

January 7, 2004

Memorandum to our Clients and Friends

New Rule Governing the Purchase and Sale of Equity IPOs

The NASD has adopted and the SEC has approved proposed rule 2790 ("Rule 2790") governing the purchase and sale of initial equity offerings. On December 24, 2003, the NASD published Notice to Members 03-79 relating to Rule 2790. The Notice to Members specifies that through the period ending March 22, 2004, persons may comply with either Rule 2790 or the old rule, however, effective March 23, 2004, Rule 2790 replaces the old rule and all persons must comply with Rule 2790.

What is a "New Issue"?

Unlike the old rule, Rule 2790 does not apply only to an IPO trading at a premium in the secondary market (i.e., a hot issue). Any "new issue" would be subject to Rule 2790's provisions, regardless of whether it trades at a premium.

A "new issue" means any initial public offering of an equity security made pursuant to a registration statement or an offering circular (i.e., not a secondary offering), but does not include: (1) offerings made pursuant to various exemptions under the Securities Act of 1933, as amended (the "Securities Act"), if the securities are considered "restricted securities" under the Securities Act, (2) offerings of certain exempted securities, (3) offerings of securities of a commodity pool, (4) rights offerings, exchange offers, or offerings made pursuant to a merger or acquisition, (5) offerings of investment grade asset-backed securities, (6) offerings of convertible securities, (7) offerings of preferred securities, (8) offerings of registered investment companies, and (9) offerings of securities (in ordinary share form or ADRs registered on Form F-6) that have a pre-existing market outside of the United States¹.

What is Prohibited and Who is a "Restricted Person"?

Rule 2790 prohibits a new issue sale to or purchase by any account in which a "restricted person" has a beneficial interest², subject to certain exceptions.

¹ Rule 2790 is not limited to U.S. initial equity offerings. Except for initial equity offerings that have a pre-existing non-U.S. market, Rule 2790 is also applicable in the case of foreign offerings where there is an NASD member broker-dealer firm (e.g., acting as the underwriter) or an associated person of an NASD member firm (e.g., receiving an allocation of the new issue as an investor in a hedge fund) connected with the transaction.

² The receipt of a management fee and/or a performance fee for operating a hedge fund would not be considered a beneficial interest, however, as noted elsewhere in this memorandum, hedge fund "portfolio managers" will be treated as "restricted persons" in connection with their fund ownership, and not as "conditionally restricted persons", as was the case under the old rule. In addition, according to the Notice to Members, the accumulation of management fee and/or performance fee payments, if subsequently invested in a collective investment account such as a hedge fund (as a deferred fee arrangement or otherwise), would constitute a beneficial interest in the account. Accordingly, if such deferred amounts are beneficially owned by a "restricted

"Restricted persons" include: (1) broker-dealers, (2) broker-dealer personnel and various immediate family members of such persons, (3) with respect to the security being offered, finders and fiduciaries to the managing underwriter and various immediate family members of such persons, (4) portfolio managers (i.e., persons with the authority to buy or sell securities for banks, investment companies, investment advisers or collective investment accounts³ (i.e., 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, but not a "family investment vehicle" or an "investment club")), and (5) certain persons with ownership interests in broker-dealers.

Preconditions for a Sale

Before selling a new issue to any account, an NASD broker-dealer must in good faith have obtained within 12 months prior to such sale, a representation indicating that the account is in compliance with Rule 2790. The representation must come from the account holder, a person authorized to represent the beneficial owners of the account or a conduit for the account (e.g., a bank, broker-dealer or investment adviser). Neither Rule 2790 nor the related Notice to Members requires that a legal opinion or an auditor opinion be delivered to a broker-dealer prior to allocating a new issue to a hedge fund.

The initial verification of a person's new issue eligibility status under Rule 2790 must be a positive written confirmation. Subsequent verifications may be made by negative consent (i.e., if the investor is silent, its eligibility status will be deemed not to have changed).

If there are restricted persons who cannot participate in a new issue, the Notice to Members recognizes that there are many ways to "carve out" such persons and has eliminated any specific procedures designed to accomplish this. While some persons may use "separate accounts", others instead may choose to maintain one account (but allocate any gains or losses attributable to new issues away from any restricted persons in the account).

Journaling

Under the old rule, the NASD was of the view that it was not permissible to allow journal entries between the accounts of non-restricted persons and restricted persons when an offering was no longer a "hot issue". In administering Rule 2790, the NASD no longer intends to require an outright sale and purchase of a new issue to transfer post-IPO ownership interests (and risks) to restricted persons. The NASD believes that it would be appropriate for firms to allow restricted persons to share in the subsequent gains and losses from new issues, provided that restricted persons' "purchase" of a new issue is not at the IPO price, but at the prevailing market price at the time their capital accounts reflect ownership of the security. Accordingly, following a new issue's initial offering, a fund may transfer a pro rata portion of the security to restricted

person" such as a hedge fund portfolio manager, they would have to be counted towards the 10% de minimis exemption discussed under "General Exemptions" below.

³ Unlike the old rule, a senior officer (e.g., a CFO or a COO), research analyst or trader for such an entity will no longer be restricted, unless such person possesses investment decision-making authority.

persons at the prevailing market price, thus allowing such restricted persons to participate in any subsequent profits or losses related to such security.

General Exemptions

The general prohibitions discussed above will not apply to sales to or purchases by the following accounts or persons, whether directly or through accounts in which such persons have a beneficial interest: (1) registered investment companies, (2) certain common trust funds, (3) certain insurance company general, separate or investment accounts, (4) accounts where the beneficial interests of restricted persons does not exceed 10% in the aggregate (the "de minimis exemption"), (5) certain publicly-traded entities, (6) foreign investment companies listed on a foreign exchange (or authorized for sale to the public by a foreign regulator) where no restricted person has more than a 5% ownership interest, (7) certain ERISA plans, (8) state or municipal government benefits plans, (9) tax-exempt charities under Section 501(c)(3) of the Internal Revenue Code, and (10) certain church plans.

With regard to (4) above, in the case of a hedge fund (and most other entities), if 10%⁴ or less of the fund is owned by restricted persons (including the interest of the hedge fund portfolio manager⁵), the fund falls within the de minimis exemption and will be able to receive a new issue allocation without allocating any new issue profits away from the restricted person investors. Moreover, based on NASD guidance, even if over 10% of the hedge fund is owned by restricted persons, the fund could still rely on the exemption and participate in a new issue by "carving down" the portion of the new issue allocation being made to restricted persons so that the beneficial ownership interest by such restricted persons in the new issue is no more than 10% (for example, a fund with 20% restricted person ownership could "carve down" the new issue allocation made to restricted persons in the fund so that they receive no more than 10% of the new issue allocation).

How Does This Affect You?

If you are planning on trading in new issues and already have an existing fund or other form of investment management arrangement in place, you will likely have to amend your relevant documents and you may have to obtain investor consent. You will also have to obtain written re-certifications of the new issue eligibility status of all of your clients. The foregoing should be accomplished by March 22, 2004. If you would like us to assist you in this process or if you have any questions generally regarding Rule 2790, please contact your principal attorney in the Investment Management Group at Seward & Kissel at 212-574-1200.

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⁴ When determining a hedge fund's compliance with the de minimis exemption, in the case of a master-feeder fund structure, the master fund must look at the feeder funds in the aggregate on a pro rata basis to determine the 10% threshold.

⁵ Since general partner capital accounts and investment manager fee deferral amounts attributable to the portfolio manager may often be large, especially in the case of more established hedge funds, these amounts may cause the fund to exceed the 10% de minimis exemption threshold.