

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51735; File No. SR-NASD-2004-165)

May 24, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to NASD Rule 2790

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 29, 2004, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II and III below, which Items have been prepared by NASD. On February 1, 2005, NASD submitted Amendment No. 1 to the proposed rule change.³ On April 18, 2005, NASD submitted Amendment No. 2 to the proposed rule change.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASD is filing with the Commission a proposed rule change to amend subparagraph (i)(9) of NASD Rule 2790 to exclude from the definition of “new issue” securities offerings of a business development company (“BDC”), a direct participation program (“DPP”), and a real estate investment trust (“REIT”). NASD also is proposing a technical change to the exemption for foreign investment companies in subparagraph (c)(6) of NASD Rule 2790 to clarify the scope

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 included minor changes to the rule text of the proposed rule change.

⁴ Amendment No. 2 included minor changes to the proposed rule change including clarifying that most REITs have invested assets at the time of their initial public offering.

of the exemption as reflected in a recent NASD staff memorandum dated August 6, 2004 (“Staff Memorandum”).⁵ In addition, NASD is proposing to amend NASD Rule 2790 to codify the filing requirement for distribution information. Below is the text of the proposed rule change. Proposed new language is italicized; proposed deletions are bracketed.

2700. SECURITIES DISTRIBUTIONS

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2790. Restrictions on the Purchase and Sale of Initial Equity Public Offerings

(a) through (b) No Change.

(c) General Exemptions

The general prohibitions in paragraph (a) of this rule shall 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) through (5) No Change.

(6) An investment company organized under the laws of a foreign jurisdiction, provided that:

(A) the investment company is listed on a foreign exchange for sale to the public or authorized for sale to the public by a foreign regulatory authority; and

(B) no person owning more than 5% of the shares of the investment company is a restricted person;

(7) through (10) No Change.

(d) through (h) No Change.

(i) Definitions

⁵ The Staff Memorandum is available on the NASD’s website at www.nasdr.com.

(1) through (8) No Change.

(9) “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. New issue shall not include:

(A) 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 or Rule 505 or Rule 506 adopted thereunder;

(B) offerings of exempted securities as defined in Section 3(a)(12) of the Act, and rules promulgated thereunder;

(C) offerings of securities of a commodity pool operated by a commodity pool operator as defined under Section 1a(5) of the Commodity Exchange Act;

(D) rights offerings, exchange offers, or offerings made pursuant to a merger or acquisition;

(E) offerings of investment grade asset-backed securities;

(F) offerings of convertible securities;

(G) offerings of preferred securities;

(H) offerings of an investment company registered under the Investment Company Act of 1940; [and]

(I) 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[.]; and

(J) offerings of a business development company as defined in Section 2(a)(48) of the Investment Company Act of 1940, a direct participation program

as defined in NASD Rule 2810(a)(4), or a real estate investment trust as defined in Section 856 of the Internal Revenue Code.

(10) No Change.

(i) Information Required to be Filed

(1) The book-running managing underwriter of a new issue shall be required to file the following information in the time and manner specified by NASD with respect to new issues:

(A) the initial list of distribution participants and their underwriting commitment and retention amounts on or before the offering date; and

(B) the final list of distribution participants and their underwriting commitment and retention amounts no later than three business days after the offering date.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Purpose

I. Securities Offerings of BDCs, DPPs, and REITs

Currently, the definition of “new issue” under subparagraph (i)(9) of NASD Rule 2790 excludes, among other things, securities offerings of closed-end investment companies registered under the Investment Company Act of 1940 (the “Investment Company Act”). NASD staff has observed that securities of closed-end investment companies “typically commence trading at the public offering price with little potential for trading at a premium because the fund’s assets at the time of the offering are the capital it has previously raised.”⁶ Moreover, if there is a premium, it is generally small. In light of these facts, NASD exempted securities of closed-end investment companies registered under the Investment Company Act from the definition of “new issue,” noting that including such offerings within the scope of NASD Rule 2790 would do little to further the purposes of the Rule and, moreover, may impair the ability of such companies to obtain capital.⁷ For similar reasons, as discussed below, NASD is proposing to exclude from the definition of “new issue” securities offerings of BDCs as defined in Section 2(a)(48) of the Investment Company Act,⁸ DPPs as defined in NASD Rule 2810(a)(4), and REITs as defined in Section 856 of the Internal Revenue Code (the “Code”).⁹

A. BDCs

According to NASD, through the passage of the Small Business Investment Incentive Act of 1980 and the corresponding amendments to the Investment Company Act, Congress enacted a

⁶ Securities Exchange Act Release No. 48701 (October 24, 2003), 68 FR 62126 (October 31, 2003) (order approving File No. SR-NASD-99-60).

⁷ Id.; Securities Exchange Act Release No. 43627 (November 28, 2000), 65 FR 76316 (December 6, 2000) (notice of filing of Amendment No. 2 to File No. SR-NASD-99-60).

⁸ 15 U.S.C. 80a-2(a)(48).

⁹ 26 U.S.C. 856.

regulatory structure for BDCs in an effort to encourage capital investment in small developing businesses and financially troubled businesses.¹⁰

A BDC is defined as a domestic, closed-end investment company that: is operated for the purpose of making investments in small and developing businesses and financially troubled businesses; that must make available significant managerial assistance to certain of its portfolio companies; and that has notified the Commission of its election to be subject to the provisions of Sections 55 through 65 of the Investment Company Act.¹¹ According to NASD, while a BDC technically is not registered under the Investment Company Act, it is subject to many of the same requirements that are applicable to registered investment companies.¹²

Section 55 of the Investment Company Act,¹³ in part, describes the securities in which a BDC can invest. These securities generally must comprise at least 70% of the value of the BDC's investment assets and include securities of certain companies, cash, cash items, U.S. government securities, and high quality debt instruments. The companies in which a BDC can invest are primarily "eligible portfolio companies" as defined in Section 2(a)(46) of the Investment Company Act,¹⁴ which generally include small developing businesses and financially troubled businesses. Further, NASD staff understands that BDCs are similar to registered

¹⁰ See Investment Company Act Release No. 11493 (December 16, 1980), 45 FR 83479 (December 19, 1980).

¹¹ See Section 2(a)(48) of the Investment Company Act; 15 U.S.C. 80a-2(a)(48).

¹² For example, in December 2003, the Commission adopted a new rule under the Investment Company Act that requires each registered investment company as well as each BDC to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering the policies and procedures. See Investment Company Act Release No. 26299 (December 17, 2003), 68 FR 74714 (December 24, 2003) (Final Rule Relating to Compliance Programs of Investment Companies and Investment Advisers).

¹³ 15 U.S.C. 80a-54.

¹⁴ 15 U.S.C. 80a-2(a)(46).

closed-end investment companies in that a BDC's primary asset at the time of its initial public offering is the capital it has raised through the offering process. Thus, NASD believes that like registered closed-end investment companies, BDCs generally commence trading at their public offering price and premiums, if any, tend to be very small.

B. DPPs and REITs

A DPP, as defined in NASD Rule 2810(a)(4), is a program that provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution, including, but not limited to, oil and gas programs, cattle programs, condominium securities, Subchapter S corporate offerings and all other programs of a similar nature, regardless of the industry represented by the program, or any combination thereof. NASD Rule 2810 excludes REITs from the definition of a DPP.

A REIT is a recognized investment vehicle for income-generating real estate, and it is allowed to benefit from the tax advantages of a trust as long as certain asset, income, and distribution criteria have been satisfied as set forth in the Code.¹⁵ For instance, pursuant to the Code, at least 75 percent of a REIT's gross income must be derived from real estate, and at least 75 percent of the value of its total assets must be represented by real estate assets, cash and cash items, and Government securities.¹⁶

According to NASD, nearly all DPPs and a few REITs, at the time of their initial public offering, have no invested assets. The initial public offering raises capital, which is subsequently invested. As such, NASD believes that the initial public offerings of these DPPs and REITs, like registered closed-end investment companies, are not expected to open at a premium. Like

¹⁵ See Section 856 of the Code; 26 U.S.C. 856.

¹⁶ Id.

registered closed-end funds, the primary asset of these DPPs and REITs immediately following the public offering is the capital raised in the offering.

According to NASD, most REITs making an initial public offering have invested assets upon consummation of the offering. Although the common stock of these REITs has a greater potential for immediate premiums in the secondary market, NASD staff's review of such offerings has shown that even in these cases, premiums, if any, tend to be small. According to NASD, because the assets of REITs (e.g., rental properties or mortgage portfolio) generally have a reasonably determinable market value, it is rare that REITs will commence trading at a significant premium. Moreover, NASD believes that investors typically invest in REITs for income rather than capital appreciation, which may further limit premiums in the immediate aftermarket.

For these reasons, NASD is proposing to exclude securities offerings of all BDCs, DPPs, and REITs from the definition of "new issue" under subparagraph (i)(9) of NASD Rule 2790. As noted above, NASD staff has found that historically most of these offerings have not traded at a substantial premium. If warranted by future developments in the trading pattern of such securities in the immediate secondary market, however, the staff would reconsider the appropriateness of a blanket exclusion for these types of offerings.

II. Foreign Investment Company Exemption

NASD also is proposing a technical change to the exemption for foreign investment companies in subparagraph (c)(6) of NASD Rule 2790 to clarify the scope of the exemption as reflected in the Staff Memorandum. The Staff Memorandum was prepared in response to inquiries about whether the foreign investment company exemption would apply to various hedge funds and other funds exempt from registration under the Investment Company Act that

were listed on a foreign exchange (such as the Irish Stock Exchange). In the Staff Memorandum, NASD staff explained that the foreign investment company exemption is intended to extend to foreign investment companies that are similar to U.S. registered investment companies.¹⁷ NASD staff further explained the exemption for foreign investment companies extends only to an investment company organized under the laws of a foreign jurisdiction that is either “listed on a foreign exchange for sale to the public” or “authorized for sale to the public,” and that does not have any restricted person that beneficially owns more than 5% of the company’s shares.

The Staff Memorandum also reiterated the position in NtM 03-79 that a foreign investment company that is limited to select investors would not be considered as “for sale to the public.” As NASD staff explained, foreign investment companies that are limited to high net worth individuals are not eligible for the foreign investment company exception. According to NASD, inasmuch as U.S. registered investment companies are not limited to sale to high net worth individuals, it would be inconsistent to permit foreign investment companies to impose such requirements and still avail themselves of the exemption provided for foreign investment companies under NASD Rule 2790. NASD believes that none of the reasons underlying the exemption for U.S. registered investment companies, such as broad public ownership, the

¹⁷ In Notice to Members (“NtM”) 97-30, which proposed the foreign investment company exception in the Free-Riding and Withholding Interpretation, IM-2110-1 (the predecessor to Rule 2790), NASD stated that:

Purchases of shares of investment companies registered under the Investment Company Act of 1940 (1940 Act) are exempt from the restrictions of the Interpretation. The rationale for this existing provision is that the interest of any one restricted person in an investment company ordinarily is de minimis and that, because the ownership of investment company shares generally is subject to frequent turnover, determining compliance with the Interpretation would be extremely difficult in this context. NASD Regulation is proposing to extend this rationale to the purchase of shares of foreign entities that are similar to U.S. investment companies. (emphasis added).

Likewise, in NtM 03-79, which announced the SEC’s approval of NASD Rule 2790, NASD explained that “the foreign investment company exception is intended to extend benefits to foreign investment entities that are similar to U.S. mutual funds.”

difficulty in identifying beneficial owners, the ability of any public investor to purchase an interest in the investment company, and the generally negligible interest of any single restricted person, are likely to be present with a foreign investment company offered only to high net worth individuals. Moreover, NASD staff believes that the purposes of NASD Rule 2790 could easily be frustrated by purchases of large quantities of a new issue by a foreign investment company listed on a foreign exchange that is owned entirely or principally by broker-dealer personnel (or other restricted persons). According to NASD, a foreign investment company that is limited to select investors would, however, be eligible to purchase new issues in accordance with the de minimis exemption set forth in subparagraph (c)(4) of NASD Rule 2790.

While NASD staff believes the text of NASD Rule 2790, NtM 03-79, and the rulemaking history of the foreign investment company provision support the interpretation provided in the Staff Memorandum, NASD staff also believes that it is appropriate to amend the rule text. Specifically, NASD is proposing to revise the foreign investment company exemption to state as follows:

(6) An investment company organized under the laws of a foreign jurisdiction, provided that:

(A) the investment company is listed on a foreign exchange for sale to the public or authorized for sale to the public by a foreign regulatory authority; and

(B) no person owning more than 5% of the shares of the investment company is a restricted person.

III. Information Required to be Filed

In 1996, NASD initiated a regulatory service, “NASDesk,” for members to transmit underwriting commitment and retention information to NASD’s Free-Riding Regulatory Database. NASD communicated with members regarding the “hot issue” status of initial public offerings (“IPOs”) using a companion system, “Compliance Desk.”¹⁸ To coincide with the implementation of NASD Rule 2790, NASD replaced NASDesk/Compliance Desk with a new system for members to submit new issue distribution information named “IPO Distribution Manager.”¹⁹ IPO Distribution Manager is a Web-based application that permits the book-running managing underwriter to transmit distribution information to NASD through Web COBRA, the Web-based filing system that members are required to use when filing information about IPOs under the Corporate Financing Rule (NASD Rule 2710).

NASD is proposing to amend NASD Rule 2790 to codify the requirement for the book-running managing underwriter to file distribution information as announced in NtM 04-20.

(2) Statutory Basis

NASD believes that the proposed rule change, as amended, is consistent with the provisions of Section 15A(b)(6) of the Act,²⁰ which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change to NASD Rule 2790, as described herein, protects investors and the public interest by ensuring that member firms make a bona fide public offering of securities at the public offering price.

¹⁸ See NtM 96-18.

¹⁹ See NtM 04-20 (March 2004).

²⁰ 15 U.S.C. 78o-3(b)(6).

B. Self-Regulatory Organization’s Statement on Burden on Competition

NASD does not believe that the proposed rule change, as amended, will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

C. Self-Regulatory Organization’s Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2004-165.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

All submissions should refer to File Number SR-NASD-2004-165. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2004-165 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²¹

Margaret H. McFarland
Deputy Secretary

²¹ 17 CFR 200.30-3(a)(12).

