

# SHARTSIS, FRIESE & GINSBURG LLP

ROBERT CHARLES FRIESE  
ARTHUR J. SHARTSIS  
MARY JO SHARTSIS  
DOUGLAS L. HAMMER  
RONALD HAYES MALONE  
JOEL ZELDIN  
JOHN P. BROADHURST  
DAVID H. KREMER  
CHARLES R. RICE  
ANTHONY B. LEUIN  
ROBERT E. SCHABERG  
TRACY L. SALISBURY  
JEFFREY A. O'CONNELL  
CAROLYN R. GORMAN  
JONATHAN M. KENNEDY  
ADAM ELSSESSER  
STEVEN O. GASSER  
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ZESARA C. CHAN  
GEOFFREY W. HAYNES  
CHRISTOPHER J. RUPPRIGHT  
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ROBERT CHARLES WARD  
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JAHAN P. RAISSI  
FRANK A. CIALONE  
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NEIL J. KOREN  
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ALISSA A. CHACKO  
ANTHONY J. CALDWELL  
AMY L. HESPENHEIDE  
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TRACY A. DONSKY  
LATISHA R. BROWN  
JAMES J. FROLIK  
RICHARD F. MUNZINGER  
CECILY D. FREYERMUTH  
HANNAH E. DUNN  
CHRISTINA E. MICKELSON  
MATTHEW J. GLUCK

EIGHTEENTH FLOOR  
ONE MARITIME PLAZA  
SAN FRANCISCO, CALIFORNIA 94111

TELEPHONE  
(415) 421-6500  
FACSIMILE  
(415) 421-2922  
WEBSITE  
[www.sfglaw.com](http://www.sfglaw.com)  
SENIOR COUNSEL  
ALAN J. ROBIN  
COUNSEL  
MONIQUE V. ALONSO  
WINNIFRED C. WARD  
JOAN L. GRANT  
ELLYN T. ROBERTS  
MARY KAY KENNEDY  
DONNA M. HERZING  
SUSAN M. LEBERMAN

December 3, 2003

Re: National Association of Securities Dealers, Inc. ("NASD")  
Rule 2790—the "New Issue" Rule

To Our Clients and Other Friends:

On October 24, 2003, the Securities and Exchange Commission ("SEC") approved NASD Rule 2790. The full text of the SEC's order approving the rule change is available at <http://www.sec.gov/rules/sro/34-48701.htm>. Rule 2790 will replace NASD Interpretive Material ("IM") 2110-1, known as the Free-Riding and Withholding Interpretation, which now governs the manner in which NASD members distribute "hot issues."

## **Effective Date**

The NASD said that it will publish a Notice to Members announcing new Rule 2790 within sixty days after SEC approval. Entities subject to the new rule will have three months from the date that the NASD publishes that Notice during which they may comply with either the old rule or the new rule. After the three-month transition period, they must comply with the new rule. If you manage a domestic or offshore hedge fund or other investment entity, and if you want to participate in initial public offerings of equity securities, your fund's offering circular and subscription documents will need to be changed to accommodate the new rule. You may also need to amend the fund's partnership agreement or articles of association, which may require the consent of the fund's investors.

## **Summary of the New Rule**

Under the new rule, a NASD member generally will be prohibited from selling a "new issue" to any account in which a "restricted person" has a beneficial interest. The NASD member will also be required to meet specified "preconditions for sale" before selling a new issue to any account.

Differences from the old rule. The following are the primary differences between NASD Rule 2790 and NASD IM 2110-1:

- Rule 2790 will apply to any “new issue,” defined as an initial public offering of an equity security, not just “hot issues,” defined in IM 2110-1 as a public offering of a security that trades at a premium in the secondary market. Unlike the old rule, the new rule will not apply to non-equity securities or to preferred stock issues.
- The new rule will eliminate a NASD member’s ability to cancel and reallocate shares the day after secondary trading begins.
- The new rule will eliminate provisions for “conditionally restricted persons.” All persons will be either restricted or unrestricted.
- The new rule will allow accounts (including hedge funds) that are beneficially owned by both restricted and unrestricted persons to allocate up to ten percent of new issue profits to restricted persons.
- The new rule will eliminate the need for a member to obtain a “hot issue” representation letter from an attorney or CPA. Instead, the member will be permitted to rely on a representation from the account holder that the account is eligible to purchase new issues under the new rule.

New Issues. The new rule will apply only to initial public offerings of equity securities. It will not apply to private placements, offerings of securities in commodity pools, rights offerings, exchange offers, offerings in mergers or acquisitions, offerings of investment grade asset-backed securities, offerings of convertible securities, offerings of preferred securities, offerings of registered investment companies and offerings of securities with pre-existing markets outside the United States. The new rule will apply to all such new issues, whether or not they are “hot.”

Restricted Persons. With stated exceptions, a NASD member generally will not be permitted to sell a new issue to any account in which a restricted person has a beneficial interest. Restricted persons include:

- Brokers or dealers and their personnel, other than limited business brokers or dealers, defined as brokers or dealers 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.
- Finders and any person acting in a fiduciary capacity to the managing underwriter, including, but not limited to, attorneys, accountants and financial consultants.
- Portfolio managers, defined as any person who has the authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment adviser or collective investment account (which includes a hedge fund, investment partnership, investment corporation or other collective

investment vehicle). A person with authority to buy or sell securities for an investment club or family investment vehicle would not be a portfolio manager.

- Owners of brokers or dealers.
- Affiliates of brokers or dealers.
- Immediate family members of restricted persons. “Immediate family” means a person’s parents, parents-in-law, spouse, siblings, brothers-in-law, sisters-in-law, sons-in-law, daughters-in-law, children, and any individuals to whom the person provides material support. “Material support” means directly or indirectly providing more than twenty-five percent of a person’s income in the preceding calendar year. Members of the immediate family living in the same household are deemed to be providing each other with material support.

Exemptions. The prohibitions of the new rule will not apply to the following:

- A person with authority to buy or sell securities for a family investment vehicle, defined as a legal entity beneficially owned solely by immediate family members.
- Accounts in which restricted persons, in the aggregate, own less than ten percent. Accounts in which restricted persons own more than ten percent may invest in new issues, so long as restricted persons receive no more than ten percent of the notional pro rata proceeds of the new issue. This exemption may be useful to many hedge fund managers. The NASD said it will issue guidance on the use of carve-out accounts for these situations when the new rule is announced.
- Registered investment companies (mutual funds).
- A common trust fund or similar fund, as described in section 3(a)(12)(A) of the Securities Act of 1933, that has investments from 1,000 or more accounts and that does not limit beneficial interests principally to trust accounts of restricted persons.
- An insurance company general, separate or investment account funded by premiums from 1,000 or more policyholders, or an insurance company general account, if the insurance company has 1,000 or more policyholders and does not limit participation principally to restricted persons.
- A publicly traded entity (other than a broker or dealer or an affiliate of a broker or dealer where such broker or dealer is authorized to engage in the public offering of new issues either as a selling group member or underwriter) that is listed on an exchange or Nasdaq, or that is a foreign issuer who meets the criteria for listing on an exchange or Nasdaq.
- A foreign investment company listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority in which no person owning more than five percent is a restricted person.

- ERISA plans that are not sponsored solely by a broker or dealer.
- A state or municipal government benefits plan subject to state and/or municipal regulation.
- Tax exempt charitable organizations under section 501(c)(3) of the Internal Revenue Code.
- A church plan under section 414(e) of the Internal Revenue Code.
- Specified issuer-directed securities.

Preconditions for sale. Under the new rule, before selling a new issue to any account, a NASD member must, in good faith, have obtained within twelve months prior to the sale, a representation from the beneficial owner or conduit (such as a bank, foreign bank, broker, dealer, investment adviser or the like) that all purchases of new issues comply with the new rule. A NASD member may not rely on any representation that it believes or has reason to believe is inaccurate. Initial verification of a person's status must be a positive affirmation of non-restricted status. Annual verification of a person's status, however, may be conducted through the use of negative consents. Thus, a NASD member may send a letter to its client that recites the client's non-restricted status and asks the client to respond only if that status has changed.

A hedge fund manager will obtain an initial representation regarding an investor's status with the investor's subscription documents. Thereafter, the hedge fund manager annually may follow the negative consent procedure described above. Following these procedures will enable the hedge fund manager to respond appropriately to the requests from brokers concerning the fund's ability to purchase new issues. As yet, it is unclear how the representation procedures will operate if more than ten percent of the fund's beneficial owners are restricted. If a fund employs carve out procedures to limit the proceeds from new issues allocated to restricted persons, presumably hedge fund managers will need to verify that the carve out procedures are adequate. The NASD is expected to address these issues in a Notice to Members.

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This letter only briefly summarizes the highlights of the new rule. If you have any questions regarding the new rule, please contact Douglas Hammer, John Broadhurst, Carolyn Gorman, Geoff Haynes, Christopher Rupright, Carolyn Reiser, Joan Grant, Ellyn Roberts, Neil Koren, Anthony Caldwell, James Frolik, Christina Mickelson or Elizabeth Storz.

Sincerely yours,

SHARTSIS, FRIESE & GINSBURG LLP