Investment Management Association

ima

Jonathan G. Katz,
Secretary,
Securities and Exchange Commission,
450 Fifth Street, NW,
Washington, DC 20549

22nd June 2005

Dear Mr Katz

NASD Rule 2790: SR-NASD-2004-165.

The Investment Management Association (IMA) is writing to comment on the proposed amendment by the National Association of Securities Dealers, Inc. ("NASD") to NASD conduct. In particular, we have a number of issues relating to the foreign investment company exemption found at NASD rule 2790(c)(6).

The IMA represents the UK-based investment management industry. IMA's members include independent fund managers, the investment arms of banks, life insurers and investment banks, and the managers of occupational pension schemes. IMA members are responsible for the management of about £2 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. IMA members represent 99% of funds under management in UK-authorised investment funds.

NASD rule 2790 prohibits a member of the NASD from selling a new issue to any account in which a "restricted person" has a beneficial interest. Under the rule, US mutual funds are twice exempted: an investment company registered under the Investment Company Act of 1940 is exempted from the restrictions on purchase of "new issue" securities under NASD rule 2790(c)(1), and offerings of an investment company registered under the Investment Company Act of 1940 (which, pending the effectiveness of the NASD proposal, will include offerings of a business development company) are excluded from the definition of "new issue" securities under NASD Rule 2790(i)(9). However, the foreign investment company exemption is more restrictive than the domestic exemptions. We understand that NASD's primary concern with regard to overseas funds is that restricted investors may circumvent the rule by using under-regulated overseas jurisdictions to establish investment vehicles to access otherwise-restricted IPOs. While we recognise the need to address NASD concerns, we believe that the rule creates an unnecessary barrier for non-US funds, with a consequent detrimental impact on capacity for US issuers to raise capital from non-US funds.

We believe that there are alternative ways to address NASD concerns and request that NASD and SEC seek a solution that provides the same treatment for non-US funds as are given to US domiciled investment companies. We would therefore seek the removal of the provision relating to identifying the beneficial ownership by "restricted persons" of foreign investment companies through more sensitive formulation of the foreign investment company exemption found at NASD rule 2790(c)(6). We also recommend that the NASD amend rule 2790 to provide workable exemptions for foreign pension plans and charities.

Because of the significance of the Rule 2790 exemptions to the ability of foreign investment companies, pension plans and charitable organisations to invest in US IPOs and, in turn, to the US capital formation process in general, we recommend that the Commission not approve this portion of the proposed rule change until this issue is resolved.

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The Foreign Investment Company Exemption

The IMA has a number of issues relating to the foreign investment company exemption as set out in NASD Rule 2790 at (c)6(A) and (c)6(B). Paragraph (c)(6) originally related to "…sales to and purchases by an investment company organized under the laws of a foreign jurisdiction, provided that: (A) the investment company is listed on a foreign exchange 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". We note that the current consultation relates to, among other things, the amendment to (c)6(A), with the addition of text that requires that the foreign investment company be listed 'for sale to the public'. While we have no comments relating to this amendment, there are a number of issues arising from (c)6(B) that are of particular concern to IMA members.

The key reasons for exemptions to Rule 2790 are the practical problems faced by domestic US funds and the nature of regulation of such funds. Like US mutual funds, funds authorised in the UK and elsewhere in Europe operate under a substantial web of regulation that is designed to prevent conflicts of interest and ensure the fair treatment of all fund investors. There are several key FSA Principles relating to treatment of customers:

- Principle 6: Customers' interests - A firm must pay due regard to the interests of its customers and treat them fairly;
- Principle 8 Conflicts of interest - A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client; and
- Principle 9 Customers relationships of trust - A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

Each of the Principles is supported by more detailed rules in the FSA handbook. In particular, I would refer you to COB 4.2, 'Terms of business and client agreements with customers', COLL 4, 'Investor Relations' and COLL 6, 'Operating duties and responsibilities'.

Practical problems of the exemption

Non-US funds, which are authorised for sale to the public, operate in a very similar way to US funds and face the same problems. The additional limitations on the non-US fund exemption create a number of specific difficulties for our members. The 5% requirement assumes that non-US funds can determine the ultimate beneficial ownership of the units or shares of the fund. Market practice and structures make it impracticable for funds to identify all their investors and thus discovering whether any person owning more than 5% of the fund is a restricted person is problematic. There are two key problems. The first relates to the use of nominee accounts and the second relates to use of multiple managers. In addition, even where the investment manager was in a position to identify all investors in a fund, the definition of a restricted person is drafted so broadly that it would be difficult to identify with certainty whether a particular investor was a restricted person.

Consolidators and distributors

UK investment funds must be authorised if they are to be made marketed to the public. The shares of such funds are often legally held in the name of a nominee account, rather than in the name of the underlying investor, partly because there is an extensive use of third-party distribution (for example, by independent financial advisors, IFAs). There are a number of factors that explain the dominance of third-party distributors. In particular, there are administrative, legal and commercial reasons that third-party distributors prefer investment funds to be held in the name of a nominee account, rather than in the name of the underlying investor.

First, administratively, it is more efficient for third-party distributors to arrange for acquisitions and disposals of investment funds on behalf of all their clients in the name of a single nominee than in each client's individual name. Second, as a significant proportion of investment fund purchases are made within an 'ISA' wrapper (i.e. a government sponsored, tax-advantaged savings product, known as an 'Individual Savings Account'), there is a strong legal rationale. UK law requires ISA managers to register an ISA in the name of either the manager, or a nominee of the manager, or jointly in the names of the manager/nominee and its underlying client. Consequently, where the ISA manager is a third-party distributor (which is frequently the case), the ISA is most likely to be registered in the name of the third-party distributor or a nominee, in which case the asset manager of any investment funds held within the ISA will be unable to identify the underlying client. Third, for commercial reasons, the use of nominee accounts allows the third-party distributor to maintain control of the primary client relationship (it is the distributor who is, for example, responsible for ensuring that know your customer requirements are met). Thus, the investment manager may not be in a position to guarantee that the required information on beneficial owners can be obtained from the third-party distributor.

Multiple managers

Most large investors (eg pension funds) use a number of investment managers to manage the assets in their fund, which may be invested in other pooled vehicles under a nominee account. The management of this pool may be split between a number of managers, either a segregated fund or another pooled vehicle. This means that an underlying beneficial owner may be part of a number of funds and could appear in different nominee accounts of the same fund. Thus, while the fund manager has an ability to identify his or her own clients, where the client is another fund, the underlying beneficial owner could not so easily be determined.

Thus the ability to determine whether a restricted person is the beneficial owner is not straightforward. Further, as the client base of both the fund and the underlying client may change from day to day, the monitoring of thresholds would be significantly difficult. This level of complexity means that attempting to develop systems to monitor restricted persons would face significant challenges, not least in terms of cost. There would be a number of other concerns relating to client confidentiality, data protection and commercial sensitivity with regard to identifying clients for other investment managers.

Definition of restricted person

In addition, the definition of restricted person is very broad and, for example, includes foreign broker-dealers, as well as certain associated persons and employees of the foreign broker-dealer and their family members. It should be noted that investment managers may not be required to know the profession of underlying beneficial holders, or those of their spouses and blood relatives as part of the general identification issue and problems encountered with the rule. Thus even where there is an ability to identify the beneficial owner, there may still be issues in determining whether the beneficial owner is a restricted person.

Impact on US issuers

NASD rule 2790 is having an increasingly detrimental impact on the ability of non-US funds to invest in US IPOs. As a result of the rule, a number of our members have expressed concern that they may need to review how they participate in US IPOs. Most have considered that they will need to consider making a smaller allocation of US IPOs in their portfolios. Several members have gone further, suggesting that they may not be able to participate in US IPOs at all.

The scope of the NASD 2790 rule includes global offerings with a US ADR listing. Non-US issuers can have a primary listing/ IPO in a local market but list an ADR in the US. The

detrimental impact of the rule therefore does not only impact US issuers but non-US issuers listing ADRs in the US as part of the global offering. Informal feedback that we have received from underwriters suggests that rather than list an ADR in the US, underwriters and issuers may prefer other GDR markets where the NASD 2790 condition does not apply. In effect, NASD has made the ADR market less attractive to non-US issuers. This in turn impacts the number of non-US issuers available to the US market.

The effect is a negative impact on US issuers' ability to raise capital from non-US investors, and on non-US issuers' ability to access US markets. This constraint will not only have the effect of reducing the actual level of investment available to US issuers, it also will reduce the breadth of investor base that can be provided by accessing non-US investors. We find this action to be particularly curious, as the SEC has increasingly taken a positive view to reforming the capital raising process to encourage greater participation. NASD 2790 goes against this tendency in this area by making it more difficult for funds to participate in US capital markets.

Effect of the rule on authorised funds

The rule as drafted also creates a significant negative impact for investment managers that invest in US securities, particularly for funds that have a wide investor base, potentially opening the manager to legal liability or regulatory action.

As in the US, investment managers in the UK have a responsibility to act in the best interests of investors and perform according to the requirements as set out in the investment agreement. A conflict arises if those responsibilities suggest that the manager should invest in a US IPO, but he is prevented from doing so as a result of rule 2790. Similarly, the manager is under an obligation to treat customers fairly. In practice, investment managers aggregate all orders with similar mandates and assume that they should be able to share in the same investment opportunity. In the case where a segregated fund was run with the same mandate as a pooled vehicle, the manager might be able to provide an attestation of the beneficial ownership of the fund that could not be provided for a pooled vehicle. This might result in differential treatment of customers.

In a robust IPO market, the performance of a fund exempt from the NASD rule (eg a US fund), or where the manager was able to identify underlying investors would potentially be stronger than an otherwise identical fund (eg a non-US authorised fund) which could not claim such exemption or identify underlying investors, thus disadvantaging investors in the latter type of fund as a direct result of the NASD 2790 rule.

Options for resolving the differential treatment in the exemptions

We recognise NASD concerns and would therefore suggest an approach that met these concerns but provided a level playing field between US and non-US funds. For the reasons outlined above, we believe that the quantities requirement as set down in section (c)6(B) is highly problematic and would therefore suggest that the section be removed.

If NASD feels that additional safeguards are required it might consider the use of an alternative characterisation of the foreign investment company exemption. In particular, for ***Foreign Mutual Funds***, conditions in the new Investment Advisers Act Rule 203(b)(3)-1(d)(1) – the hedge fund rule – could be used to craft an exemption for foreign domiciled retail funds. Under the SEC's rule, an adviser would not have to look through a private fund for purposes of determining the number of US investors if that private fund (i) has its principal office and place of business outside the United States, (ii) makes a public offering of its securities in a country other than the United States, and (iii) is regulated as a public investment company under the laws of the country other than the United States, as described in Rule 203(b)(3)-1(d)(3). The exemption should define a "foreign mutual fund" for these purposes as one that has its principal office and place of business outside the US, makes a

public offering of its securities in a country outside the US, is regulated as a public investment company under the laws of the country other than the US. We believe that a use of this formulisation would meet the concerns of the NASD while providing sufficient flexibility for non-US funds.

For ***Pension funds and Charities***, we seek similar treatment as to US funds, where there is a recognition of the low risk nature of the vehicle to the influence of restricted persons. One possibility that NASD may wish to consider is to provide an exemption for pension funds recognised by a national authority.

The term "pension scheme" is defined in Article 3(1)(o) of the UK US Taxation Treaty amendment as "...any plan, scheme, fund, trust or other arrangement established in a Contracting State which is: (i) generally exempt from income taxation in that State; and (ii) operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements". Work-based pension schemes in the UK in the UK are regulated by the Pensions Regulator[1], which was established under the Pensions Act 2004. A work-based pension scheme is defined as any scheme that an employer makes available to employees. This includes all occupational schemes, and any stakeholder and personal pension schemes where employees have direct payment arrangements.

Charities in the UK are subject to registration by the UK Charity Commission[2], established by law as the regulator and registrar for charities in England and Wales. In Scotland it falls to HM Inland Revenue to "recognise" a Scottish charity. In Northern Ireland the position is currently under review.

If the NASD feels that additional safeguards are required it might consider the use of additional conditions. A set of conditions that would be effective could be that (i) the manager is regulated in a jurisdiction that is a member of IOSCO, (ii) has investment discretion over the account and makes specific investment decisions without input of clients.

The IMA asks that the Commission and NASD consider the issues as set out in this letter and review the approach taken in NASD 2790. We would welcome the opportunity to explain in detail the operation of UK funds and the regulatory environment in which they operate. We would be very pleased to meet with the Commission or NASD to further explore these issues should clarification be required.

Yours sincerely,

Gerard Fitzpatrick
IMA

cc: The Honourable William H. Donaldson
The Honourable Paul S. Atkins
The Honourable Roel C. Campos
The Honourable Cynthia A. Glassman
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[1] Please see http://www.thepensionsregulator.gov.uk.
[2] Please see http://www.charity-commission.gov.uk.

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