

New Issues Procedures

General

The new issues environment has been evolving since NASD Rule 2790 and its companion NASD Notice to Members 03-79 (collectively, the "Rule") was published in the fourth quarter of 2003. The Rule brought some welcome changes – principally the "de minimis" test where restricted persons in hedge funds could now participate to a limited extent in new issues – but it also brought complexities. In addition to the "normal" de minimis arithmetic, the Rule contemplated that hedge funds would be applying the de minimis test to their investor entities such as funds-of-funds that could be partially restricted. Plus, in addition to non-restricted, restricted, and partially-restricted, a fourth category of participant has emerged that doesn't want to participate in new issues at all.

Why zero participation? There are two principal reasons: some brokerage firms may have policies for employees that are more restrictive than the Rule; plus some funds-of-funds opt out to avoid perceived complexity at their level or to abide by older existing allocation language in their legal documents.

Since the attractiveness of IPOs is cyclical and methodologies of dealing with the Rule will likely evolve, it is to be expected that many current "zero participation" investors may elect to change their status in future periods. Thus, new issues identification will likely be a dynamic process.

Because it may help managers to understand the classifications and collect the proper information from investors, it is helpful to share the way that our GLASSSM partnership accounting system codes investors:

| Code | Meaning |
|----------------------|--|
| 0 | not restricted, full participation in new issues |
| 1 | fully restricted, participates in new issues up to the de minimis limit |
| .xx (such as .25) | partially-restricted – a two digit decimal representing the proportion of restricted persons in an entity investor |
| N | an investor that will not participate in new issues |

One nuance to keep in mind is that the Rule applies to brokerage firms and sets forth a series of requirements that permit the broker to allocate new issues to a customer account. Accordingly, when that customer account is a hedge fund, the broker will seek certain representations confirming that the fund is, for example, properly identifying restricted persons and undertaking procedures to meet the requirements for the de minimis exemption.

Determining New Issue Gain or Loss

One significant benefit of the Rule is that accounting requirements have been streamlined. New issues are now specifically permitted to be co-mingled with other securities, plus the de minimis requirement can be met via an income allocation, versus a segregation of capital. The result is the elimination of mechanical obstructions that might delay restricted persons' participation in subsequent gains after the IPO event. APM typically lifts the "new issue" identification at the close on the first day of public trading. The gain or loss for the first day is allocated specially as new issue income, and the subsequent price changes are shared by all participants. Accomplishing this as early as possible (and where an easily obtainable and objective price is available) limits the time period where all investors' interests are not entirely aligned.

Special Considerations Relating to Investments from Funds-of-Funds

Funds-of-funds investors will generally fall into two camps: those that are passive and accept allocations made by the underlying hedge fund; and those that wish to make further new issues allocations at their level. This latter approach will usually be associated with a fund-of-funds having (1) a significant proportion of restricted persons plus (2) a desire to maximize new issue income for its unrestricted participants. The former passive type is the simplest administratively; since the allocations are directly controlled by the hedge fund,

Special Considerations Relating to Investments from Funds-of-Funds continued

it is relatively easy to make the necessary representations to the broker. If the fund-of-funds is intent on making its own allocations, the hedge fund manager will, in turn, need a representation letter from the fund-of-funds. This is something that should be reviewed for arithmetic accuracy by your administrator and for legal sufficiency by counsel.

APM would expect funds-of-funds investors to make one of the following four allocation choices:

- ❖ *No New Issue Income.* A somewhat unlikely choice, since even a partially restricted allocation will normally result in some added income (assuming, of course, that new issues appreciate). However, for some funds-of-funds, it is administratively appealing, especially if it has investors of its own who want no new issues participation.
- ❖ *Claims to be "partially restricted" with a percentage that is updated or reaffirmed each calendar year by January 15th.* As noted above, this is perhaps the easiest process; it requires no special allocation work by the fund-of-funds, plus the hedge fund follows its ordinary de minimis process.
- ❖ *The fund-of-funds undertakes a de minimis allocation at its level.* The fund-of-funds will submit an acceptable representation letter that it will limit new issue income to its restricted persons to 10%. The hedge fund will therefore code the fund-of-funds as 10% restricted. Because the fund-of-funds will need the information for its de minimis arithmetic, the hedge fund will need to report the monthly allocations of new issue income in dollars to the fund-of-funds.
- ❖ *The fund-of-funds undertakes a complete carve-out of new issue income at its level – not allocating any such income to its restricted persons.* Again, because the hedge fund will have a representation letter saying that the fund-of-funds is limiting new issue income to its restricted persons to zero, the hedge fund will code the fund-of-funds at "0." Because the fund-of-funds will need the information for its carve-out, the hedge fund will need to report the monthly allocations of new issue income in dollars to the fund-of-funds.

Note that in the third and fourth choice, the hedge fund needs (1) a representation letter from the fund-of-funds suitable to its counsel and (2) must report added detail on new issue income monthly.

A New Issue Checklist

Fund managers contemplating purchasing new issues should discuss the Rule with counsel and:

- Ensure that fund legal documents permit flexibility in allocations to address the four types of participation. Avoid specific allocation formulas – see the discussion in the MFA article below.
- Create a "restricted person" questionnaire for the subscription materials (including "percentage restricted" values to 2 decimal points for fund-of-fund investors) that conforms to the new Rule.
- Use that questionnaire as necessary to update restricted person identifications for investors who subscribed prior to the rule change (some persons aren't restricted anymore).
- Provide APM with a current schedule of investors with each restricted status. (Keep in mind that APM can't properly allocate new issue income unless our investor data is up to date.)
- Identify new issues to APM as they occur. Ensure that fund documentation permits the termination of new issue status as of the close on the first day of public trading.

General Information

For a broad overview of the New Issues Rule and a discussion of the changes, the following is the content of an article we authored for the MFA Reporter published in May/June 2005 called "In the Trenches with New Issues."

In the Trenches with New Issues

On October 23, 2003, the SEC approved new NASD Rule 2790, replacing the old Free-Riding and Withholding Interpretation (IM-2110-1) that addressed the distribution of "hot issues" during an initial public offering. The NASD finalized the details in a Notice to Members (3-79) published on December 23, 2003.

For years, the Free-Riding and Withholding Interpretation had governed – and not always logically – the allocations of IPOs. In hedge-fund-land, the industry abided by the rules via "carve-outs" that eliminated income allocations from "Hot Issues" to persons restricted under the rule.

In the view of nearly all in the industry, the changes are universally positive (and overdue). However, nearly all funds have needed to undertake some updating of their procedures, subscription and offering materials. Plus, since the definition of "Restricted Person" has changed, any fund buying IPOs has had to circulate the new definitions to their investors and update their records.

In addition, nuances of the de minimis exemption for entities that included both restricted and non-restricted persons have been emerging. In addition to the "normal" de minimis arithmetic, the new Rule contemplated applying the de minimis test to entities such as funds-of-funds that could be partially restricted. To further complicate matters, in addition to non-restricted, restricted, and partially-restricted, a fourth category of participant is emerging that doesn't want to participate in new issues at all.

The primary reason for the existence of this last group would appear to be the difficulty of upstream allocations at some funds-of-funds. While most administrators have probably automated a partially-restricted de minimis procedure, it is not trivial arithmetic, so some self-administered funds are opting not to play. Of course, this may all change again if the IPO market becomes hot news in coming years.

The primary purpose of this discussion is to address the arithmetic of the de minimis exemption; however, it would be best to begin with an overview of the primary effects of the new rule on hedge funds. Note that this discussion is limited in scope to the relevance of the new

rule for hedge funds and funds-of-funds and does not constitute legal advice. Fund managers should consult their own legal counsel, auditors, and administrators.

There are a number of changes related to hedge funds and funds-of-funds: The new "New Issues Rule" has a number of benefits for the investment industry and hedge funds in particular. Among other details:

"New Issues" versus "Hot Issues"

The new rule applies to all new issues, hot or not. The NASD recognized the difficulties that arose due to the uncertainties of whether an IPO would actually be "hot." For hedge funds who used the "Hot" definition, it created a "heads you win, tails I lose" situation for restricted persons. If the IPO levitated, the restricted investor missed out; if it sank, restricted persons now had a piece of it. Many in the industry had already observed this inequity and had added accounting procedures that already used the "New" issues definition prior to the rule change. This still met the requirements of the old rule, since a procedure for all "new" issues by definition included all "hot" ones as well.

Limitation to Equity Securities

The term "new issue" generally means "any initial public offering of an equity security" and specifically excludes convertible and preferred securities, most ADRs, investment grade asset-backed securities, and mutual fund shares.

New definition of non-brokerage firm Restricted Persons

The scope of restricted persons at non-brokerage firm financial services firms has been narrowed to "portfolio managers" – persons who have "authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment advisor, or collective investment account." (Plus, of course, their immediate family members and those receiving material support.) "Senior officers" of such organizations who do not have such authority are no longer restricted. This change likely eliminated some persons from the rolls of restricted investors at hedge funds.

In the Trenches with New Issues continued

General Partner / Investment Manager Accounts

The new rule confirms the existing interpretation that the definition of "beneficial interest" excludes the receipt of a management or performance-based fee for operating a hedge fund. However, once earned and reinvested in the fund (or earned but deferred in a deferred compensation arrangement offshore), such capital is restricted.

Representations from the Fund Manager to the Broker

Under the former rule, an accountant or attorney was required to certify to the broker that it had reviewed the investor list of the hedge fund and verified that procedures existed to exclude restricted persons from hot issues participation. The new rule simply requires a representation obtained "within the previous 12 months" from "the account holder(s), or a person authorized to represent the beneficial owners of the account, that the account is eligible to purchase new issues in compliance with this rule." Accordingly, the General Partner of a fund may make this representation directly.

The initial verification of compliance must be a positive affirmation; however, the NASD Notice states that subsequent annual verifications may be in the form of negative consents. Accordingly, the broker may inquire whether anything in the initial representation has changed; and, in the absence of a reply, assume continued compliance.

Note that since the definition of a restricted person has changed (see above), existing letters attesting to compliance under the old rules should be replaced.

Trade Mechanics

Formerly, the NASD required that hedge funds purchase hot issues in an account separate from the normal trading accounts of the hedge fund. Now it is permissible to "maintain one account but adjust the capital accounts of restricted persons to remove any gains (or losses) attributable to new issues." In addition, hedge funds may permit

restricted persons to participate in subsequent gains after the initial IPO, without a sale from the separate account and a repurchase in the general account of the hedge fund. No time frame is specified; however, we recommend using the closing price on the first day of public trading. Accomplishing the transfer as early as possible (and where an easily obtainable and objective price is available) limits the time period where all investors' interests are not entirely aligned.

The "De Minimis" Provision for Collective Investment Accounts

The new rule contains a significant exemption for "an account if the beneficial interests of restricted persons do not exceed in the aggregate 10% of such account." Further commentary in the SEC release and the NASD Notice state that a "collective investment account in which restricted persons held an interest of 10% or greater could continue to invest in new issues, provided that such restricted persons received no more than 10% of the notional pro rata proceeds of the new issue." Accordingly, a fund with 15% restricted persons could still allocate a 2/3 pro rata share of new issue gains to restricted investors and abide by the 10% limit.

This concept, when applied to restricted natural persons, is all fairly straightforward; where the arithmetic becomes challenging is where investors in a fund are partially restricted. For natural persons, one is either restricted or not; however, an investor which is itself a fund – a fund-of-funds or "feeder fund" as termed in the NASD Notice – can be partially restricted. Accordingly, in addition to the "yes" or "no" determination for individuals, a hedge fund should solicit a restricted percentage from its fund-of-funds investors.

The net of the mix of fully and partially restricted investors will determine whether the underlying hedge fund (the "master fund" in the NASD Notice) will exceed the 10% de minimis threshold and be required to effect a pro rata allocation adjustment. While partially restricted percentages could change monthly, the NASD says it "will

allow the representative of a master fund to rely on information from any feeder fund that is no more than 12 months old. Similarly, the representative of a feeder fund that in turn receives investments from other feeder funds may rely on information that is no more than 12 months old."

Thus, a "feeder" fund-of-funds having 25% restricted persons could comprise less than 10% of a "master" fund in which it invests, provided that the "master" fund purchasing the new issue had few other restricted investors. At the same time, other "master" funds in which the "feeder" fund-of-funds invests may have high percentages of restricted investors and need to apply a de minimis adjusted allocation.

The NASD Notice lays the burden of compliance on the "master" hedge fund – the one that is directly purchasing the new issues. This requires that all "master" hedge funds have the accounting capability to test their de minimis status and perform the adjusted allocation if necessary. On first glance, one might believe that one solution would be for all "feeder" fund-of-funds to simply certify that they are abiding by the 10% de minimis test at their levels. However, if a hedge fund has any "fully" restricted persons – such as the general partner itself, this approach goes out the window.

Basically, any hedge fund that participates in new issues will need to incorporate de minimis arithmetic or else simply carve out all restricted persons from participation. Since this may become a marketing issue with respect to fund-of-funds investors, over the long-term, most funds will develop de minimis procedures.

Exploring the De Minimis Arithmetic

As mentioned earlier, we presently are encountering 4 types of investor participation: non-restricted, restricted, partially-restricted, and elective non-participation. Any allocation model must prepare for these investor selections. In order to illustrate the nuances of de minimis arithmetic, let's progress through 3 different approaches:

In this first example, we follow an apparently logical approach in a fund with 3 equal-sized \$1 million investors: a fund-of-funds with 30% restricted persons ("FOF"), a restricted individual ("Mr Restricted"), and a non-restricted person ("Mr Clean"). It is intuitive to allocate 90% of the \$100,000 in new issue gains to the \$1.7 million of capital that is not restricted (70% of the FOF, plus 100% of Mr. Clean), and 10% of the new issue income to the remaining \$1.3 million of capital that is restricted. End of story... But is it?

Improper Allocation of \$100,000 New Issue Income

| Participant Name | Restricted % | Total Begin Capital | Breakdown of dollars | | In percentage of type | | Allocations | | New Issue Income | Restricted Participation in New Issues |
|------------------|--------------|---------------------|----------------------|------------|-----------------------|------------|--------------|------------|------------------|--|
| | | | Unrestricted | Restricted | Unrestricted | Restricted | Unrestricted | Restricted | | |
| FOF | 30% | 1,000,000 | 700,000 | 300,000 | 41% | 23% | 37,059 | 2,308 | 39,367 | 11,810 |
| Mr. Restricted | 100% | 1,000,000 | 0 | 1,000,000 | 0% | 77% | 0 | 7,692 | 7,692 | 7,692 |
| Mr. Clean | 0% | 1,000,000 | 1,000,000 | 0 | 59% | 0% | 52,941 | 0 | 52,941 | 0 |
| | | 3,000,000 | 1,700,000 | 1,300,000 | 100% | 100% | 90,000 | 10,000 | 100,000 | 19,502 |

The right-most column is the product of the “Restricted %” column and the “New Issue Income” column. As can be seen, the apparently logical sequence described above results in restricted persons getting nearly 20% of the new issue income.

How does this occur? Keep in mind that the final allocations at the FOF are not within the control of the “master” hedge fund. Of the \$39K in new issue income going to FOF, we were expecting only \$2K of it – 5.9%

– to go to restricted persons. FOF, of course, will do its own allocations pro rata and 30% of the entire amount would by default go to its restricted persons.

Since the problem lies with inadvertent allocations coming from the unrestricted component of the FOF, one might be tempted to first make allocations to restricted capital and then add limited allocations to partially non-restricted capital so as to avoid the problem. Such a method might look as follows:

Seek restricted maximum allocation; add to partially non-restricted in same proportion, allocate remainder to Mr. Clean

| Participant Name | Restricted % | Total Begin Capital | Breakdown of dollars | | In percentage of type | | 10,000 | Allocations | 75,000 | New Issue Income | Restricted Participation in New Issues |
|------------------|--------------|---------------------|----------------------|-------------------|-----------------------|-------------------|------------|---|------------------------|------------------|--|
| | | | Restricted | 100% Unrestricted | Restricted | 100% Unrestricted | Restricted | Add to partially non-restricted in proportion | Remainder to Mr. Clean | | |
| Mr. Restricted | 100% | 1,000,000 | 1,000,000 | | 63% | 0% | 6,250 | | | 6,250 | 6,250 |
| FOF1 | 30% | 1,000,000 | 300,000 | | 19% | 0% | 1,875 | 4,375 | | 6,250 | 1,875 |
| Mr. Clean | 0% | 1,000,000 | | 1,000,000 | 0% | 100% | | | 75,000 | 75,000 | 0 |
| Just Say No | N | 1,000,000 | | | 0% | 0% | | | | 0 | 0 |
| FOF2 | 20% | 1,000,000 | 200,000 | | 13% | 0% | 1,250 | 5,000 | | 6,250 | 1,250 |
| FOF3 | 10% | 1,000,000 | 100,000 | | 6% | 0% | 625 | 5,625 | | 6,250 | 625 |
| | | 6,000,000 | 1,600,000 | 1,000,000 | 100% | 100% | 10,000 | 15,000 | 75,000 | 100,000 | 10,000 |

You will note that this example has 3 added investors: two more FOFs with different restricted percentages; plus “Just Say No” – an investor who elects not to participate at all. If you inspect the right-most column, it is apparent that this method contains a result that complies with the de minimis limit.

However, upon closer examination, it is illogical that every restricted person – partially or fully restricted – gets the same allocation. Mathematically, this occurs because the initial restricted allocation and the proportional adjustments for the partially non-restricted component of the FOFs are essentially reciprocal.

In order to achieve a result weighted to non-restricted participation – where the 10% restricted FOF would receive a larger allocation than a fully restricted individual, it is necessary to add some steps and start with a provisional allocation based on unrestricted capital. The following model is the one used by ALPS Price Meadows for its de minimis allocations.

Seek unrestricted maximum allocation; determine direct and indirect restricted allocation; adjust proportionally; allocate remainder to Mr. Clean

| Participant Name | Restricted % | Total Begin Capital | Unrestricted - All Types | 100% Unrestricted | Restricted - All Types | Provisional Allocations | | Direct & Indirect Restricted Allocation | Adjusted Provisional Allocations (0.54) | Remainder to Mr. Clean | Final New Issue Income | Restricted Participation in New Issues | |
|------------------|--------------|---------------------|--------------------------|-------------------|------------------------|-------------------------|---|---|---|------------------------|------------------------|--|--------|
| | | | | | | To All Non-restricted | To 100% Restricted (its share of \$10K) | | | | | | |
| Mr. Restricted | 100% | 1,000,000 | 0 | | 1,000,000 | 0 | 6,250 | 6,250 | 6,250 | 3,392 | 0 | 3,392 | 3,392 |
| FOF1 | 30% | 1,000,000 | 700,000 | | 300,000 | 18,529 | 0 | 18,529 | 5,559 | 10,056 | 0 | 10,056 | 3,017 |
| Mr. Clean | 0% | 1,000,000 | 1,000,000 | 1,000,000 | 0 | 26,471 | 0 | 26,471 | 0 | 14,366 | 47,765 | 62,131 | 0 |
| Just Say No | N | 1,000,000 | | | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| FOF2 | 20% | 1,000,000 | 800,000 | | 200,000 | 21,176 | 0 | 21,176 | 4,235 | 11,492 | 0 | 11,492 | 2,298 |
| FOF3 | 10% | 1,000,000 | 900,000 | | 100,000 | 23,824 | 0 | 23,824 | 2,382 | 12,929 | 0 | 12,929 | 1,293 |
| | | 6,000,000 | 3,400,000 | 1,000,000 | 1,600,000 | 90,000 | 6,250 | 96,250 | 18,426 | 52,235 | 47,765 | 100,000 | 10,000 |
| | | | | | | | | | Exceeds 10K, so; ratio adj 0.54 | Remainder 47,765 | | | |

In this process, the 90% of new issue income that should go to unrestricted persons is provisionally allocated pro rata across all types of unrestricted participations (both fully and partially unrestricted). Secondly, any fully restricted investors (but not those who are partially restricted – they’ve already received indirect allocations via step #1) are allocated proportional shares of 10% of new issue income. The sum of these two allocations is multiplied times the “Restricted %” to determine all indirect and direct restricted allocations. In this example, the allocation of \$18K exceeds 10%. Consequently, allocations are adjusted proportionally to limit allocations to 10% – the factor of 0.54. Finally, what’s left over is allocated proportionally among participants who are “100% Unrestricted.”

The outcome of this last process complies with the New Issues Rule and results in a more logical distribution of income among the various restricted participants.

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