

Securities Law Developments

NEWSLETTER

NOVEMBER 25, 2003

NASD Replaces Free-Riding and Withholding Interpretation with a New IPO Rule

On October 24, 2003, the Securities and Exchange Commission ("SEC") approved a rule filing by the National Association of Securities Dealers, Inc. ("NASD") relating to the allocation of initial public offerings ("IPOs") of equity securities.¹ As approved by the SEC, new NASD Rule 2790 (the "Rule") entirely replaces the "Free-Riding and Withholding Interpretation" (the "Interpretation").² Rule 2790 will take effect upon the issuance by the NASD of a Notice to Members discussing the requirements of the Rule. The NASD has represented that this Notice will be published no later than December 24, 2003; members may comply with either the Interpretation or Rule 2790 during a three-month period following such publication. *Accordingly, full compliance with the Rule is expected in February or March of 2004.*

I. Overview of New Rule 2790

Currently, the Interpretation seeks to protect the integrity of the public offering process by regulating the manner in which a "hot issue" is allocated. New NASD Rule 2790 is intended to accomplish similar objectives, but with a slightly different focus: all "new issues," not just "hot issues," will be subject to the Rule's requirements. Additionally, the Rule simplifies the existing requirements under the Interpretation by redefining "restricted person" and eliminating the "conditionally restricted person" concept.

The Rule also introduces two significant changes that will require many firms to re-design their current syndicate compliance systems

¹ See *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*, Securities Exchange Act ("Exchange Act") Release No. 48,701 (October 24, 2003), 68 Fed. Reg. 62,126 (October 31, 2003), available at <http://www.sec.gov/rules/sro/34-48701.htm> ("Approval Order").

² See "Free-Riding and Withholding," NASD Interpretive Material ("IM") 2110-1. This Interpretive Material was adopted pursuant to NASD Conduct Rule 2110. The NASD's rule filing was first published for public comment in 2000 and underwent additional publications prior to the Approval Order. See *Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Trading in Hot Equity Offerings*, Exchange Act Release No. 42,325 (January 10, 2000), 5 Fed. Reg. 11,2656 (January 18, 2000), available at http://www.nasdr.com/pdf-text/rtf99_60_fr_not.pdf ("Proposed Rule"); *Notice of Filing of Amendment No. 2 to Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Trading in Hot Equity Offerings*, Exchange Act Release No. 43,627 (November 20, 2000), 65 Fed. Reg. 76,316 (December 6, 2000); *Notice of Filing of Amendment Nos. 3 and 4 to Proposed Rule Change by the National Association of Securities Dealers, Inc. Regarding Restrictions on the Purchase and Sale of Initial Public Offerings of Equity Securities*, Exchange Act Release No. 46,942 (December 4, 2002), 67 Fed. Reg. 75,889 (December 10, 2002).

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and controls. First, firms must receive from *each* person or account, within 12 months prior to any allocation of an IPO to that account, a representation that the person or account is eligible as a non-restricted person to receive new issue securities. Note that initial representations obtained by the firm must be affirmative and in writing, but each subsequent representation may be a negative affirmation. Second, restricted persons will be allowed, for the first time, to hold an interest in a collective investment account (such as a private investment fund) that receives an IPO allocation, provided such restricted persons hold no more than 10 percent of the account's beneficial ownership.

II. Significant Differences Between the Interpretation and Rule 2790

A. The Scope - "New Issue" versus "Hot Issue"

1. Securities Subject to the Rule

Rule 2790 applies to new issues of an "equity security," as that term is defined in Section 3(a)(11) of the Exchange Act, subject to certain exceptions. The requirements of the Rule do not apply to offerings of straight debt securities or any of the following:

- Non-registered offerings of securities conducted pursuant to an exemption under Section 4(1), 4(2) or 4(6) of the Securities Act of 1933 ("Securities Act"), or Rule 504 (if the securities are "restricted" under Rule 144(a)(3) of the Securities Act), or Rules 144A, 505 or 506 under the Securities Act;

- Offerings of "exempted securities" as defined in Section 3(a)(12) of the Exchange Act;
- Offerings of securities of a commodity pool operated by a commodity pool operator;
- Rights offerings, exchange offers, or offerings made pursuant to a merger or acquisition;
- Offerings of investment grade asset-backed debt;³
- Offerings of convertible securities;
- Offerings of preferred securities;
- Offerings by a registered investment company; and
- Offerings of certain securities with a pre-existing market outside the United States.⁴

2. Types of New Issues

Rule 2790 applies to *all* equity new issues. This stands in contrast to the Interpretation, which covers only "hot issues," broadly defined as "securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins." Further, as the Rule covers *only* new issues of equity securities, it does not apply to secondary or follow-on offerings.

B. Elimination of Cancellation Provision

Because Rule 2790 applies to all "new issues," it does not include the Interpretation's "cancella-

³ The NASD has established that "certain types of asset-based securities may be considered equity rather than debt and therefore might not be covered by the proposed rule's implicit exemption for debt securities." See *Approval Order*, 68 Fed. Reg. at 62,131.

⁴ The NASD has chosen not to exclude IPOs sold offshore in accordance with Regulation S. See *Approval Order*, 68 Fed. Reg. at 62,131.

⁵ Free-Riding and Withholding Rule, NASD Interpretation Memo IM-2110-1(a)(1).

tion provision.” Currently, the cancellation provision in the Interpretation exempts a firm who otherwise would be in violation for having allocated a hot issue to a restricted person if the firm: (1) canceled the trade before the end of the first business day following the date on which secondary market trading commenced for that issue; and (2) reallocated such security at the public offering price to a non-restricted person or account. This provision was principally intended to allow firms to cancel trades in the event a new offering unexpectedly became a “hot issue.” Because the Rule contains no such cancellation provision, it is possible that an inadvertent allocation to a restricted person may constitute a violation of Rule 2790, even if the firm promptly corrects its mistake by canceling the trade.

C. Elimination of the Conditionally Restricted Person Status

Along with the cancellation provision, the Rule eliminates the “conditionally restricted person” concept. Though such terminology was never used in the Interpretation verbatim, the term is generally used by many firms to describe: (1) members of an associated person’s immediate family who were not supported directly or indirectly by the associated person; (2) finders; (3) any one acting as a fiduciary of the managing underwriter; and (4) senior officers and directors, securities department personnel, or any other employee that might influence or whose activities were in any way related to buying or selling securities for a bank, savings and loan institution, insurance company, investment company, investment advisory firm, or any other institutional-type account. Under certain defined circumstances, the Interpretation allows a conditionally restricted person to receive shares in a hot issue. In contrast, Rule 2790 provides that all persons will be placed in one of two categories: restricted or non-restricted persons. Consequently, many who fall into the conditionally restricted person status, in the absence of an exception or exemption, are now classified as restricted under the Rule.

D. Definition of “Restricted Persons”

The term “restricted person” under Rule 2790 includes the following:

1. Broker-dealers and any officer, director, general partner, associated person, or employee of a member or any other broker-dealer. However, the personnel and agents of a “limited business broker-dealer” (defined as a broker-dealer whose authorization to engage in the securities business is limited solely to purchasing and selling investment company/variable contracts securities and direct participation program securities) are specifically excluded. The NASD specifically notes that a member may look to the Form BD as evidence of a firm’s status but must inquire further about whether the firm meets the conditions of a limited business broker-dealer. Also note, Rule 2790 does not prohibit sales or purchases from one member of a selling group to another member that are incidental to the distribution of a new issue by a broker-dealer involved in the offering process, at the public offering price, as an accommodation to a non-restricted person customer of the broker-dealer.
2. Finders and fiduciaries of the managing underwriter regarding offerings for which they are acting in those capacities.
3. Portfolio managers, defined as 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--including a non-natural person.
4. Owners and affiliates of broker-dealers excluding any affiliate (except another broker-dealer) that is publicly traded.

5. Immediate family members of restricted persons, defined as 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 the person provides "material support." The term, "material support," is further defined as the direct or indirect provision of more than 25% of a person's income in the prior calendar year which is presumed to include immediate family living in the same household. Under the Interpretation, members of the immediate family of an associated person may not purchase hot issues from the firm employing the associated person. Rule 2790 expands this prohibition to preclude purchases of new issues from *affiliates* of the firm employing the associated person so as to clarify that immediate family members of associated persons may use neither traditional nor online distribution channels to circumvent the prohibitions on sales to them.

A. Definition of "Beneficial Interest"

In determining whether an account is restricted or unrestricted, a firm must determine whether a restricted person has a "beneficial interest" in the account. Currently, the Interpretation defines "beneficial interest" broadly to include "not only ownership interests, but every type of direct financial interest of any persons" in such account. Members have found this definition confusing. Under Rule 2790, the NASD seeks to clarify this by defining "beneficial interest" as an interest that confers the right to receive the benefit of profits or losses rather than solely legal ownership. This definition of beneficial interest excludes the initial receipt of an investment management or performance based fee for operating a collective investment account or other similar fees earned by investment advisers acting in a fiduciary capacity, but includes *deferred* investment management or performance based fees.

B. 10 Percent De Minimis Threshold for Restricted Person Participation

To lessen the blow of the elimination of the conditionally restricted person status, the Rule introduces the 10 percent de minimis threshold. Essentially, this provision will allow firms to sell new issues to a collective investment account in which restricted persons have beneficial interests, provided that such restricted persons own no more than 10 percent of the account. Further, Rule 2790 allows the use of "carve-out" arrangements, just as they are allowed today under the Interpretation. As such, a collective investment account with greater than 10 percent of the beneficial ownership held by restricted persons may segregate the interests of restricted persons from non-restricted persons and purchase securities in a new issue for the non-restricted person class.

C. Preconditions to Sale - Written Representations

Rule 2790 introduces a precondition that must be met prior to any new issue allocation to an account. Within 12 months prior to a sale of a new issue to an account, a member must have obtained a written representation from a beneficial owner or conduit (for example, a bank, foreign bank, broker-dealer, or investment adviser) that all purchases of new issues are in compliance with the Rule. The initial verification of the person's status must be a positive affirmation of non-restricted status, however, the annual verification process may be conducted through the use of negative consents. Additionally, a firm may rely upon the information it receives from an account unless it believes, or has reason to believe, that the information is inaccurate. Electronic communications for eligible accounts, consistent with Rule 17a-3 under the Act, are sufficient; the firm, however, is not permitted to obtain the representations verbally. In addition, a firm is required to retain a copy of all records and information relating to these representations for at least three years following the firm's last sale of a new issue to that account. Accordingly,

firms will need to devise and implement processes to obtain written representations from new and existing accounts and to refresh the representations on a 12-month cycle.

During the public comment period, several comments sought guidance on what type of information a firm would be required to review as part of the initial verification process--particularly where there are multiple layers of beneficial ownership. In response, the NASD explained that, in the context of a "fund-of-funds" account, a person authorized to represent the beneficial owners of a "master fund" (*i.e.*, the fund that receives the new issue allocation directly from the NASD member firm) would be required to represent that the fund is able to purchase new issues. As stated in the Approval Order, the NASD "expects" that the representative of the master fund making such a representation to the member firm will have ascertained the status of investors in the "feeder funds" (*i.e.*, funds that invest in the master fund).⁶ If unable to ascertain the status of investors in a particular feeder fund, the master fund should deem such feeder fund to be restricted and ensure that the profits from a new issue are not allocated to that feeder fund (or consider whether any other exemption, such as the 10 percent de minimis threshold, might be available for that feeder fund).

D. Various Exemptions

The Rule contains various general exemptions to allow purchases of new issue securities by persons or accounts that may fall within the definition of "restricted person." The Rule exempts any new issue allocations to the following accounts or persons: (1) registered investment companies; (2) certain qualifying common trust funds and insurance companies; (3) publicly traded entities other than (a) a broker-dealer authorized to engage in the public offering of new issues either as a selling

group member or underwriter or (b) any affiliate of such broker-dealer; (4) foreign investment companies; (5) ERISA plans not sponsored by a broker-dealer; (6) state and municipal government benefit plans; (7) tax-exempt charities; and (8) church plans. The NASD has chosen not to exempt foreign employee benefit plans.

In addition, the Rule contains three exemptions which apply under limited circumstances: (1) the directed share program exemption; (2) the anti-dilution exemption; and (3) the undersubscribed offerings and stand-by purchaser exemption.

1. Directed Share Program Exemption

Rule 2790, with a few changes, adopts the Interpretation's directed share program exemption. According to the Interpretation, employees and directors of a parent or subsidiary of, or any other entity that controls or is controlled by an issuer, may purchase securities in an IPO that are specifically directed to such persons even if, otherwise, they would be restricted.⁷ However, the securities acquired are subject to a three-month lock-up period in the absence of a "bona fide independent market for such securities."

In contrast, Rule 2790 extends the directed share program exemption to include employees and directors of all the issuer's affiliates and eliminates any requirement under the exemption for a three-month lock-up period. The exemption is limited, however, to circumstances where: (1) the issuer's program has at least 10,000 participants; (2) every participant is offered an opportunity to purchase an equivalent number of shares or will receive shares based upon 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

⁶ See Approval Order, 68 Fed. Reg. at 62,130.

⁷ Section (d)(1) of the Rule provides that "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." See Approval Order, 68 Fed. Reg. at 62,145.

method; and (4) the class of participants does not contain a disproportionate number of restricted persons. Further, the NASD has emphasized that the exemption only applies where the issuer in fact directs shares and not where a member firm asks, suggests or advises an issuer to direct securities to a restricted person.⁸

2. Anti-Dilution Exemption

Another specific exemption excludes from the Rule's general prohibitions IPO allocations to a restricted person holding a beneficial interest in an account for the limited purpose of preventing dilution of such person's percentage interest. A restricted beneficial owner may receive proceeds of an IPO if: (1) 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; (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 or transferred for three months following the effective date of the offering. Note, this provision replaces a similar Interpretation provision but differs in that it allows a beneficial owner to count the time it held an interest in another company purchased by the issuer in order to meet the first condition.

3. Undersubscribed Offerings and Stand-By Purchaser Exemption

The last specific exemption outlined by the Rule allows an underwriter, pursuant to an underwriting agreement, to allocate a portion of an IPO the firm has underwritten to a proprietary investment account when there is insufficient demand in the market to meet its underwriting obligations. In addition, the purchase and sale of new issues pursuant to a stand-by agreement are permitted if the following conditions are met: (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 a three-month lock-up period.

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⁸ See Approval Order, 68 Fed. Reg. at 62,139.