

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-52209; File No. SR-NASD-2004-165)

August 4, 2005

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

**I. INTRODUCTION**

On October 29, 2004, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”) and Rule 19b-4 thereunder to, among other things, amend the definition of “new issue” under NASD Rule 2790. On February 1, 2005, NASD submitted Amendment No. 1 to the proposed rule change.<sup>1</sup> On April 18, 2005, NASD submitted Amendment No. 2 to the proposed rule change.<sup>2</sup> The proposed rule change, as amended, was published for comment in the Federal Register on June 1, 2005.<sup>3</sup> The Commission received eight comment letters on the proposal, as amended.<sup>4</sup> On July 18,

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<sup>1</sup> Amendment No. 1 included minor changes to the rule text of the proposed rule change.

<sup>2</sup> 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.

<sup>3</sup> See Securities Exchange Act Release No. 51735 (May 24, 2005), 70 FR 31554 (June 1, 2005).

<sup>4</sup> Letter from Hines Real Estate Securities, Inc. to Jonathan G. Katz, SEC, dated June 14, 2005 (“Hines”); Letter from Investment Program Association to Jonathan G. Katz, SEC, dated June 22, 2005 (“IPA”); Letter from Hong Kong Investment Funds Association to Jonathan G. Katz, SEC, dated June 22, 2005 (“HKIFA”); Letter from Investment Management Association to Jonathan G. Katz, SEC, dated June 22, 2005 (“IMA”); Letter from Investment Company Institute to Jonathan G. Katz, SEC, dated June 22, 2005 (“ICI”); Letter from Dechert LLP to Jonathan G. Katz, SEC, dated June 22, 2005 (“Dechert”); Letter from The Investment Trusts Association, Japan, to Jonathan G. Katz, SEC, dated June 22, 2005 (“ITA”); and Letter from T. Rowe Price Associates, Inc. to Jonathan G. Katz, SEC, dated June 23, 2005 (“T. Rowe Price”).

2005, the NASD submitted a response to comment letters.<sup>5</sup> This order approves the proposed rule change, as amended.

## **II. DESCRIPTION OF PROPOSED RULE CHANGE**

### **A. Securities Offerings of BDCs, DPPs, and REITs**

The proposals would amend subparagraph (i)(9) of NASD Rule 2790 to exclude from the definition of “new issue” securities offerings of a business development company (“BDC”) as defined in Section 2(a)(48) of the Investment Company Act,<sup>6</sup> a direct participation program (“DPP”) as defined in NASD Rule 2810(a)(4), and a real estate investment trust (“REIT”) as defined in Section 856 of the Internal Revenue Code (the “Code”).<sup>7</sup>

### **B. Foreign Investment Company Exemption**

The proposals would include a technical change to the exemption for foreign investment companies in subparagraph (c)(6)(A) of NASD Rule 2790 to clarify the scope of the exemption as reflected in a recent NASD staff memorandum dated August 6, 2004 (“Staff Memorandum”).<sup>8</sup> Currently, subparagraph (c)(6) exempts from the Rule sales to and purchases by an investment company organized under the laws of a foreign jurisdiction, provided that: (1) the investment company is listed on a foreign exchange or authorized for sale to the public by a foreign regulatory authority; and (2) no person owning more than 5% of the shares of the investment company is a restricted person. In

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<sup>5</sup> Letter from Gary L. Goldsholle, Associate Vice President and Associate General Counsel, NASD to Katherine A. England, Assistant Director, Division of Market Regulation, Commission (July 18, 2005).

<sup>6</sup> 15 U.S.C. 80a-2(a)(48).

<sup>7</sup> 26 U.S.C. 856.

<sup>8</sup> The Staff Memorandum is available on the NASD’s Web site at [www.nasd.com](http://www.nasd.com).

the Staff Memorandum, among other things, NASD staff explained that 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. Accordingly, the proposal would amend the rule text to clarify the scope of the exemption so that investment companies listed on a foreign exchange must be “for sale to the public.”

### **C. Information Required to be Filed**

The proposals would amend NASD Rule 2790 to codify the requirement for the book-running managing underwriter to file distribution information as announced in a Notice to Members.<sup>9</sup> In 2004, to coincide with the implementation of NASD Rule 2790, NASD initiated a new system for members to submit new issue distribution information named “IPO Distribution Manager.”<sup>10</sup> Through IPO Distribution Manager, the lead managing underwriters of offerings involving a “new issue” as defined in Rule 2790 will be required to make two filings with the Corporate Financing Department. In the initial filing, which must be filed on or before the offering date, the managing underwriter must submit the initial list of distribution participants and their commitment and retention amounts. In the final filing, which must be filed no later than three days after the offering date (T+3), the managing underwriter must submit the final list of distribution participants and their commitment and retention amounts.

## **III. DISCUSSION**

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<sup>9</sup> See Notice to Members 04-20 (March 2004) (“NtM 04-20”).

<sup>10</sup> See Id.

The Commission received eight comment letters on the proposed rule change, two of which supported the proposal,<sup>11</sup> and six of which did not address the substance of the proposed rule change. After careful review, the Commission finds, as discussed more fully below, that the proposed rule change, as amended, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities association. The Commission finds specifically that the proposed rule change is consistent with Sections 15A(b)(6) and 15A(b)(9) of the Exchange Act.<sup>12</sup>

Section 15A(b)(6) requires that the rules of a registered national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Section 15A(b)(9) requires that the rules of an association not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Section 3(f) of the Exchange Act directs the Commission to consider, in addition to the protection of investors, whether approval of a rule change will promote efficiency, competition, and capital formation.<sup>13</sup> In approving the proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation.

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<sup>11</sup> See Hines and IPA.

<sup>12</sup> 15 U.S.C. 78o-3(b)(6) and (b)(9).

<sup>13</sup> 15 U.S.C. 78c(f).

**A. Securities Offerings of BDCs, DPPs, and REITs (NASD Rule 2790(i)(9)(J))**

The proposal would amend NASD Rule 2790(i)(9) to exclude from the definition of “new issue” securities offerings of BDCs, DPPs, and REITs. The NASD staff has found that, historically, most of these offerings do not commence trading at a substantial premium. Accordingly, NASD believes 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. One commenter that supported the proposed rule change agreed that it is highly unlikely for shares in a REIT to commence trading at a significant premium.<sup>14</sup> Another commenter in support of the proposed rule change also noted its belief that the inclusion of DPP and REIT securities within the definition of “new issue” does little to further the purpose of Rule 2790 and has a negative impact on the ability of DPPs and REITs to raise capital.<sup>15</sup>

The Commission believes it is appropriate for the NASD to exclude from the definition of “new issue” BDCs, DPPs, and REITs because these products historically commence trading at their public offering price and premiums, if any, tend to be very small. We believe that the proposed rule change, in carving-out these securities offerings, is reasonable in that it, among other things, does not impede the ability of BDCs, DPPs, and REITs in raising capital, while preserving the rule’s investor protection goals. We also note that NASD has stated that, if warranted by future developments in the trading pattern of BDCs, DPPs, or REITs, NASD staff would reconsider the appropriateness of the exclusion for offerings of these types of securities. Thus, the

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<sup>14</sup> See Hines.

<sup>15</sup> See IPA.

Commission believes that the proposed rule change to exclude BDCs, DPPs, and REITs from the definition of “new issue” is consistent with Sections 15A(b)(6) and 15A(b)(9) of the Exchange Act.

**B. Foreign Investment Company Exemption (NASD Rule 2790(c)(6)(A))**

The proposal would include a technical change to the exemption for foreign investment companies in subparagraph (c)(6)(A) of NASD Rule 2790 to clarify the scope of the exemption as reflected in the Staff Memorandum. NASD believes this technical change is important because 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).

Of the six commenters that did not support approval of the proposed rule change, all focused on the Rule’s existing exemption for foreign investment companies in subparagraph (c)(6)(B), which provides that a foreign investment company is eligible for an exemption from the Rule if, among other things, no person owning more than 5% of the shares of the investment company is a restricted person.<sup>16</sup>

The Commission notes that the proposed rule change to subparagraph (c)(6)(A) of the Rule is intended to clarify the scope of the exemption so that investment companies listed on a foreign exchange must be “for sale to the public.” As noted above, several commenters expressed concern regarding the 5% threshold in subparagraph (c)(6)(B) of the Rule. We note however, that this restriction is not a part of the current proposals, but has been in place since 1998 (as part of the predecessor to Rule 2790, the Free-Riding

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<sup>16</sup> See HKIFA, IMA, ICI, Dechert, ITA and T. Rowe Price.

and Withholding Interpretation).<sup>17</sup> We therefore agree with the NASD that the concerns expressed by commenters in this regard are not germane to the current proposals.<sup>18</sup>

We also understand that NASD intends to continue to consider the concerns raised by commenters regarding the 5% limitation in subparagraph (c)(6)(B) of the Rule and to have further discussions with the industry regarding the Rule and whether additional amendments are appropriate. We urge the NASD to continue in these discussions with the industry in order to determine whether additional amendments to the Rule are appropriate. Thus, we find that the proposed rule change to clarify that, to satisfy the conditions of the exemption, a foreign investment company must, among other things, be “for sale to the public,” is reasonable and consistent with Sections 15A(b)(6) and 15A(b)(9) of the Exchange Act.

#### **C. Information Required to be Filed (NASD Rule 2790(j))**

The proposals would amend NASD Rule 2790 to codify the requirement for the book-running managing underwriter to file distribution information as announced in NtM 04-20. None of the commenters specifically addressed this aspect of the proposed rule change. The Commission believes this proposal is appropriate in order to provide clarity to the industry regarding new issue distribution data. Accordingly, the Commission believes this proposal is consistent with Sections 15A(b)(6) and 15A(b)(9) of the Exchange Act.

#### **D. Implementation**

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<sup>17</sup> See Securities Exchange Act Release No. 40001 (May 18, 1998), 63 FR 28535 (May 26, 1998).

<sup>18</sup> One commenter, Dechert, on behalf of six Canadian mutual funds, alleged that the NASD’s treatment of foreign entities in NASD Rule 2790 unduly burdened these Canadian mutual funds in violation of North American Free Trade Agreement (“NAFTA”). However, the Commission believes that the Rule is grounded in investor protection concerns and is not intended to unduly burden foreign investment companies.

The NASD suggests that the proposed rule change become effective 45 days after approval by the Commission and the Commission believes that this is reasonable.

**IV. CONCLUSION**

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,<sup>19</sup> that the proposed rule change (SR-NASD 2004-165), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

J. Lynn Taylor  
Assistant Secretary

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<sup>19</sup> 15 U.S.C. 78s(b)(2).

<sup>20</sup> 17 CFR 200.30-3(a)(12).