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## M E M O R A N D U M

**To:** Clients & Friends

**From:** Cadwalader, Wickersham & Taft LLP

**Date:** November 4, 2003

**Re:** New NASD Rule 2790 (Replaces “Free-Riding and Withholding” Interpretation with regard to “Hot Issues”)

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On October 24, 2003, the SEC approved NASD Rule 2790 – “Restrictions on the Purchase and Sale of Initial Equity Public Offerings” (“Rule 2790”). Rule 2790 will replace the NASD’s existing “Free-Riding and Withholding” Interpretation, IM-2110-1 (“IM-2110-1,” popularly known as the “Hot Issue Rule”). Prior to December 23, 2003, the NASD will issue a “Notice to Members,” announcing effectiveness of Rule 2790, but will give NASD members a three-month transition period during which they can comply with either IM-2110-1 or Rule 2790.

The policy objectives of Rule 2790 are similar to those under IM-2110-1, which generally prohibit broker-dealers from selling equity securities in initial public offerings to their own accounts or to the accounts of other persons who may be in a position to direct future business to the broker-dealer. Rule 2790 (as was the case with IM-2110-1) will have a significant impact on hedge funds and other private investment funds, which must decide how to handle investments from investors who are “restricted persons” (see point 2 below). Under Rule 2790, a private investment fund or other “collective investment account” (see point 2 below) that invests in “new issues” (see

point 1 below) will have three choices: (1) prohibit investments by “restricted persons”; (2) sell two classes of interests - one to “non-restricted persons,” which class can participate in profits and losses from “new issues,” and the other to “restricted persons,” which class cannot participate in such investments; or (3) agree to limit investments by “restricted persons” to not more than 10% of the fund’s capital, thereby qualifying for the general *de minimis* exemption (see point 3 below). Considering that many private investment funds permit continuing investments and redemptions by investors, and investments in the fund by the manager will be deemed investments by a “restricted person,” taking advantage of the 10% *de minimis* exemption may be difficult for some funds.

Rule 2790 continues to permit the use of so-called “carve-out accounts” by a private investment fund or other “collective investment account” to separate the interests of restricted and non-restricted persons, or to reduce the interests of restricted persons to below the 10% threshold. The NASD staff is expected to provide further guidance concerning the use of such accounts in its “Notice to Members” regarding the effectiveness of Rule 2790.

The following briefly summarizes Rule 2790 and highlights issues that may be important to private investment funds:

1. Covered Offerings – “New Issues”. IM-2110-1 applies only to “hot issues” – *i.e.*, those public offerings that trade at a premium in the secondary market, whenever such market begins. Rule 2790, however, applies to all initial public offerings of equity securities -- not just those that are regarded as “hot issues.” Under Rule 2790, “new issues” include any initial public offering of an “equity security,” as defined in Section 3(a)(11) of the Securities Exchange Act of 1934, as amended, whether made pursuant to a registration statement or an offering circular (*e.g.*, common stock issued by a bank, which is exempt from SEC registration). Excluded, however, are “equity securities” that are: (a) sold in reliance on the exemptions under Section 4(1), 4(2), or 4(6) of the

Securities Act of 1933, or SEC Rules 144A, 505 or 506 promulgated thereunder; (b) issued by a commodity pool; (c) sold in a rights offering, exchange offer, or pursuant to a merger or acquisition; (d) investment grade-rated asset-backed securities; (e) convertible or preferred securities; (f) issued by a registered investment company; or (g) ordinary shares or ADRs registered on SEC Form F-6 with a pre-existing market outside the U.S.

2. Revised Categories of Restricted Persons. Similar to IM-2110-1, Rule 2790 prohibits an NASD member firm or an associated person of an NASD member firm from selling a new issue security to any account in which a beneficial interest is held by: (a) a broker-dealer or an associated person of a broker-dealer; (b) a finder or a person with a fiduciary relationship to a managing underwriter; (c) portfolio managers (*i.e.*, 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); (d) a person with a direct or indirect ownership interest in a broker-dealer that triggers a listing on the broker-dealer's Form BD; or (e) certain "immediate family members" of any of the foregoing persons.

Rule 2790 liberalizes the current restrictions on sales to portfolio managers, by limiting the restriction to those persons having the authority to buy or sell securities for the covered entities or collective investment accounts. "Collective investment account" is defined in Rule 2790 as any hedge fund, investment partnership, investment corporation, or other collective investment vehicle that is engaged primarily in the purchase or sale of securities, but excludes certain "family investment vehicles" and "investment clubs."

In one major change, Rule 2790's definition of "restricted person" excludes the prior exemption in IM-2110-1 for so-called "conditionally restricted persons." Accordingly, under Rule 2790 a person will either be restricted or not restricted.

3. General Exemptions. Rule 2790 includes a number of general exemptions that would permit otherwise restricted persons to purchase new issues, either directly or through accounts in which they have a beneficial interest. These accounts include:

- certain publicly-traded entities (other than broker-dealers authorized to engage in public offerings of new issues or their affiliates);
- accounts (including hedge funds and other private investment funds) in which the beneficial interests of restricted persons, including portfolio managers, do not, in the aggregate, exceed 10% of the account;
- registered investment companies;
- certain non-U.S. investment companies listed on a non-U.S. exchange or authorized for sale to the public by a non-U.S. regulatory authority, provided that no person owning over 5% of the fund shares is a restricted person;
- certain insurance company general, separate or investment accounts;
- certain ERISA and governmental benefits plans; and
- tax exempt charitable organizations.

Of particular interest to private investment funds is a new exemption, the *de minimis* exemption, that permits sales of new issues to any account in which restricted persons do not have more than a 10% beneficial interest (to the extent that beneficial interests of restricted persons exceed the 10% limit, the account may employ a “carve-out” whereby interests of restricted persons in excess of the 10% limit do not participate in gains or losses from new issues).

“Beneficial interest” means any economic interest, such as the right to share in gains or losses. However, the receipt of a management or performance-based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity, will not constitute a beneficial interest in the account. If these fee payments are, however, subsequently invested in a collective investment account, they will constitute a beneficial interest in the account.

The 10% exemption may prove more difficult for certain funds. For example, funds permitting continuing investments or redemptions will be required to monitor investors as to their status as “restricted persons” to stay within the 10% limit. Further, in a fund of funds context it will be necessary for the underlying fund making investments in new issues to also take into account the restricted persons of any fund of funds investor, as well as any investment made by the fund manager. Thus, it may be necessary for certain fund managers to monitor the percentage of restricted persons at several levels in order to take advantage of the *de minimis* exemption.

4. Recordkeeping Requirements. Rule 2790 imposes a new recordkeeping obligation upon NASD member firms. Specifically, Rule 2790 requires, as a precondition to selling a new issue to an account, that an NASD member in good faith obtain, within 12 months prior to such sale, a representation from the beneficial owner(s) of the account or a conduit (*i.e.*, a bank, broker-dealer, or investment adviser) that the account is eligible to buy new issues. This new recordkeeping obligation eliminates the requirement in IM-2110-1 whereby private investment funds had to provide a representation letter from an attorney or a certified public accountant certifying that the fund either had only non-restricted persons as investors, or two classes of interests for restricted persons and non-restricted persons.

We will continue to monitor Rule 2790 and related developments. If you have any questions as to how Rule 2790 is likely to affect you and how you do business, please call Alan M. Parness at (212) 504-6342; Ed Lyon at (202) 862-2249; Jonathan M. Wainwright at (212) 504-6122; Tim Selby at (212) 504-6868; or Corina Boelsterli at (212) 504-6197 with any questions.