

SECURITIES ALERT

AKIN

GUMP

STRAUSS

HAUER &

FELD, L.L.P.

A GLOBAL LAW FIRM FOR THE 21st CENTURY

JUNE 2000

TRADING IN HOT EQUITY OFFERINGS

The National Association of Securities Dealers, Inc. (NASD) has filed a proposal with the Securities and Exchange Commission (SEC) to create a new rule dealing with Trading in Hot Equity Offerings, Rule 2790. Rule 2790, if adopted, will replace the current Free-Riding and Withholding Interpretation, IM-2110-1 (Interpretation). Rule 2790, as proposed by the NASD, incorporates comments that were solicited by the NASD in its Notice to Members, No. 98-81, published October 1998, from member firms as part of its efforts to review the relevance of the NASD rules in today's markets.

Rule 2790, if approved, will narrow the range of when a security is deemed to be a "hot issue." Significant features of Rule 2790 include:

- establishing a threshold premium of 5 percent or more above the public offering price at any time during the first five minutes of trading in the secondary market based upon the security's volume-weighted price to determine whether a security is a "hot issue"
- applying "hot issue" rules to equity offerings only
- eliminating the blanket exclusion for secondary offerings
- eliminating the "conditionally restricted status"
- redefining categories of "restricted persons"

- establishing a minimal ownership interest exception to the "carve-out" procedure
- expanding issuer-directed share programs to reach sister companies of the issuer and eliminating the three-month "lock-up" to restricted persons
- replacing written certifications as a precondition for sale of a "hot issue" with an annual verification requirement.

Five Percent Threshold Premium

Under the current rule, a "hot issue" is any security of a public offering that trades at a premium, no matter how small, in the secondary market whenever such secondary market begins. In practice, the NASD's compliance department has the responsibility of reviewing after-market quotations to determine whether a security is a "hot issue." Therefore, a security that begins trading at a fraction over its initial closing price would be deemed a "hot issue" under the current rule even if it were not a "hot" security with a substantial market demand.

The proposed rule provides immediate guidance in determining the "hot issue" status of a security. Under the proposed rule, a "hot issue" is "any security that is part of a public offering if the volume-weighted price during the first five minutes of trading in the secondary market is 5 percent or more above the public offering price." The NASD believes that a 5 percent premium would distinguish public offerings with a substantial excess investor demand from those that are inflated by the market supply, and thus less susceptible to market manipulation. The NASD further believes that this

calculation can be performed by any member or investor who has access to trade data. Further, the proposed rule provides a cancellation provision when a “hot issue” security is sold to the account of a restricted person. Under the proposed rule, a member does not violate the rule if the member cancels the sale of a “hot issue” prior to the end of the first business day following the date that market trading commences (i.e., T+1) and reallocates the security at the public offering price to a non-restricted person.

Equity Offerings Only

The current rule applies to equity offerings and offerings of certain non-investment-grade debt. Past amendments to the current rule eliminated application of the Interpretation for most investment-grade debt securities on the basis that the prices of these securities were based primarily upon interest rate movements rather than on market demand, and thus did not resemble equity securities.

The proposed rule eliminates application of the rule for non-investment-grade debt as well. The proposed rule applies only to public offerings of “equity securities,” as the term is defined under Section 3(a)(11) of the Securities Exchange Act of 1934, as amended. However, because an “equity security” includes any security that is convertible with or without consideration, into such a security, or carrying a warrant or right to subscribe or purchase such a security, an offering of convertible securities or warrants that are bundled with non-investment-grade debt remains subject to the proposed rule.

Secondary Offerings

Recent amendments to the Interpretation eliminated all secondary offerings of actively traded securities from application of the rule. The rationale was that most secondary offerings did not trade at a substantial premium.

The proposed rule applies to all public offerings, including secondary offerings, provided the security trades at a 5 percent premium in the first five minutes after the close of the public offering. The rationale is that in light of the new definition of

a “hot issue” security, a blanket exclusion for all secondary offerings would no longer be necessary. Any public offering that meets or exceeds the threshold price is subject to the proposed rule.

“Conditionally Restricted” Status

The current rule defines a “restricted person” to generally include securities industry insiders and other persons who are in a position to direct reciprocal business to a NASD member. Absent any exception to the current rule, such persons are absolutely restricted from deriving a benefit from a “hot issue.” The Interpretation, however, provides an exception to the absolute restriction and creates a “conditionally restricted person” status permitting certain persons to participate in a “hot issue” if they can demonstrate that:

- the securities were sold to them in accordance with their normal investment practice
- the amount of securities sold to any one such person was insubstantial
- the NASD member’s aggregate sales to such persons were insubstantial and not disproportionate in an amount as compared to sales to other members of the general public.

The proposed rule eliminates the “conditionally restricted person” category. The rationale is that such persons are in fact restricted persons who are generally in a position to direct business to a NASD member. Thus, permitting such persons to acquire “hot issues” for their own account is contrary to public policy.

If adopted, Rule 2790 would affect hedge fund managers, investment advisers and other investment portfolio managers, many of who have historically taken advantage of this exception, and would preclude such persons from purchasing “hot issues.”

Categories of “Restricted Persons”

The proposed rule revises the categories of “restricted persons” to include:

- members or other broker/dealers, unless the ultimate purchaser is a non-restricted person purchasing the security at the public offering price
- officers, directors, general partners, employees or agents of a member or any other broker/dealer (other than a limited business broker/dealer)
- with respect to the security being offered, finders or any person acting in a fiduciary capacity to the managing underwriter, including, but not limited to, attorneys, accountants and financial consultants
- any employee or other person who supervises, or whose activities directly or indirectly involve or are related to, the buying or selling of securities for a bank, savings and loan institution, insurance company, investment company, investment adviser or collective investment account
- any affiliate of a broker/dealer (other than a limited business broker/dealer)
- any natural person or member of the person's immediate family who owns 10 percent or more or has contributed 10 percent or more of the capital of a broker/dealer (other than a limited business broker/dealer).

The proposed rule suggests a function-oriented approach. For example, a "finder" is restricted from participating in "hot issues" for only those offerings for which it is specifically acting in the capacity of a finder or fiduciary. The finder is a restricted person under the current rule and remains restricted under the proposed rule. The senior officer and employee restriction with respect to the securities activities of a bank, insurance company, investment adviser or other collective investment type account under the current rule is narrowed to include only such persons in supervisory roles, or whose activities directly or indirectly are related to the buying or selling of securities for such institutions enumerated in the proposed rule.

Another significant change in the proposed rule eliminates the term "institutional type account" and replaces it with the term "collective investment account." While the current rule

does not specifically define "institutional type account," it provides a non-exclusive list, including hedge funds, investment partnerships, investment corporations or investment clubs. The proposed rule more precisely defines "collective investment account" to include "any hedge fund, investment partnership, investment corporation or any other collective investment vehicle that manages assets of other persons." Therefore, the effect of the proposed rule would preclude individuals, such as portfolio managers, from participating in "hot issues" on the basis that they manage money of other persons. On the other hand, a "collective investment account" does not include any entity in which the decision to buy or sell securities is made jointly by each of the persons investing in the entity or by a member of their immediate family, an example being a family investment partnership formed for tax or estate purposes. The rationale suggests that managing one's own money should not preclude a person from purchasing a "hot issue."

Elimination of Carve-Out Procedure for Minimal Ownership Interests

The current rule requires the use of "carve-outs" to allocate profits and losses from "hot issues" away from restricted persons with an interest in an investment partnership or such other investment vehicle. In general terms, the investment partnership must establish a separate brokerage account for new-issue purchases and certify to its accountants that (i) all "hot issues" were placed in this new separate account and (ii) no restricted persons participate in such account. In addition, prior to execution of a "hot issue" transaction, the partnership's attorneys or accountants must provide an opinion to the member firm that persons having an interest in the new issue account are not restricted.

The proposed rule creates an exemption from the "carve-out" process for all "collective investment accounts" that are owned beneficially by restricted persons, provided the restricted persons in aggregate own less than 5 percent of the account. The practical effect is to allow a restricted person to

maintain a direct capital interest, albeit small, in the “collective investment account.” In addition, the proposed rule would permit “conditionally restricted persons,” as defined under the current rule, to continue to participate in “hot issues” to a limited extent. The rationale is that investors would like to see a general partner or portfolio manager invest in the account he/she manages. This minimal ownership interest exception is consistent with the current rule for registered investment companies and foreign investment companies.

As under the current rule, if a “collective investment account” that is beneficially owned 5 percent or more in aggregate by restricted persons wants to purchase “hot issues,” it may do so, provided the restricted persons’ interests are carved out from the account. The proposed rule does not enumerate specific “carve-out” procedures but does require that, prior to any sale of a “hot issue,” the collective investment account demonstrate to the NASD member that restricted persons are not participating in the “hot issue” and that their interests have been carved out.

Issuer-Directed Share Programs

Under the current rule, issuer-directed securities may be freely sold by members to employees and directors of an issuer, the parent of an issuer, a subsidiary of an issuer or any other entity that controls or is controlled by an issuer, provided that in the case where no bona fide independent market exists, the securities are locked up for three months.

Rule 2790 proposes two changes to this provision. First, Rule 2790 expands the current rule to permit that issuer-directed securities be freely sold to employees of entities that are under common control of an issuer. Therefore, the rule will reach sister companies of an issuer. Second, Rule 2790 eliminates the three-month lock-up for sales to restricted persons. The rationale is that issuers should be free to set conditions for sale of securities to all its employees without restrictions and all employees and directors of the issuer and affiliated companies should be able to purchase securities of the issuer on equal terms.

Preconditions for Sale

The current rule requires that prior to any sale of a “hot issue,” the NASD member receive documentation demonstrating that a restricted person is not participating in the “hot issue.” Specifically, an investment partnership must submit a written certification from its accountant or attorney as a precondition for sale of a “hot issue.”

The proposed rule eliminates multiple pre-sale requirements and requires only a verification, or a written representation, to the NASD member within the previous 12 months prior to the sale of a “hot issue,” representing that no restricted person or ultimate purchaser, in the case of a conduit account, has a beneficial interest in the account, except as permitted under the rule.

Conclusion

Rule 2790, if adopted, will provide immediate guidance as to when a security is a “hot issue.” The practical effect of the 5 percent threshold premium would permit greater participation in “hot issues” by persons and companies with ties to the NASD. On the other hand, certain industry insiders who manage other people’s money, such as hedge fund managers, and who currently enjoy “conditionally restricted person” status, would participate to a lesser extent. But for the exception of minimal ownership interests, such money managers would be absolutely restricted. In contrast to the Interpretation, the overall effect of Rule 2790 would be to generally eliminate the confusion under the current rule, streamline compliance by investment partnerships and other investment entities, and provide objective criteria to determine participation in “hot issues.”

IF YOU HAVE ANY QUESTIONS OR COMMENTS ABOUT TRADING IN HOT EQUITY OFFERS, OR
SECURITIES LAW IN GENERAL, PLEASE CONTACT:

STEPHEN E. OLDER
PHONE: (212) 872-1068
E-MAIL: SOLDER@AKINGUMP.COM

RONALD R. ADEE
PHONE: (212) 872-1069
E-MAIL: RADEE@AKINGUMP.COM

MARY L. BADIAC
PHONE: (212) 872-1007
E-MAIL: MBADIAC@AKINGUMP.COM

AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.
ATTORNEYS AT LAW
590 MADISON AVENUE
NEW YORK, NY 10022
PHONE: (212) 872-1000
FAX: (212) 872-1002

PLEASE VISIT OUR WEB SITE AT WWW.AKINGUMP.COM

© 2000 AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.,
ALL RIGHTS RESERVED