

**SEC APPROVES NEW RULE 2790 (RESTRICTIONS ON THE PURCHASE
AND SALE OF IPOs OF EQUITY SECURITIES);
REPLACES FREE-RIDING AND WITHHOLDING INTERPRETATION**

January 28, 2004

On December 23, 2003, the National Association of Securities Dealers, Inc. (the "NASD") published a Notice to Members announcing the new Rule 2790 entitled "Restrictions on the Purchase and Sale of IPOs of Equity Securities" (the "Rule") which replaced NASD IM-2110-1, known as the Free-Riding and Withholding Interpretation (the "Interpretation"). The Rule, like the Interpretation it replaced, is designed to protect the integrity of the public offering process.

During the three-month transition period between December 23, 2003 and March 23, 2004, NASD members can comply with either the Interpretation or the Rule. *As of March 23, 2004, all members must comply with the Rule.* As a result of the Rule, domestic or offshore investment vehicles (including hedge funds) that intend to participate in new issues will likely need to change their offering and governing documents, and, in some cases, such changes may require the consent of the vehicles' investors.

**PRIMARY DIFFERENCES BETWEEN
THE RULE AND THE INTERPRETATION**

SCOPE: "NEW ISSUES" V. "HOT ISSUES"

The Rule only covers "new issues" (defined to include any initial public offering of an equity security) and eliminates the Interpretation's requirement that an offering must be a "hot issue" (a public offering of a security that trades at a premium in the secondary market) in order to be subject to the Rule's restrictions. "New issues" do not include private offerings, offerings of exempted securities, offerings of securities of a commodity pool operated by a commodity pool operator, rights offerings, exchange offers, offerings made pursuant to a merger or acquisition, offerings of investment grade asset-backed securities, offerings of convertible and preferred securities, offerings of securities of an investment company registered under the Investment Company Act of 1940, as amended, offerings of securities (in ordinary share form or ADRs registered on Form F-6) that have a pre-existing market outside of the United States and purchases and sales pursuant to standby agreements.

ELIMINATION OF THE "CONDITIONALLY RESTRICTED" STATUS

Under the Interpretation, persons generally referred to as "conditionally restricted" were eligible to purchase hot issues if certain conditions were met. The Rule eliminates the "conditionally restricted" status and treats all persons as either restricted or non-restricted.

ADOPTION OF A “DE MINIMIS” EXEMPTION; USE OF CARVEOUT METHODOLOGY

The Rule adopts an exemption that allows an account that is beneficially owned in part by restricted persons to purchase new issues if the aggregate beneficial interests of such persons do not exceed 10% of such account. Notwithstanding the foregoing, accounts in which restricted persons own more than 10% may invest in a new issue so long as restricted persons receive no more than 10% of the proceeds of the new issue.

As before, the initial receipt of a performance-based fee or allocation does not constitute a beneficial interest, although the subsequent investment of such fee or allocation in the account (pursuant to a deferred fee arrangement or otherwise) does constitute a beneficial interest. In addition, collective investment accounts may use a “carveout methodology” to reduce the beneficial interest of restricted persons in new issues to 10% or less. The NASD has also eliminated the requirement to observe specific carveout procedures, such as the establishment of separate brokerage accounts, in recognition that there may be many effective means of segregating interests of restricted persons. Furthermore, the NASD will now permit the “journaling” of new issues from the accounts of non-restricted persons to those of restricted persons so long as the interest in the new issue is transferred to restricted persons after the new issue begins trading at the prevailing market price rather than the IPO price.

Hedge fund managers should review the offering and governing documents of their funds which intend to participate in new issues to determine whether the Rule and, in particular, the “de minimis” exemption and the carveout procedures, require any changes to such documents.

ELIMINATION OF “HOT ISSUE OPINIONS”

The Rule eliminates the need for a member to obtain a “hot issue” representation letter from an attorney or a certified public accountant relating to the eligibility of an account to participate in new issues. Instead, a member may now rely on a representation from the account holder relating to the eligibility of such account to participate in new issues.

THE DEFINITION OF RESTRICTED PERSONS AND EXEMPTIONS

The definition of “restricted persons” now includes the following categories:

- NASD members or other broker/dealers (other than limited business broker/dealers and investment partnerships registered as broker-dealers that follow a carveout methodology) and their personnel
- Finders and fiduciaries acting in a fiduciary capacity in the particular offering
- Portfolio managers, including any person who has the authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment advisor or collective investment account (including any hedge

fund, investment partnership, investment corporation, or any other collective investment vehicle but excluding family investment vehicles and investment clubs). Thus, hedge fund managers and their personnel with investment decision-making authority are restricted persons.

- Affiliates of broker/dealers
- Immediate family members of restricted persons and individuals to whom restricted persons provide material support

The Rule contains a number of exemptions and does not apply to purchases and sales of new issues by the following:

- Accounts where the aggregate beneficial interests of restricted persons do not exceed 10% (see the description of the “de minimis exemption” above)
- Registered investment companies
- Certain common trust funds
- Certain insurance company general, separate or investments accounts
- Certain publicly traded entities (other than broker/dealers and their affiliates where such broker/dealers are authorized to engage in the public offering of new issues)
- Certain foreign investment companies that are either public or authorized for sale to the public
- ERISA plans; provided that such plans are not sponsored solely by a broker/dealer
- Certain state and municipal government benefit plans
- Tax-exempt charities organized under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”)
- Church plans described in Section 414(e) of the Code.

Hedge funds investing in new issues should update their subscription agreements to reflect changes in the definition of restricted persons and exemptions therefrom, and should re-canvass their existing investors to determine the status of their investors under the new definition.

PRECONDITIONS FOR SALE

The Rule requires that a member may not sell new issues to any account unless within the previous 12 months it has in good faith obtained a representation from the beneficial owners of the account (or a person authorized to represent such owners) that the account is eligible to purchase new issues or from certain conduits that all purchases of new issues by such account are in compliance with the Rule. NASD requires the initial verification of an account's status under the Rule to be a positive affirmation. The annual verifications thereafter may be done through the use of the negative consent letters. Thus, a member may furnish a customer with its account information on record used to determine that the account is eligible to purchase new issues and ask the customer to indicate whether anything has changed to make the account restricted. In the absence of any response from the customer, the member may continue to deem the account non-restricted. Where the customer is an investment vehicle (e.g., a hedge fund), the member may rely on the representation of the general partner or another authorized person of such fund which will, in turn, need to ascertain the status of the fund's investors in order to make the required representation to the member. As noted above, the Rule eliminates the need for hedge funds and similar investors to furnish an opinion from an attorney or an accountant in order to participate in new issues. However, the subscription agreements of investment vehicles investing in new issues must continue to contain a representation from each investor as to its status as a restricted or non-restricted person under the Rule, and these representations must be updated annually (as indicated above, such annual updates may be done through the use of the negative consent letters).

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This memorandum only briefly summarizes the Rule that is available at <http://www.nasdr.com/pdf-text/0379ntm.pdf>. If you have any questions concerning the new rule, please contact Thomas H. Bell (tbell@stblaw.com), Philip Culhane (pculhane@stblaw.com), Mark Lab (mlab@stblaw.com), Michael Nooney (mnooney@stblaw.com), Glenn Sarno (gsarno@stblaw.com), Michael Wolitzer (mwolitzer@stblaw.com), or Olga Gutman (ogutman@stblaw.com) of our firm at (212) 455-2000.