WilmerHale

Special Notice to Hedge Fund Clients: SEC Approves Amended "Hot Issue" Rule

2003-11-14

I. Introduction

More than five years after the National Association of Securities Dealers, Inc. ("NASD") proposed new NASD Rule 2790 governing purchases and sales of "hot issue" offerings, the Securities and Exchange Commission ("SEC") approved Rule 2790 on an accelerated basis by issuing a simultaneous Notice of Filing and Order Granting Accelerated Approval of Amendment No. 5 to Rule 2790 in a release dated October 24, 2003.[1]

Under new Rule 2790, an NASD member generally is prohibited from selling a "new issue" to any account in which a "restricted person" has a beneficial interest. The term "restricted person" includes most broker-dealers, most owners and affiliates of a broker-dealer, and certain other classes of person. As described below, the new rule requires a member, before selling a new issue to any account, to meet certain "preconditions for sale." These preconditions generally require the member to obtain a representation from the beneficial owner of the account that the account is eligible to purchase new issues in compliance with the rule. The rule provides several general exemptions, the basic rationale of which is that sales to and purchases by entities that have numerous beneficial owners - and, therefore, are likely to have only a small percentage of restricted persons owners - are not the types of transactions the rule should proscribe.

II. Summary of Changes in New Rule

New NASD Rule 2790 will substantially amend and replace current NASD Interpretation Material ("IM") 2110-1, commonly known as the "Free-Riding and Withholding Interpretation." The primary differences between new Rule 2790 and IM-2110-1 are set forth in the following table:

	(Old) IM-2110-1	(New) Rule 2790
"New Issues" Versus "Hot Issues"	Only applies to offerings of securities that immediately trade at a premium in the secondary market.	Applies to any "new issue public offering of an equity whether the new issue tra secondary market.[2]

Cancellation Provision	No violation occurs if the member: (1) cancels the trade before the end of the first business day following secondary market trading; and (2) reallocates the trade at the public offering price to a non-restricted person or account.	None – NASD no longer b provision is necessary be applies to all new issues.
"Conditionally Restricted" Status	Certain "conditionally restricted" persons (such as certain independent family members of an associated person and officers, directors and persons in the securities department of a bank, insurance company, investment company or investment advisory firm) generally may purchase hot issues if such purchases are consistent with the person's normal investment practice and in insubstantial amounts (both as to the person and the member).	Eliminated – NASD prefer persons are treated as eit restricted.
***De Minimis* Exception**	None – No participation is permitted by restricted persons (other than conditionally restricted persons).	Restricted persons are pe a collective investment ac issues, provided that sucl account for no more than beneficial ownership.
Portfolio Managers	Treated as conditionally restricted. Broad definition includes <u>any</u> senior officer of a financial institution, funds or accounts or person in the securities department or otherwise having influence over buying or selling securities (or any person materially supported by such person).	Treated as restricted pers issues only to the extent a *minimis* exception). Howe beneficial interest specific a management or perforn operating a collective inve fees for acting in a fiduciar Significantly narrower def persons who have "autho

		for such financial institutic
Carve-Out Procedures (i.e., segregating the interests of restricted and non-restricted persons in a single account)	Permitted – specifically contemplated under IM-2110-1.	Still permitted -- provided received no more than 10 proceeds of the new issu
Preconditions for Sale	No specific verification requirements for non-entity accounts. For investment partnerships or corporations, a member must receive prior to the transaction either (i) a list of all persons having a beneficial interest in the account and their business connections or (ii) a written representation from the entity's counsel or independent accountants certifying among other things a reasonable belief that no person with a beneficial interest in the account is a restricted person. Investment entities are required to have annual audits of their hot issue allocations by their independent accountants.	Within the 12 months prio issue, a member must ob from the account holder (that the account is eligible If an interest in the accour as a conduit for others, th obtain from that entity a re purchases of new issues compliance with the Rule The initial verificat person's eligibility r positive affirmation restricted status, bu intends to permit s annual verification of negative consent

III. Compliance Dates

The proposed rule change will take effect upon the issuance by the NASD of a Notice to Members discussing the new rule. The NASD has stated that it will publish this Notice to Members no later than 60 days after the SEC's accelerated approval of the new Rule on October 24, 2003. NASD members will have the option of complying with either old IM-2110-1 or new NASD Rule 2790 for

three months following publication of the Notice to Members. Thereafter, NASD members must comply with new Rule 2790.

IV. Steps to Take Now

Managers of hedge funds will need to revise their procedures for complying with the hot issue rule. While new Rule 2790 will generally make compliance less burdensome going forward due to the elimination of the requirement for a letter from counsel and annual accountant certification, hedge fund managers will need to take some steps within the next few months to continue to participate in IPOs.

- You may need to send supplemental questionnaires to existing investors to confirm their status under the new rule. Although existing subscription agreements and investor questionnaires may establish a sufficient basis for determining the status of some investors as restricted persons, the current documentation is unlikely to work under the new rule for all investors. You could elect to send a supplemental questionnaire to all investors (perhaps updating your records for anti-money laundering purposes at the same time). Alternatively, you could identify those investors whose status is now ambiguous, such as persons who were previously restricted because they are senior officers of an institutional type account (but may not have investment decision making authority and therefore may no longer be restricted). Similarly, many fund of funds or investment partnerships that invest in hedge funds have provided in the past a “conditionally restricted” opinion. You will need to verify those entities’ status under the amended rule or treat them as restricted.

- You should revise your subscription and offering documents to reflect the amended rule.

- You should determine if restricted persons represent more than 10% of your fund. For this purpose, the interests of the general partner and the hedge fund’s portfolio managers and persons with investment discretion will count towards the 10% threshold. However, you can disregard the performance fee or allocation for determining this 10% economic interest. If restricted persons represent 10% or more of the hedge fund, many partnership agreements permit the general partner to allocate interest in hot issues away from restricted persons. Now, you can allow restricted persons collectively to be allocated a 10% interest in the hot issue and allocate away any excess economic interest. A pro-rata cutback of the restricted persons who are investors in the hedge fund is likely to be the most equitable result, but the rule does not prescribe a particular methodology. Regardless of the methodology chosen, your accounting process will need to be appropriately adjusted. If less then 10% of the economic interests in the hedge fund are held by restricted persons, you can now abandon the use of carve out procedures, simplifying your accounting.

- Offshore funds that offer a separate hot-issue-eligible class of shares will need to determine whether investors can be exchanged from one share class to the other as a

result of a change in investor status under the new rule.

- NASD members are required to allocate new issues to an account only if they have received supporting representation from the account within the past twelve months. Consequently, broker-dealers will be requesting certifications initially and verification (probably by negative consent) at least annually.

The NASD is expected to provide some additional interpretive guidance on the application of the new rule. This interpretive guidance will presumably be included in the Notice to Members publishing the new rule, which is expected to be released shortly.

V. Questions and Contacts

If you have any questions on these matters, please contact any of the following partners of the Investment Management Group or the Hale and Dorr LLP attorney with whom you most often work.

---

[1] SEC Release No. 34-48701; File No. SR-NASD-99-60.

[2] The definition of "new issue" in this rule includes certain exclusions, all of which are consistent with the term initial public offering.

[3] New Rule 2790 does not prescribe a particular manner for carving out the interests of restricted persons, but intends to offer detailed guidance concerning the use of carve-out accounts in a Notice to Members to be published after approval of new Rule 2790 change.

[4] In a so-called "master-feeder" structure, a person authorized to represent the beneficial owners of the master fund (*i.e.*, the fund that purchases the new issues from the member directly) is required to represent that the fund is able to purchase new issues. The NASD expects that any such person, in making such representation, would ascertain the status of investors in the feeder funds (*i.e.*, funds that invest in the master fund). If the representative of the master fund is unable to ascertain the status of investors in a feeder fund, the master fund must deem such feeder fund to be restricted and ensure that the profits from new issues are not allocated to that fund (or consider whether any other exemption, such as the *de minimis* exemption, might apply to that feeder fund). In Amendment No. 5, the NASD stated that it would address this matter further in a Notice to Members following the SEC's approval of new Rule 2790 change.

Authors

Timothy F. Silva

PARTNER

Chair, Investment Management Practice

timothy.silva@wilmerhale.com

+1 617 526 6502