

## MEMORANDUM

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TO: Clients and Friends

DATE: November 24, 2003

RE: **SEC Approves NASD Changes to Restrictions on New Issue Securities**

The Securities and Exchange Commission (“SEC”) recently adopted changes to National Association of Securities Dealers, Inc. (“NASD”) Interpretative Material 2110-1, also known as the “Free-Riding and Withholding” interpretation (the “Interpretation”).<sup>1</sup> Under new NASD Rule 2790, which would replace the Interpretation, an NASD member generally would be prohibited from selling “new issue” equity securities (“New Issue Securities”)<sup>2</sup> to an account in which a person restricted under the rule has a beneficial interest.

Similar restrictions in the Interpretation apply only to initial offerings of securities that are priced at a premium when secondary market trading begins, known as “hot issue” securities. The new rule extends the restrictions to all initial public offerings of New Issue Securities.

Rule 2790 takes effect upon publication of a forthcoming NASD Notice to Members to be made no later than December 23, 2003. Once the rule becomes effective, NASD members will have three months to transition their compliance programs to accommodate the new rule. During the transition period, members may comply with either Rule 2790 or the Interpretation.

### General Prohibitions

Under the new rule, a member or person associated with a member may not sell New Issue Securities to any account in which a restricted person has a beneficial interest,<sup>3</sup> or purchase such securities for the member’s or associated person’s account. Moreover, a member may not continue to hold New Issue Securities acquired by the member as an underwriter or a selling group member, except as provided by the rule as appropriate in the context of a public offering

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<sup>1</sup> See SEC Release No. 34-48701 (October 24, 2003), available at <http://www.sec.gov/rules/sr/34-48701.htm>

<sup>2</sup> Rule 2790 excepts from the definition of a “new issue” subject to the rule, certain equity securities, including preferred and convertible securities, commodity pool securities, securities of registered investment companies, investment-grade asset-backed securities and offerings of securities of foreign private issuers that have a pre-existing market outside the United States.

<sup>3</sup> Beneficial interest is defined as any economic interest, such as the right to share in gains or losses.

of the securities.<sup>4</sup> Under the Interpretation, members are only restricted from selling and purchasing hot issue securities and from continuing to hold hot issue securities acquired by the member as an underwriter.

Under the Interpretation, a member that sells hot issue securities to a person restricted under the rule would not be deemed to have violated the rule if the member cancels the trade in the event the New Issue unexpectedly opens at a premium. Under the new rule, this cancellation provision is no longer applicable because members will be required to predetermine the status of all accounts purchasing the New Issue Securities.

### **“Restricted Person” Status**

The term “Restricted Person” includes any member, broker-dealer or other broker-dealer personnel. Broker-dealer personnel include the following:

- Any officer, director, general partner, associated person, or employee of a member or any other broker-dealer;
- Any agent of a member or any other broker-dealer that is engaged in the investment banking or securities business; or
- Any immediate family member of broker-dealer personnel if the person restricted materially supports, or receives material support from, the immediate family member; is employed with the member, or an affiliate of the member, selling the new issue to the immediate family member; or has the ability to control the new issue.

The definition does not include the personnel and agents (and their immediate family) of a “limited business broker-dealer.” A 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.

New Rule 2790 preserves a provision in the Interpretation that treats finders and fiduciaries of the managing underwriters as Restricted Persons. But the new rule no longer prohibits sale of securities to all senior officers and employees of institutional-type accounts. Instead, it treats as a Restricted Person one who has the authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment advisor

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<sup>4</sup> The new rule does not prohibit any of the following: (1) sales or purchases from one member of the selling group to another member of the selling group that are incidental to the distribution to a non-restricted person at the public offering price; (2) sales or purchases by a broker-dealer of a new issue at the public offering price as part of an accommodation to “non-restricted” customers of the broker-dealer; or (3) purchases by a broker-dealer organized as an investment partnership, or a new issue at the public offering price, provided such purchases are credited to the capital accounts of its partners in accordance with the ten percent *de minimis* threshold.

or collective investment account.<sup>5</sup> The NASD specifically declined to exclude hedge fund managers and other managers of collective investment accounts from compliance with the rule.

One of the most important changes under Rule 2790 is the elimination of “conditionally restricted person” status, which has allowed certain Restricted Persons such as hedge fund managers and senior officers at banks to participate in hot issue securities if the purchase is part of the person’s normal investment practice. The new rule treats all persons as restricted or non-restricted. Thus, under new Rule 2790, persons who would have qualified as conditionally restricted persons under the Interpretation will not be eligible to participate in an offering of New Issue Securities unless another exemption applies.

## **General Exemptions**

### **Accounts of Specified Institutions**

Rule 2790 contains a number of exemptions for specified accounts, including:

- An investment company registered under the Investment Company Act of 1940;
- A common trust fund that has investments from 1,000 or more accounts and does not limit beneficial interests in the fund principally to trust accounts of Restricted Persons;
- An insurance company general, separate or investment account, provided:
  - The account is funded by premiums of more than 1,000 policyholders or, if a general account, 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 accounts to principally Restricted Persons or, if a general account, the insurance company does not limit its policyholders principally to Restricted Persons;
- A state or municipal government benefits plan that is subject to state or municipal regulation; and
- A church plan under Section 414(e) of the Internal Revenue Code.

Sales of New Issue Securities may be made to any of these institutions either directly or through accounts in which they have a beneficial interest. The Interpretation only exempted investment companies registered under the 1940 Act and certain insurance companies from its regulations.

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<sup>5</sup> A “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. The term does not include a “family investment vehicle” or “investment club,” as defined by the Rule.

## **Ten Percent *De Minimis* Participation**

Rule 2790 contains an exemption for accounts in which the beneficial interests of Restricted Persons, in the aggregate, do not exceed ten percent. Under the new exemption, Restricted Persons may hold interests in a collective investment, such as a hedge fund, that purchases New Issue Securities, provided such persons account for no more than ten percent of the account's beneficial ownership. Consequently, an investment manager or other Restricted Person may still participate in an offering of New Issue Securities, but only if the person's interest in the account, together with the interests of other Restricted Persons, does not exceed ten percent.

An investment manager will not be deemed to have an interest in the managed account by virtue of collecting a management fee or performance-based fee for administering the account, unless the fee is deemed to be invested in the account.

The NASD also approved the continued use of "carve out" procedures to allow a manager of an account who wishes to purchase New Issue Securities for such account to segregate the interests of Restricted Persons. Thus, a collective investment account in which Restricted Persons hold more than a ten percent interest may continue to invest in New Issue Securities, provided that Restricted Persons do not receive more than ten percent of the notional pro rata proceeds of the new issue. A forthcoming NASD Notice to Members will address the use of carve-out accounts in greater detail.

## **Joint Back Office ("JBO") Arrangements**

The proposed rule codifies an exemption for JBO broker-dealers previously granted by the NASD staff. JBO broker-dealers include certain hedge funds, or their subsidiaries, that have elected to register as broker-dealers in order to share back office facilities with another registered broker-dealer, thereby entitling them to more favorable margin treatment. In the exemption, which was issued with respect to amendments to the Interpretation that precluded JBO broker-dealers from purchasing hot issues, the NASD staff said that the underlying beneficial owners of the fund – not its status as a JBO – should determine its eligibility for hot issue securities.

Under the proposed rule, a fund that registers as a JBO broker-dealer may purchase New Issue Securities provided the beneficial interests of any Restricted Persons investing in the fund do not exceed in the aggregate ten percent of the fund.

The exception for JBO broker-dealers does not extend to any persons associated with (as opposed to have an investment interest in) the broker-dealer.

## **Other Exemptions**

The new rule also provides an exemption for publicly-traded entities (other than a broker-dealer or its affiliates where the broker-dealer is authorized to act as an underwriter or selling group participant) that are listed on a national securities exchange, are traded on the Nasdaq

National Market (“Nasdaq”), or are foreign issuers whose securities meet the criteria for listing on a national securities exchange or the Nasdaq. Under the Interpretation, publicly traded entities receive no such exemption.

The new rule also contains an exemption for foreign investment companies. The investment company must be listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority, and no person owning more than five percent of the shares of the investment company may be a Restricted Person.<sup>6</sup> This preserves the exemption provided for by the Interpretation but reduces the criteria the foreign fund would be required to meet.

Employee Retirement Income Security Act (“ERISA”) plans qualified under 401(a) of the Internal Revenue Code (“IRC”) and Tax-Exempt Charitable Organizations organized under 501(c)(3) of the IRC are also exempt from the new rule. Consistent with the Interpretation, the ERISA exemption does not cover an ERISA plan sponsored solely by a broker-dealer.

### **Issuer-Directed Securities**

Under Rule 2790, prohibitions on the sale of New Issue Securities do not apply to securities that are specifically directed by the issuer to specific persons, except that issuer-directed securities may not be sold to or purchased by an account in which broker-dealer personnel or fiduciaries to the managing underwriter have a beneficial interest, unless such persons, or a member of their immediate family, are employees of or directors of the issuer or the issuer’s parent or subsidiary.

Under the Interpretation, only employees and directors of an issuer, a parent or subsidiary of an issuer, or any other entity that controls or is controlled by an issuer, may purchase New Issue Securities that are specifically directed by the issuer to such person. The Interpretation also mandates a three-month lock-up period for securities acquired pursuant to this exemption if a *bona fide* independent market for the securities does not exist. The new rule permits the sale of issuer-directed securities to the family members of employees that are otherwise restricted because they are broker-dealer personnel or fiduciaries of the underwriter. The lock-up period is no longer required under Rule 2790.

The new rule also provides that restrictions on the purchase and sale of New Issue Securities do not apply to securities that are part of a program sponsored by an issuer (or affiliate) that has at least 10,000 participants who are offered an opportunity to purchase an equivalent numbers of shares. If not all participants receive shares under the program, the selection must be based on a non-discretionary allocation method. Furthermore, the class of participants may not contain a disproportionate amount of Restricted Persons. This exemption provides an additional means of avoiding restrictions on purchase and sale of New Issue Securities that was not provided for under the Interpretation.

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<sup>6</sup> A foreign investment company that fails to meet this standard may still qualify for the ten percent *de minimis* exception.

## **Anti-Dilution Provisions**

Rule 2790 also states that the prohibitions do not apply to the purchase and sale of New Issue Securities to an account in which a Restricted Person has a beneficial interest if the account meets four criteria:

- (1) The account has held an equity ownership in the issuer for a period of one year prior to the effective date of the offering;
- (2) The sale of the new issue to the account 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;
- (3) The sale of the new issue to the account does not include any special terms; and
- (4) The new issue purchased pursuant to this exemption is not sold, transferred, assigned, pledged or hypothecated for three months following the offering.

The rule would supersede a similar provision in the Interpretation and modify it slightly to allow an equity holder, for purposes of meeting the requirement that the interest in the issuer be held for one year, to count the period in which the holder had an interest in another company purchased by the issuer.

## **Stand-By Purchasers and Under-Subscribed Offerings**

The new rule does not prohibit an underwriter, pursuant to an underwriting agreement, from placing a portion of a public offering in its investment account if it is unable to sell that portion to the public. Moreover, the prohibitions on new issues do not apply to sales and purchases made pursuant to a stand-by agreement that meets four conditions:

- (1) The stand-by agreement is disclosed in the prospectus;
- (2) The stand-by agreement is the subject of a formal written agreement;
- (3) The managing underwriter represents in writing that it is unable to find any other purchasers for the securities; and
- (4) Securities sold pursuant to the stand-by agreement are subject to the three-month lock-up period.

Under the Interpretation, there is no concern about under-subscribed offerings because there is sufficient demand for hot issue offerings. The exemption for stand-by purchases and sales remains the same as the existing exemption in the Interpretation.

## **Preconditions to Sale**

Rule 2790 does not permit a member to sell New Issue Securities to an account until the member has met the rule's preconditions for sale. A member must obtain an affirmative representation from the account holder that the account is eligible to purchase New Issue Securities in compliance with the rule. If an interest is held by a bank, foreign bank, broker-dealer, investment adviser, or other conduit, the member would be required to obtain a representation from the conduit. All representations must be obtained within 12 months prior to the sale. A member may not rely on a representation that it believes, or has reason to believe, is inaccurate.<sup>7</sup>

With respect to subsequent verifications, the NASD only requires the member to obtain a "negative consent" on an annual basis. Thus, members may send account holders a notice asking them to reply only if their status has changed. If the account holder does not reply, the member may conclude under the rule that there is no change in status. Members must retain all records for a period of three years following the latest sale of New Issue Securities to that account.

In the fund-of-fund context, where there are multiple layers of investors, a person authorized to represent the beneficial owners of the master fund must represent that the fund is able to purchase New Issue Securities. Thus, the authorized person must ascertain the status of all investors in the feeder funds to ensure that Restricted Persons participating in a feeder fund do not have more than ten percent beneficial ownership in the fund.

Rule 2790 has eliminated the Interpretation's requirement for representations from attorneys or accountants confirming that hedge funds or foreign investment companies have met the required standards.

## **Conclusion**

As previously stated, Rule 2790 takes effect upon publication of a forthcoming Notice to be made no later than December 23, 2003. Once the rule becomes effective, NASD members will have three months to transition their compliance programs to accommodate the new rule. During the transition period, members may comply with either rule.

We would be pleased to assist you in this process, or to answer any questions you may have.

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<sup>7</sup> A member must use an appropriate level of diligence to determine whether an individual is authorized to represent the beneficial owners of the account.

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