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NASD Rule 2790 Revises Restrictions on the Purchase and Sale of Initial Equity Public Offerings

Background of Rule 2790

Since 1970, the National Association of Securities Dealers, Inc. ("NASD") has regulated the purchase and sale of "hot issue" offerings by NASD member broker-dealers. On October 15, 1999, the NASD filed with the Securities and Exchange Commission ("Commission" or "SEC"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act") and Rule 19b–4 thereunder, a proposed rule change that would govern trading in "hot equity" offerings. The rule, NASD Rule 2790 (the "rule"), would revise and replace NASD IM–2110–1, commonly known as the Free-Riding and Withholding Interpretation ("Interpretation").

On December 21, 1999, the NASD submitted Amendment No. 1 to the proposed rule change. The proposed rule change and Amendment No. 1 were published for comment in the Federal Register on January 18, 2000. On October 11, 2000, the NASD submitted Amendment No. 2 to the proposal, which, among other things, changed the subject of the proposed rule from "hot issues" to "new issues." Amendment No. 2 was published for comment in the Federal Register on December 6, 2000. The NASD submitted Amendment No. 3 to the proposal on March 20, 2001, and Amendment No. 4 to the proposal on June 27, 2002. Amendments Nos. 3 and 4 were published in the Federal Register on December 10, 2002. On October 22, 2003, the NASD filed Amendment No. 5 with the SEC (with its accompanying release, "Amendment 5"). On October 24, 2003, the SEC announced that it had approved the rule as published in Amendment 5.

Effectiveness of the Rule

Amendment 5 provides that there will be a three-month transition period during which members may comply with either the Interpretation or the new rule. The three-month period will begin upon publication of a Notice to members announcing the rule change, which publication will occur no later than 60 days following the October 24, 2003 approval by the Commission.

Purpose of Rule 2790

The purpose of the rule, like the Interpretation it would replace, is to protect the integrity of the public offering process by:

- Ensuring that members make a bona fide public offering of securities at the public offering price;
- Ensuring that members do not withhold securities in a public offering for their own benefit or use such securities to reward certain persons who are in a position to direct future business to the member; and
- Ensuring that industry "insiders," including members and their associated persons, do not take advantage of their "insider" position in the industry to purchase hot issues for their own benefit at the expense of public customers.

General Application to All Initial Public Offerings

The rule applies to the sale of all initial equity public offerings.[1] This is a change from the Interpretation, which applies to "hot issues" of securities and defines a hot issue as any security that trades "at a premium" whenever secondary market trading begins.

The NASD believes that this approach is the most straightforward way to achieve the purposes of the rule. It is both easier to understand and avoids many of the complexities associated with the canceling and

[1] The rule applies to all "new issues," which are defined in the rule as any initial public offering of an equity security made pursuant to a registration statement or offering circular. The term "new issue" and the exemptions therefrom are described fully at "Prohibitions of Proposed Sale" below.

reallocating of the sale of an initial public offering ("IPO") to a non-restricted person in the event that an offering unexpectedly becomes a hot issue. Another significant change is that the rule applies to equity offerings only.[2]

Elimination of the "Conditionally Restricted" Status

Another significant change in the rule is the decision to eliminate the so-called "conditionally restricted" status and treat persons either as restricted or non-restricted.[3] The NASD believes that this bright-line approach best serves investors and members.

Under the Interpretation, conditionally restricted persons can purchase hot issues if: (i) the securities are sold to the customer in accordance with the customer's normal investment practice; (ii) the amount of securities sold to any one such person is insubstantial; and (iii) the member's aggregate sales to conditionally restricted persons is insubstantial and not disproportionate in amount as compared to sales to other members of the public.

In many cases, however, the NASD believes that treating a person as only conditionally restricted is contrary to the public interest. Many of the persons treated as conditionally restricted are in a position to direct business to a member. If a determination is made that members should not sell hot issues to persons who can direct business to the member, the NASD does not believe that these concerns are alleviated if the person can meet certain criteria, such as a "normal investment practice." Moreover, as a practical matter, certain of these persons may have the requisite investment history despite being in a position to direct and control future business to a member.

The issues associated with the elimination of the "conditionally restricted" status under the rule may in some circumstances be mitigated by several exemptions from the application of the rule (described below), including the de minimis exemption for sales to an account if the beneficial interests of restricted persons do not exceed in the aggregate 10% of such account.

Restricted Persons

In light of the elimination of the conditionally restricted status, NASD has defined "restricted person" to include the following categories of persons:

(1) NASD Members or Other Broker-Dealers.

(2) Broker-Dealer Personnel

(i) Any officer, director, general partner, associated person, or employee of a member or any other broker-dealer (other than a limited business broker-dealer);[4]

(ii) 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; or

(iii) An immediate family member[5] of a person specified in subparagraph (i) or (ii) above if the person specified in subparagraph (i) or (ii): (a) materially supports, or receives material support[6] from, the immediate family member; (b) is employed by or associated with the member, or an affiliate of the member, selling the new issue to the immediate family member; or (c) has an ability to control the allocation of the new issue.

(3) Finders and Fiduciaries

(i) With respect to the security being offered, a finder or any person acting in a fiduciary capacity to the

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[2] Historically, the Interpretation applied to equity and debt securities. However, as part of a series of amendments in 1998, NASD exempted most types of investment grade debt and investment grade asset-backed securities from the Interpretation on the grounds that "such offerings do not raise the same issues as equity offerings inasmuch as the price for a particular debt security generally fluctuates based on interest rate movements rather than demand factors."

[3] Under the Interpretation, conditionally restricted persons include: (i) members of the immediate family of an associated person who are not supported directly or indirectly by such associated person; (ii) finders in respect to the public offering or any person acting in a fiduciary capacity to the managing underwriter (including accountants, attorneys and consultants); and (iii) senior officers and directors of a bank, savings and loan institution, insurance company, investment company, investment advisory firm, or any other institutional type account, or any person in the securities department of any of the foregoing entities, or any other employee who may influence or whose activities directly or indirectly involve or are related to the function of buying or selling securities for any of the foregoing entities.

[4] "Limited business broker-dealer" means any broker-dealer whose authorization to engage in the securities business is limited solely to the purchase and sale of investment company/variable contract securities and direct participation program securities.

[5] "Immediate family member" means a person's parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children, and any other individual to whom the person provides material support.

[6] "Material support" means directly or indirectly providing more than 25% of a person's income in the prior calendar year. Members of the immediate family living in the same household are deemed to be providing each other with material support.

managing underwriter, including, but not limited to, attorneys, accountants, and financial consultants; and

(ii) An immediate family member of a person specified in subparagraph (i) if the person specified in subparagraph (i) materially supports, or receives material support from, the immediate family member.

(4) Portfolio Managers

(i) Any person who has authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account;[7] and

(ii) An immediate family member of a person specified in subparagraph (i) above that materially supports, or receives material support from, such person.

(5) Persons Owning a Broker-Dealer

(i) Any person listed, or required to be listed, in Schedule A of a Form BD (other than with respect to a limited business broker-dealer), except persons identified by an ownership code of less than 10%;

(ii) Any person listed, or required to be listed, in Schedule B of a Form BD (other than with respect to a limited business broker-dealer), except persons whose listing on Schedule B relates to an ownership interest in a person listed on Schedule A identified by an ownership code of less than 10%;

(iii) Any person listed, or required to be listed, in Schedule C of a Form BD that meets the criteria of (i) and (ii) above;

(iv) Any person that directly or indirectly owns 10% or more of a public reporting company listed, or required to be listed, in Schedule A of a Form BD (other than a reporting company that is listed on a national securities exchange or is traded on the Nasdaq National Market, or other than with respect to a limited business broker-dealer);

(v) Any person that directly or indirectly owns 25% or more of a public reporting company listed, or required to be listed, in Schedule B of a Form BD (other than a reporting company that is listed on a national securities exchange or is traded on the Nasdaq National Market, or other than with respect to a limited business broker-dealer); and

(vi) An immediate family member of a person specified in subparagraphs (i)-(v) above unless the person owning the broker-dealer: (a) does not materially support, or receive material support from, the immediate family member; (b) is not an owner of the member, or an affiliate of the member, selling the new issue to the immediate family member; and

(c) has no ability to control the allocation of the new issue.

Prohibitions on Sale of New Issues

The rule states that a member or a person associated with a member may not:

- Sell, or cause to be sold, a *new issue* (as described below) to any account in which a restricted person has a beneficial interest,[8] unless otherwise permitted,
- Purchase a new issue in any account in which such member or person associated with a member has a beneficial interest, unless otherwise permitted, and
- Continue to hold new issues acquired by the member as an underwriter, selling group member, or otherwise, except as otherwise permitted by the rule.

The rule does not, however, prohibit: (i) sales or purchases from one member of the selling group to another member of the selling group that are incidental to the distribution of a new issue to a non-restricted person at the public offering price; or (ii) sales or purchases by a broker-dealer of a new issue at the public offering price as part of an accommodation to a non-restricted person that is a customer of the broker-dealer.

"New issue" means any initial public offering of an equity security as defined in Section 3(a)(11) of the Act, made pursuant to a registration statement or offering circular.

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[7] "Collective investment account" means any hedge fund, investment partnership, investment corporation, or any other collective investment vehicle that is engaged primarily in the purchase and/or sale of securities.

A "collective investment account" does not include a "family investment vehicle" or an "investment club." "Family investment vehicle" means a legal entity that is beneficially owned solely by immediate family members.

"Investment club" means a group of friends, neighbors, business associates, or others that pool their money to invest in stock or other securities and are collectively responsible for making investment decisions.

[8] "Beneficial interest" means any economic interest, such as the right to share in gains or losses. The receipt of a management- or performance-based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity, is not initially considered a beneficial interest in the account. In Amendment 5, however, the NASD stated that the accumulation of such fees, if subsequently invested in the collective investment account (as a deferred fee arrangement or otherwise) would constitute a beneficial interest in the account.

A new issue does not include: (i) offerings made pursuant to an exemption under Section 4(1), 4(2), or 4(6) of the Securities Act of 1933, or SEC Rule 504 if the securities are "restricted securities" under SEC Rule 144(a)(3), or Rule 144A, Rule 505, or Rule 506 adopted thereunder; (ii) offerings of exempted securities as defined in Section 3(a)(12) of the Act, and rules promulgated thereunder; (iii) offerings of securities of a commodity pool operated by a commodity pool operator as defined in the Commodity Exchange Act; (iv) rights offerings, exchange offers, or offerings made pursuant to a merger or acquisition; (v) offerings of investment grade asset-backed securities; (vi) offerings of convertible securities; (vii) offerings of preferred securities; (viii) offerings of an investment company registered under the Investment Company Act of 1940; and (ix) 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.

Preconditions for Sale

Under the rule, before selling a new issue to any account, a member must in good faith obtain within the twelve months prior to such sale, a representation from:

- Beneficial owners, account holder(s), or persons authorized to represent the beneficial owners of the account that states the account is eligible to purchase new issues in compliance with this rule; and
- Banks, foreign banks, broker-dealers, investment advisers, or other conduits that state all purchases of new issues are in compliance with this rule.

Currently, under the Interpretation, verification is required as frequently as before every sale or as long as every 18 months. With the streamlined documentation procedures and the availability of electronic and oral communications, the NASD believes that an annual verification requirement strikes an appropriate balance between benefit and burden.

A member may not rely upon any representation that it believes, or has reason to believe, is inaccurate. A member shall maintain a copy of all records and information relating to whether an account is eligible to purchase new issues in its files for at least three years following the member's last sale of a new issue to that account.

Research and diligence required in order to verify the eligibility of an account

The NASD has, in earlier discussions regarding the (then proposed) rule, discussed the research and diligence required by broker-dealers and others in order to meet the preconditions for sale set forth in the rule. Responding to comments made to earlier amendments to the (then proposed) rule, the publication of Amendment No. 2 to the rule addressed concerns that this change would require an annual mailing to all customers that may be interested in purchasing new issues (in order to ascertain the status of individual accounts) and might prohibit the use of electronic communications.[9] In response to these comments, the SEC stated that the NASD intends to state in the Notice to Members announcing SEC approval of the proposed rule change that an annual mailing is not required, and that electronic or oral communications are permitted so long as such communications and the response are documented internally by the member firm.

In the same discussion, the SEC stated that the application of the rule would be the same in a fund (or "fund of funds") context. That SEC Release states that:

> "a member could secure a representation from a person authorized to represent the beneficial owners of the fund that is purchasing the new issue from the member (such as the fund's general partner) that the account is eligible to purchase new issues. Naturally, the ability of a general partner to make such a representation will be contingent on his or her receiving similar representations from general partners of the other funds investing in the fund, or by reviewing information about the investors in such funds. However, unlike the current Interpretation, there are no provisions requiring certifications by attorneys or certified public accountants. While members may wish to rely upon counsel or an accountant to investigate the status of an account, such an approach is no longer required by the rule. NASD Regulation will announce in the Notice to Members announcing approval of Rule 2790 that members may use negative consent letters in all but the initial account verification."[10]

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[9] See SEC Release 34-43627, published at 65 Federal Register 235 at 76322 (December 6, 2000).

[10] *Ibid*., at 76322-76323. In this regard, Amendment 5 notes that a broker-dealer may, under the SEC's new books and records rules, allow a firm to furnish a customer with account information and ask that customer to verify that such information is correct. For more information regarding the SEC's recent amendments to the record-keeping requirements of broker-dealers, please see "SEC Amendments to Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934 Take Effect", which is currently available at <http://www.shearman.com/documents/CM_04_05_03.pdf>.

In addition, that SEC Release notes that the NASD is not opposed to third-party vendors compiling or aggregating information about the status of persons under the rule, and specifically states that if a third-party vendor develops a reliable application to determine the status of purchasers under the rule, NASD members generally could rely upon data from that vendor or application to meet the standards required by the rule as a precondition to sale.

Elimination of the Cancellation Provision

Under the Interpretation, a member that sells a hot issue to a restricted person or account may cure a violation of the rule by canceling the trade before the end of the next business day following the date on which secondary market trading commences for that issue and reallocating such security at the public offering price to a non-restricted person or account. Since the rule applies to all new issues, the NASD no longer believes that this cancellation procedure is necessary. The NASD now expects members to determine the status of all prospective purchasers prior to selling a new issue.

Exemptions from the Rule

The general prohibitions of the rule as described above do not apply to sales to and purchases by the following accounts or persons, whether directly or through accounts in which such persons have a beneficial interest:

(1) Investment Company Exemption. An investment company registered under the Investment Company Act of 1940.

(2) Common Trust Fund Exemption. A common trust fund or similar fund as described in Section 3(a)(12)(A)(iii) of the Act is exempt, provided that (i) the fund has investments from 1,000 or more accounts; and (ii) the fund does not limit beneficial interests in the fund principally to trust accounts of restricted persons.

(3) Investment Account Exemption. An insurance company general, separate or investment account is exempt, provided that (i) the account is funded by premiums from 1,000 or more policyholders, or, if a general account, the insurance company has 1,000 or more policyholders; and (ii) the insurance company does not limit the policyholders whose premiums are used to fund the account principally to restricted persons, or, if a general account, the insurance company does not limit its policyholders principally to restricted persons.

(4) De Minimis Exemption. An account, if the beneficial interests of restricted persons do not exceed in the aggregate 10% of such account.[11]

The inclusion of a *de minimis* exemption in the rule as adopted represents a substantial change from the current Interpretation, which has no such exemption. The *de minimis* ownership exemption avoids imposing on investors the burden of creating segregated accounts in those instances where restricted persons have only a nominal and passive interest in an account that purchases new issues.

(5) Publicly Traded Entity Exemption. A publicly traded entity (other than a broker-dealer or an affiliate of a broker-dealer where such broker-dealer is authorized to engage in the public offering of new issues either as a selling group member or underwriter) is exempt if the publicly traded entity (i) is listed on a national securities exchange; (ii) is traded on the Nasdaq National Market; or (iii) is a foreign issuer whose securities meet the quantitative designation criteria for listing on a national securities exchange or trading on the Nasdaq National Market.

The publicly traded entity exemption recognizes the practical limitations in identifying each of the beneficial owners of a publicly traded entity and that the benefits of investments in new issue securities are indirectly shared by the public shareholders. In proposing a publicly traded entity exemption, however, the NASD stated, "broker-dealers, even publicly traded broker-dealers, should not purchase or withhold IPOs."

The NASD believes that looking to whether a broker-dealer is authorized to engage in public offerings excludes from the public company exemption the "full service" broker-dealers and their parent companies that the rule is plainly designed to reach. On the other hand, the rule will allow purchases of new issues by the many publicly traded companies that have broker-dealer affiliates for limited corporate purposes.

(6) Foreign Investment Company Exemption. An investment company organized under the laws of a

[11] In order to reflect certain interpretive guidance that the NASD gave in 1998, the rule provides that purchases by a broker-dealer organized as an investment partnership of a new issue at the public offering price is permitted, provided that such purchasers are credited to the capital accounts of its partners in accordance with the other provisions of the rule. The rule therefore treats so-called "joint-back office" broker-dealers, or "JBOs," in the same manner as any other investment account, and provides that a JBO may purchase new issues if the beneficial interests of restricted persons in the aggregate are less than 10%.

foreign jurisdiction is exempt, provided that (i) the investment company is listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority; and (ii) no person owning more than 5% of the shares of the investment company is a restricted person.

(7) Employee Benefit Plan Exemption. An Employee Retirement Income Security Act benefit plan that is qualified under Section 401(a) of the Internal Revenue Code is exempt, provided that such plan is not sponsored solely by a broker-dealer.

The NASD has stated that it is hesitant to adopt a blanket exemption for foreign benefit plans because it is not familiar with the employee benefit laws in all foreign jurisdictions. In some cases, the NASD believes that foreign laws may permit benefit plans to allocate new issues only to certain plan participants, may provide for unequal distribution of profits from new issues, or may benefit a very narrow category of restricted persons. The NASD has also stated that it may be possible for a foreign benefit plan to be constructed as a means to circumvent the rule, e.g., a benefit plan for a "shell" corporation that consists entirely or principally of restricted persons.

(8) Government Benefit Plan Exemption. A state or municipal government benefit plan that is subject to state and/or municipal regulation is exempt.

(9) Charitable Organization Exemption. A tax-exempt charitable organization under Section 501(c)(3) of the Internal Revenue Code is exempt.

(10) Church Plan Exemption. A church plan under Section 414(e) of the Internal Revenue Code is exempt.

"Carve-outs" for Restricted Persons

The rule, like the Interpretation, allows accounts that wish to purchase new issues to segregate the interests of restricted persons from non-restricted persons. Prior to 1992, NASD prohibited sales of hot issues to any fund that contained a restricted person. In August 1992, NASD established certain "carve-out" procedures whereby an investment fund could segregate the interests of restricted persons and ensure that hot issues purchased by the fund did not benefit restricted persons. This position was codified in amendments to paragraph (g) of the Interpretation in 1994. Paragraph (g) of the Interpretation contains specific steps that must be followed to use a "carve-out" account. These procedures include the creation of a "separate brokerage account" and written confirmations, representations, and certifications from accountants and/or attorneys.

In the rule, the NASD has eliminated the specific "carve-out" procedures while retaining the flexibility for purchasers to segregate the interests of restricted persons from new issue allocations. In administering the procedures in the current Interpretation, the NASD staff has recognized that accounts may employ a variety of methods to carve out the interests of restricted persons and that specifying a particular method has excluded other equally effective methods. In proposing the rule change, the NASD stated that it does not intend to prescribe a particular manner for carving out the interests of restricted persons. If NASD determines in the future that additional guidance is needed in this area, it may issue guidance in a Notice to Members.

Issuer-Directed Securities

Like the Interpretation, the rule provides an exemption for issuer-directed securities. Specifically, the prohibitions on the purchase and sale of new issues in the rule do not apply to securities that:

(1) are specifically directed by the issuer to persons that are restricted under the rule; provided, however, that securities directed by an issuer may not be sold to or purchased by an account in which any restricted person specified in subparagraphs (i)(11)(B) (Broker-dealer Personnel) or (i)(11)(C) (Finders and Fiduciaries) of the rule has a beneficial interest, unless such person, or a member of his or her immediate family, is an employee or director of the issuer, the issuer's parent, or a subsidiary of the issuer or the issuer's parent. For purposes of this section of the rule, a parent/subsidiary relationship is established if the parent has the right to vote 50% or more of a class of voting security of the subsidiary, or has the power to sell or direct 50% or more of a class of voting security of the subsidiary;

(2) are part of a program sponsored by the issuer or an affiliate of the issuer that meets the following criteria: (i) the opportunity to purchase a new issue under the program is offered to at least 10,000 participants; (ii) every participant is offered an opportunity to purchase an equivalent number of shares, or will receive a specified number of shares under a predetermined formula applied uniformly across all participants; (iii) if not all participants receive shares under the program, the selection of the participants eligible to purchase shares is based upon a random or other non-discretionary allocation method; and (iv) the class of participants does not contain a disproportionate number of restricted persons as compared to the investing public generally; or

(3) are directed to eligible purchasers who are otherwise restricted under the rule as part of a

conversion offering[12] in accordance with the standards of the governmental agency or instrumentality having authority to regulate such conversion offering.

Anti-Dilution Provisions

The prohibitions on the purchase and sale of new issues do not apply to an account in which a restricted person has a beneficial interest, if the following conditions are met:

- The account has held an equity ownership interest in the issuer, or a company that has been acquired by the issuer in the past year, for a period of one year prior to the effective date of the offering;
- The sale of the new issue to the account shall not increase the account's percentage equity ownership in the issuer above the ownership level as of three months prior to the filing of the registration statement in connection with the offering;
- The sale of the new issue to the account shall not include any special terms; and
- The new issue purchased pursuant to this paragraph of the rule (relating to anti-dilution provisions) shall not be sold, transferred, assigned, pledged, or hypothecated for a period of three months following the effective date of the offering.

Stand-By Purchasers

The prohibitions on the purchase and sale of new issues in the rule shall not apply to the purchase and sale of securities pursuant to a stand-by agreement that meets the following conditions:

- The stand-by agreement is disclosed in the prospectus;
- The stand-by agreement is the subject of a formal written agreement;
- The managing underwriter(s) represent(s) in writing that it was unable to find any other purchasers for the securities; and
- The securities sold pursuant to the stand-by agreement shall not be sold, transferred, assigned, pledged or hypothecated for a period of three months following the effective date of the offering.

Under-Subscribed Offerings

The rule as adopted contains provisions addressing under-subscribed offerings. Specifically, the rule does not prohibit an underwriter, pursuant to an underwriting agreement, from placing a portion of a public offering in its investment account when it is unable to sell that portion to the public.

This provision was added to ensure that the rule change is not inconsistent with an underwriter's contractual obligations to the issuer. The NASD does not, however, believe that these provisions should be used to allow an underwriter to sell new issues to restricted persons.

Exemptive Relief

As in the past, the NASD, for good cause shown after taking into consideration all relevant factors, may conditionally or unconditionally exempt any person, security or transaction (or any class or classes of persons, securities or transactions) from this rule to the extent that such exemption is consistent with the purposes of the rule, the protection of investors, and the public interest.

[12] "Conversion offering" means any offering of securities made as part of a plan by which a savings and loan association, insurance company, or other organization converts from a mutual to a stock form of ownership.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact any of the following key personnel with respect to NASD or broker-dealer issues:

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