

NEW NASD HOT ISSUE RULE EFFECTIVE

On December 23, 2003 the NASD published Notice to Members 03-79¹ making effective new Rule 2790, which replaces the current Free-Riding and Withholding Interpretation² (the “Prior Rule”) and generally prohibits the offer and sale by NASD member broker-dealers (“Members”) of New Issue Securities³ 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,⁴ and immediate family members that materially support, or receive material support from, such Restricted Persons.

Through March 22, 2004 Members may comply with either the Prior Rule or Rule 2790 on an account-by-account basis. However, any representations relied on to comply with Rule 2790 must be made based on the definitions and provisions of Rule 2790. On and after March 23, 2004 Members must comply with Rule 2790.

¹ Notice to Members 03-79 is found at http://www.nasdr.com/2610_2003.asp.

² On October 24, 2003, the Securities and Exchange Commission (the “SEC”) approved NASD Rule 2790, SEC Release No. 34-48701 (October 24, 2003), <http://www.sec.gov/rules/sro/34-48701.htm>. The SEC Release provided that Rule 2790 would be effective when the NASD issued a Notice to Members further explaining the workings of the new Rule. Additionally, on December 30, 2003, in Release 34-48973, the SEC required the NASD to file as a proposed rule change the statements in Notice to Members 03-79 dealing with joint back office brokers and fund-of-funds verification. The prior NASD Interpretation, commonly known as the “Hot Issue Rule”, is found in the NASD Manual at IM-2110-1.

³ 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.

⁴ 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 adviser 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.

In our Client Memorandum dated November 6, 2003 we outlined the changes to be implemented by Rule 2790. Notice to Members 03-79 further clarifies the NASD position on certain aspects of Rule 2790.

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

1. **Offerings Subject to the Rule.** The restrictions of Rule 2790 apply to all initial public offerings (“IPOs”) of most equity securities, whether or not they immediately trade at a premium in the 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. Notice to Members 03-79 specifies that Members and their associated persons are also subject to the Rule with respect to foreign securities offerings.
2. **Elimination of “Conditionally Restricted Persons”.** 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 and such persons are now in most cases considered Restricted Persons.
3. **“De Minimis” Exemption.** Members are allowed to sell New Issue Securities to an account in which the beneficial interests⁵ of Restricted Persons in the aggregate do not exceed 10%. 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.⁶

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

⁵ “Beneficial Interest” is defined as any economic interest, such as the right to share in gains or losses.

⁶ 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. Notice to Members 03-79 clarifies that joint back office broker-dealers organized as entities other than partnerships will also have this exemption available. Nevertheless, the associated persons of such joint back office broker-dealers will remain Restricted Persons.

management or performance-based fee is accumulated and subsequently invested in the collective investment vehicle (as a deferred fee arrangement or otherwise), it will constitute a beneficial interest and count toward the 10% ceiling. Notice to Members 03-79 clarifies that when an entity that actually makes the investment in New Issue Securities (the “Master Fund”) is owned by another entity (the “Feeder Fund”), that has owners that are Restricted Persons, the interest of Restricted Persons in the Master Fund is determined by multiplying the percentage ownership the Restricted Persons have in the Feeder Fund by the percentage interest that the Feeder Fund has in the Master Fund. For example, if 15% of a Master Fund is owned by a Feeder Fund in which Restricted Persons own 50%, then the interest of Restricted Persons in the Master Fund is 15% x 50%, or 7.5%. Notice to Members 03-79 also underscores that the person responsible for providing representations concerning the Master Fund buying the New Issue Securities is responsible for aggregating the interests of Restricted Persons in any Feeder Funds that invest in the Master Fund.

4. **“Carve-outs”**. Notice to Members 03-79 reiterates that the NASD has eliminated specific “carve-out” procedures found in the Prior Rule and states that there may be many effective means of segregating interests of Restricted Persons, including establishing “separate accounts” similar to those permitted under the Prior Rule or maintaining one account but adjusting the capital accounts of Restricted Persons to remove any gains (or losses) attributable to New Issue Securities.
5. **Subsequent Transfers to Restricted Persons**. The Notice to Members also indicates that the NASD will no longer require an outright purchase and sale of a New Issue Security to later transfer ownership interests (and risks) to Restricted Persons and allow them to share in the subsequent gains and losses from New Issue Securities, provided that the journaling over of a New Issue Security is not at the IPO price, but at the prevailing market price at the time of the transfer.
6. **Issuer-Directed Sales**. 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 certain 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 one of their immediate family members are also employees or directors of the issuer, the issuer’s parent or a subsidiary of the issuer or its parent.⁷ The three-month lock-up of Hot Issue Securities for Restricted Persons required in the Prior Rule has been eliminated.

⁷ 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.

7. **Owners of Broker-Dealers.** 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.⁸ Although not specifically mentioned in Rule 2790, the NASD has made clear, and the SEC has reiterated in its Release, that affiliated companies of broker-dealers are also restricted. The Notice to Members also specifies that “affiliation” is determined as it is in NASD Rules 2710 and 2720, which presume affiliation at a 10% ownership interest.
8. **Other Exemptions.** 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 Issue Securities. 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.
9. **Foreign Investment Companies and ERISA Plans.** The exemptions for sales of New Issue Securities to foreign investment companies and ERISA plans have been simplified.⁹ However, the Notice to Members notes that the NASD will not consider

⁸ Form BD Schedule A lists direct owners, and Schedule B lists 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 nonlisted public companies listed on Schedule A and 25% owners of such companies listed on Schedule B.

⁹ The Prior Rule allowed sales of Hot Issue Securities to foreign investment companies, provided that the Member allocating shares to the foreign investment company received a written certification from an attorney or accountant licensed in the United States or in the foreign investment company’s home jurisdiction to the effect that: (A) the foreign investment company had 100 or more investors; (B) the foreign investment company 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 foreign investment company’s 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 foreign investment company was within certain categories of Restricted Person. Rule 2790 eliminates requirements (A) and (C), as well as the requirement for 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 was not involved in financial services activities was not

(Continued on next page . . .)

a foreign investment company to qualify for an exemption on the basis that it has been authorized by a foreign regulatory authority for offer and sale to the public if sales are in fact restricted to high net worth individuals.

10. **Annual Verification.** Members selling New Issue Securities are required to verify annually that an account may purchase New Issue Securities in accordance with Rule 2790.¹⁰ 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. Notice to Members 03-79 provides that a person making a representation on behalf of a Master Fund may rely on a representation from a Feeder Fund that is no more than 12 months old. Similarly, a representative of a Feeder Fund that receives investments from other Feeder Funds may rely on information provided by those other Feeder Funds that is no more than 12 months old. Feeder Funds that are partially owned by Restricted Persons should specify the percentage of ownership by Restricted Persons when making representations so that the Master Fund may make proper aggregation calculations for purposes of the 10% *de minimis* exemption.

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 comply with new restrictions created by Rule 2790. We will be pleased to assist our clients in this process.

(Continued from previous page)

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.

- ¹⁰ Before selling a New Issue Security to an account, a Member is 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 Issue 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.

If you have any questions concerning Rule 2790, please call Roger D. Blanc (212-728-8206, rblanc@willkie.com), Daniel Schloendorn (212-728-8265, dschloendorn@willkie.com), Emily M. Zeigler (212-728-8284, ezeigler@willkie.com) or Martin R. Miller (212-728-8690, mmiller@willkie.com) of this firm.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, New York 10019. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Web site is located at www.willkie.com.

January 5, 2004

Copyright © 2004 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information.