

January 2004

New NASD Rule 2790 Revises Restrictions on the Purchases and Sales of Initial Public Offerings

By Steven Felsenstein, Joel Telpner and Brenda Chavez¹

“Changes will have to be made in the information obtained for new accounts, and firms will have to revisit the supporting information for existing client accounts so that information satisfies the new rule”

The Securities and Exchange Commission has approved a new rule proposed by the National Association of Securities Dealers, Inc. (the “NASD”) that replaces previous restrictions on the purchases and sales of “hot issue” equity securities with a broader prohibition covering initial public offerings. Currently, NASD Interpretative Memorandum 2110-1, also known as the “Free-Riding and Withholding Interpretation” (the “Interpretation”) governs the manner in which NASD members may distribute hot issues.

As with the Interpretation, new NASD Rule 2790 (the “new rule” or “Rule 2790”) is intended to protect the integrity of the public offering process by:

- Ensuring that NASD members make *bona fide* public offerings of securities at the offering price so that industry insiders, including NASD members and their associated persons, do not take advantage of their “insider” position in the industry to purchase new issues for their own benefit at the expense of public customers; and
- Ensuring that members do not withhold securities in a public offering in order to use such securities to direct compensation in a manner that is not consistent with the public interest and fair dealing or to reward persons who are in a position to direct future business to members.

Under the Rule 2790, a member is not permitted to sell a new issue to an account until the member has met the preconditions in the new rule, which requires a member to have obtained, within 12 months prior to the sale, information from the account holder(s), or a person authorized to represent the beneficial owner(s) of the account, that the

Amsterdam
Atlanta
Boca Raton
Boston
Chicago
Dallas
Delaware
Denver
Fort Lauderdale
Los Angeles
Miami
New Jersey
New York
Orlando
Philadelphia
Phoenix
Tallahassee
Tysons Corner
Washington, D.C.
West Palm Beach
Zurich

account is eligible to purchase new issues in compliance with the rule. An account is eligible if no restricted person has an interest in the account, or if such interests do not exceed a specified threshold. A restricted person is considered to have a beneficial interest in an account if the person has an economic interest, such as the right to share in profits or losses.

The new rule requires members to retain a copy of all records and information obtained for at least three years following the last sale of a new issue to that account. Further, the new rule prohibits the use of oral verification to determine compliance with the rule. Finally, the new rule provides that a member may rely upon the information it receives from a customer unless the member believes, or has reason to believe, that the information is inaccurate.

While the new rule draws upon concepts and procedures in the Interpretation, there are significant changes, and advance planning is needed to avoid later disruption for broker-dealers and for investors. As was the case under the Interpretation, Rule 2700 imposes a compliance duty on both the selling broker-dealer, and on any associated person that acquires new issues (IPO securities).

Broker-dealers have to take steps to assure that their procedures comply with the new rule. Changes will have to be made in the information obtained for new accounts, and firms will have to revisit the supporting information for existing client accounts so that information satisfies the new rule. Existing investor entities such as hedge funds, trusts, or other pooled investment vehicles that want to invest in IPO securities will need to update information about the beneficial owners of the entity in order to be able to respond adequately to the requests of the broker-dealers from which they acquire IPO securities. Given the changes described below, it is likely that existing questionnaires and account files will not obtain or

hold all the data now required. It is likely that follow-up inquiries to existing investors will be needed to complete required information.

The Most Significant Changes Included in Rule 2790 are:

- *“New Issue” versus “Hot Issue”*

The Rule 2790 governs “new issues,” defined as an initial public offering of an equity security. This represents a substantive change from the Interpretation, which covered only “hot issues,” newly-issued securities that immediately traded at a premium. Consequently, Rule 2790 applies to the purchase and sale of all initial equity public offerings, not just those that later trade above a designated premium. The NASD believes that this approach will avoid many of the complex cancellation procedures of the previous rule. In fact, since the new rule will apply to all new issues, the NASD no longer believes that a cancellation provision that was needed under the Interpretation is necessary. Generally, exempted offerings and offerings of restricted securities are not considered new issues for purposes of the new rule.

- *Introduction of a de minimus threshold for restricted persons*

The new rule introduces the concept of a *de minimus* exemption. Under the new rule, investor entities in which restricted persons have an interest will be permitted to purchase new issues, provided that restricted persons account for no more than 10% of the account’s beneficial ownership. Rule 2790 modifies but continues the practice provided by the Interpretation of allowing “carve-outs.” Under the *de minimus* concept, an investment account in which restricted persons hold an interest of 10% or more could invest in new issues, provided that such restricted persons receive

no more than 10% of the notional pro rata proceeds of the new issue. The NASD will publish detailed guidance concerning the use of carve-out accounts in a separate Notice to Members.

- *Elimination of “conditionally restricted person”*

The New Rule eliminates the “conditionally restricted person” status and instead treats all persons as either restricted or non-restricted. Although the term “conditionally restricted person” was not previously defined, it included such persons as members of the immediate family of an associated person, finders in respect to the public offering, any person acting in a fiduciary capacity to the managing underwriter (including accountants, attorneys, and consultants) and senior officers and directors of banks, insurance companies and investment advisory firms. These formerly “conditionally restricted persons” are now treated the same as any other restricted person and may be prohibited from purchasing equity securities, unless an exemption applies.

- *Securities excluded from the rule*

The New Rule exempts various types of securities offering from its application, including all debt securities, convertible securities, offerings of securities of commodity pools, rights offerings to existing shareholders, exchange offers, and offerings made pursuant to a merger or acquisition. Rule 2790 also exempts offerings of investment-grade asset-backed securities, securities of an investment company registered under the Investment Company Act of 1940 and offerings of securities (including ADRs registered on Form F-6) of foreign private issuers that have a pre-existing market outside of the United States. Although Rule 2790 does not contain a specific exemption for secondary offerings, the definition of “new issues” implicitly exempts secondary offerings.

- *Restricted persons*

The definition of “restricted person” under the new rule includes NASD members, other broker/dealers and any officer, director, general partner, associated person, or employee of a member or other broker-dealer (other than a limited business broker/dealer - a broker/dealer that only engages in the purchase and sale of investment company/variable contract securities and direct participation program securities), any agent of a member or any other broker/dealer (other than a limited business broker/dealer) that is engaged in the investment banking or securities business. It covers persons who own broker-dealers and are listed, or required to be listed, in Schedule A, Schedule B, and Schedule C of a Form BD (other than with respect to a limited business broker/dealer). Rule 2790 includes certain immediate family members of such specified persons.

In addition, the New Rule prohibits the sale of new issues to any senior officer of a bank, savings and loan institution, insurance company, investment company, investment advisory firm or any other institutional type account. The New Rule preserves the treatment of finders and fiduciaries of managing underwriters as restricted persons. However, in the case of a law firm or consulting firm, the restriction only applies to persons working on the particular offering.

- *General exemptions*

The general prohibitions of the new rule do not apply to sales or purchases from several classes of person, whether directly or through accounts in which such persons have a beneficial interest. These classes of persons include, investment companies registered under the Investment Company Act of 1940, certain common trust funds and insurance companies,

certain publicly traded entities, certain foreign investment companies, certain benefit plans established under the Employee Retirement Income Security Act (“ERISA”), a state or municipal government plan that is subject to state and/or municipal regulation, certain foreign employee benefit plans, certain church plans, and tax exempt charitable organizations.

- *Carve-out procedures*

The new rule continues the carve-out found in the Interpretation that allows an investment fund to segregate the investments of restricted persons to avoid allocating new issues to investors who are restricted persons. However, the new rule eliminates any specific procedures that investment funds must follow for achieving segregation, instead recognizing that a variety of methods may be employed for carving out the interests of restricted persons.

- *Effective date*

The new rule may be relied upon effective as of December 23, 2003, but reliance on the Interpretation is permitted through March 23, 2004, after which time the Interpretation will no longer be available.

Footnotes

¹J. Richard Tucker and Terrance J. Reilly contributed to this article

Practice Areas:

- Alternative Dispute Resolution
- Americans with Disabilities Act
- Antitrust
- Appellate
- Aviation
- Biotechnology
- Business Immigration
- Corporate and Securities
- Education
- Energy and Natural Resources
- Executive Compensation and Employee Benefits
- Entertainment
- Environmental and Land Use
- Finance
- Financial Institutions
- Franchise and Distribution
- Gaming
- Global Business Group
- Global Trade
- Golf and Resorts
- Governmental Affairs
- Government Contracts
- Health Business Group
- Intellectual Property
- Investment Funds
- Labor and Employment
- Litigation
- Native American
- Public Finance
- Public Infrastructure
- Public Utilities
- Real Estate
- Real Estate Operations
- Reorganization, Bankruptcy and Restructuring
- Retail
- Sports
- Structured Finance
- Tax
- Technology, Media and Telecommunications
- Transportation
- Trusts and Estates
- Wealth Preservation

Contact Information

Please contact one of the following attorneys for more information:

Brenda D. Chavez	212.801.6834
New York	chavezb@gtlaw.com
Steven M. Felsenstein	215.988.7837
Philadelphia	felsensteins@gtlaw.com
Terrance J. Reilly	215.988.7815
Philadelphia	reillyte@gtlaw.com
Joel S. Telpner	212.801.6598
New York	telpnerj@gtlaw.com
J. Richard Tucker	302.661.7378
Delaware	tuckerjr@gtlaw.com

This GT ALERT is issued for informational purposes only and is not intended to be construed or used as general legal advice. Greenberg Traurig attorneys provide practical, result-oriented strategies and solutions tailored to meet our clients' individual legal needs.