASD Rule 2790 defines securities to which the revised restrictions apply as “New Issue” securities. The Prior Rule uses the term “Hot Issue” securities to describe securities to which its restrictions apply. Since the terms describe different securities, we use the term “New Issue Securities” in this memorandum when describing the new provisions and “Hot Issue Securities” when describing the prior restrictions.

³ The term “Portfolio Manager” includes any person 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. “Collective investment account” is defined 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.” “Collective investment account” does not include (i) a “family investment vehicle” (which is defined as a legal entity beneficially owned solely by immediate family members) or (ii) an “investment club.” “Immediate family member” means 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 or any other individual to whom the person provides material support.

after market. Rule 2790 specifically excludes from its restrictions preferred and convertible securities, commodity pool securities, securities of registered investment companies, investment-grade asset-backed securities and certain ADRs.

2. Under the Prior Rule, Members could sell Hot Issue Securities to “conditionally” Restricted Persons, including hedge fund managers, if the purchase was in accordance with the Restricted Person’s normal investment practice and met certain other tests. The concept of a “conditionally” Restricted Person has been eliminated in Rule 2790.
3. Members will be allowed to sell New Issue Securities to an account in which the beneficial interests of Restricted Persons in the aggregate do not exceed 10% (up from 5% in a prior proposal). Thus, a manager of a hedge fund may participate in New Issue Securities offerings, but only within the 10% limit, (which applies in the aggregate to all Restricted Persons investing in a given account) and in a manner consistent with its fiduciary obligations to its investors.⁴ Consistent with interpretations under the Prior Rule, Rule 2790 excludes from the definition of “beneficial interest” the receipt of a management or performance-based fee for operating a collective investment account. The manager of a hedge fund or other collective investment account, therefore, may still receive a performance-based fee that takes into account the performance of New Issue Securities. If, however, a management or performance-based fee is deferred and deemed invested in the collective investment account, it will constitute a beneficial interest and will count toward the 10% ceiling. The NASD has undertaken to provide detailed guidance in its upcoming Notice to Members concerning the use of “carve out” procedures whereby a hedge fund or other collective investment vehicle may segregate the beneficial interests of Restricted Persons and non-Restricted Persons.
4. Issuer-directed sales of New Issue Securities are permitted under Rule 2790 to any Restricted Person other than broker-dealer personnel, persons acting as finders or fiduciaries to an underwriter and immediate family members of such persons. Persons associated with broker-dealers, finders or fiduciaries and their immediate family members will be allowed to participate in issuer-directed share programs *only* if they or their immediate family members are also employees or directors of the

⁴ “Beneficial Interest” is defined as any economic interest, such as the right to share in gains or losses. In a previously proposed version of Rule 2790, managers of hedge funds and other Portfolio Managers, if they were not otherwise Restricted Persons, would have been able to participate in IPOs through the hedge funds or other fiduciary accounts they manage, but not through their personal accounts. Rule 2790 as now approved does not include this concept. While broker-dealers are generally Restricted Persons, investment partnerships that register as broker-dealers (typically to qualify for more favorable margin treatment), so-called “joint back office broker-dealers,” will still have the benefit of the 10% *de minimis* test. Nevertheless, the associated persons of such joint back office broker-dealers will remain Restricted Persons.

issuer, the issuer's parent or a subsidiary of the issuer or its parent.⁵ The three-month lock up of Hot Issue Securities for Restricted Persons required in the Prior Rule has been eliminated.

5. Rule 2790 includes as Restricted Persons owners of a broker-dealer who are listed or required to be listed as direct or indirect owners on Form BD for the broker-dealer.⁶ Although not specifically mentioned in Rule 2790, the NASD has made clear, and the SEC has reiterated in its Release, that sister companies of broker-dealers are also restricted.
6. Publicly-traded entities and accounts beneficially owned by such entities are exempt from Rule 2790 unless they are, or are affiliated with, a broker-dealer that is authorized to engage in public offerings of New Issues. Also exempt from the Rule are registered investment companies and tax exempt charitable organizations under Section 501(c)(3) of the Internal Revenue Code, or accounts in which they have a beneficial interest, insurance company separate or investment accounts, provided the account is funded by premiums from 1,000 or more policyholders, and insurance company general accounts if the insurance company has 1,000 or more policyholders and such policyholders are not limited principally to Restricted Persons.
7. The exemptions for sales of New Issue Securities to foreign investment companies and ERISA plans have been simplified.⁷

⁵ Rule 2790 also contains an exemption for issuer-sponsored programs offered to 10,000 or more participants and conversion offerings regulated by a governmental agency.

⁶ Form BD Schedule A lists direct owners and Schedule B indirect owners of the broker-dealer. Except in certain circumstances, immediate family members of such owners are also restricted. Rule 2790 excludes from this category of Restricted Person all persons on Schedules A and B with ownership interests under 10%. Rule 2790 also excludes owners of a "Limited Business broker-dealer," 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. Rule 2790 also restricts 10% owners of certain non-listed public companies listed on Schedule A and 25% owners of such companies listed on Schedule B.

⁷ The Prior Rule allowed sales of Hot Issue Securities to foreign investment companies, provided that the Member allocating shares to the foreign company received a written certification from an attorney or accountant licensed in the United States or in the foreign company's home jurisdiction to the effect that: (A) the fund had 100 or more investors; (B) the fund was listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority; (C) no more than 5% of the fund assets were to be invested in the Hot Issue Securities being offered; and (D) no person owning more than 5% of the shares of the fund was within certain categories of Restricted Person. Rule 2790 eliminates requirements (A) and (C), as well as the requirement for
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8. Members selling New Issue Securities will be required to verify annually that an account may purchase New Issue Securities in accordance with Rule 2790.⁸ After the initial written verification, subsequent verifications may take the form of a “negative consent.” The requirement in the Prior Rule for letters from accountants or lawyers confirming that hedge funds or foreign investment companies have met the requisite standards has been eliminated.

Rule 2790 simplifies compliance requirements for Members selling New Issue Securities, and the process by which investors purchasing New Issue Securities demonstrate to Members that they are eligible to do so. Nevertheless, the procedures currently used by Members and investors will need to be modified to rely on new exemptions and to avoid new restrictions created by Rule 2790. We will be pleased to assist our clients in this process.

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an attorney or accountant certification. Nevertheless, the new general requirements for written verification initially and confirmation every 12 months (described below), would apply.

The Prior Rule provided that: (A) an employee benefit plan sponsored by a broker-dealer was restricted; (B) an employee benefit plan sponsored by an entity that is not involved in financial services activities was not restricted, whether or not any plan participants were restricted; and (C) an employee benefit plan sponsored by an entity that was engaged in financial services activities, including but not limited to banks, insurance companies, investment advisers or other money managers, was not restricted, provided that the plan permitted participation by a broad class of participants and was not designed primarily for the benefit of Restricted Persons. Rule 2790 exempts ERISA plans qualified under Section 401(a) of the Internal Revenue Code that are not sponsored solely by a broker-dealer.

- ⁸ Before selling a New Issue Security to an account, a Member will be required to have obtained in good faith, within 12 months prior to the sale, a representation of the account holder or a person authorized to represent the beneficial owners of the account that the account is eligible to purchase New Issue Securities. When selling New Issues Securities to a bank, foreign bank, broker-dealer, investment adviser or other conduit, the representation must be that all purchases are in compliance with Rule 2790. The Member may not rely upon a representation that it believes or has reason to believe is inaccurate. A Member must keep a copy of all records and information relating to the eligibility of an account in its files for at least three years following the last sale of New Issue Securities to that account. The NASD has indicated it will not permit Members to verify customer account information orally.

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