



June 22, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: NASD Rule 2790 (File No. SR-NASD-2004-165)

Dear Mr. Katz:

The Investment Company Institute¹ is writing to comment on the NASD's proposed rule change relating to Rule 2790,² specifically the portion of the proposal relating to the exemption from the rule for foreign investment companies. Many investment management companies that advise U.S. mutual funds and pension funds also provide management services to foreign mutual funds, pension funds and charitable organizations. Rule 2790 treats these types of foreign investors very differently than their U.S. counterparts and provides exemptions for these investors that, as currently structured, are ineffectual in permitting these entities to invest in initial public offerings ("IPOs") in the U.S. securities market. The Institute therefore recommends that the NASD change the current exemption for foreign investment companies to eliminate the provision relating to the beneficial ownership of "restricted persons" and, in general, redefine what constitutes a foreign investment company for purposes of the rule. We also recommend that the NASD amend the rule to provide workable exemptions to permit foreign pension plans and foreign charitable organizations to invest in IPOs in the U.S. securities market.

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

Application of Rule 2790 to Foreign Investment Companies

Rule 2790 generally prohibits an NASD member from selling a "new issue" to any account in which a "restricted person" has a beneficial interest. The rule contains a number of exemptions to this prohibition. In particular, Rule 2790 provides a straightforward exemption for sales to and purchases by an investment company registered under the Investment

¹ The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter.

² SEC Release No. 34-51735 (May 24, 2005), 70 FR 31554 (June 1, 2005).

Company Act of 1940 ("1940 Act").³ The rule provides a different test for sales to and purchases by non-U.S. investment companies. In particular, it exempts 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.⁴

The proposed rule change is intended to clarify the scope of the first part of the foreign investment company exemption by explicitly limiting the exemption only to those funds that are available to the public.⁵ While the proposed technical amendment to the rule would accomplish this goal, it does not address the more troublesome provision of the exemption – the condition in the second part of the exemption relating to the ownership of a restricted person in the fund.

Specifically, the manner in which investors hold shares of foreign investment companies makes this condition of the exemption unworkable. As in the case of U.S. registered investment companies, foreign investment companies may not know the identity of some of their shareholders because shares in the fund often are held indirectly, for example, through intermediaries using omnibus accounts in the name of broker-dealers (or other financial intermediaries) on behalf of the beneficial owners of the shares. These intermediaries do not provide ownership information to the funds regarding the accounts held on an omnibus basis. The broad scope of the definition of "restricted person" under Rule 2790 also contributes to the difficulties in complying with this condition of the exemption. In particular, the definition of restricted person includes foreign broker-dealers, as well as certain associated persons and employees of the foreign broker-dealer and their family members. Finally, shares of foreign investment companies are typically owned by a large number of individual shareholders, with constant changes in shareholder positions due to new purchases, additional purchases and redemptions. For these reasons, it is not possible for a foreign investment company to identify all the beneficial owners of the fund, and how much of the fund they own, in order to determine whether any restricted person owns more than 5% of the fund for purposes of the exemption.⁶ Accordingly, it also is not practical for foreign investment companies to provide a representation, as required under the rule, that all purchases of new issues are in compliance with the rule.⁷

³ NASD Rule 2790(c)(1).

⁴ NASD Rule 2790(c)(6).

⁵ The proposal adds the words "for sale to the public" to the provision of the exemption relating to listing on a foreign exchange.

⁶ The NASD acknowledged the difficulties of investment companies complying with provisions in Rule 2790 relating to the calculation of ownership of fund assets in discussing the exemption for investment companies registered under the 1940 Act. Specifically, the NASD stated that "the rationale for this ... provision is ... that, because the ownership of investment company shares generally is subject to frequent turnover, determining compliance with the [rule] would be extremely difficult in this context." NASD Notice to Members 97-30.

⁷ NASD Rule 2790(b).

As a consequence, our members report that foreign registered investment companies often are unable to participate in an IPO in the U.S. market, effectively shutting them out from a significant category of investment. According to data collected by the Institute on the assets of publicly sold mutual funds in 41 countries around the world, at the end of 2004, there were approximately 8,000 non-U.S. registered mutual funds with an international investment focus, with total net assets of almost \$1.1 trillion.⁸ Given the significant amount of foreign mutual fund assets that could be invested in U.S. IPOs, effectively preventing such IPO investments not only is harmful to these foreign funds, but also could prove harmful to the capital formation process in the United States.

Institute Recommendations

In order to address these concerns, the Institute recommends revising the foreign investment company exemption in a manner that would permit the investment of foreign investment companies in the U.S. IPO market while, at the same time, prevent circumvention of the rule by restricted persons.

Specifically, the Institute recommends that the NASD eliminate the condition in the second part of the exemption relating to the determination of ownership in the fund by restricted persons. At the same time, we recognize NASD concerns regarding preventing restricted persons from establishing investment companies and other investment vehicles abroad to circumvent Rule 2790. We therefore recommend that the NASD replace this quantitative condition with additional conditions designed to prevent the ability of restricted persons to influence the investment decisions of the fund. In particular, we recommend that the NASD require the investment adviser for the foreign investment company to have investment discretion over the account. Doing so would, in effect, rule out the ability of restricted persons to influence the fund. In order to further ensure that restricted persons cannot circumvent the rule, we also recommend a condition in the exemption explicitly requiring that the foreign investment company not be created and not be operated for the purpose of circumventing Rule 2790.

In order to ensure that the exemption is limited only to those funds that are available to the public, the Institute recommends that the NASD amend the first part of the exemption and create a definition of a foreign investment company similar to that used by the Commission in its rule requiring the registration under the Investment Advisers Act of 1940 of certain hedge fund advisers.⁹ Under the Commission's rule, a public investment company is a company that (1) has its principal office and place of business outside the United States, (2) makes a public offering of its securities in a country outside the United States, and (3) is regulated as a public

⁸ The Institute collects this information on behalf of the International Investment Funds Association. Not all countries that participate in this survey provide information on the amount of assets dedicated to investing outside the local market and thus the estimates above are understated.

⁹ SEC Release No. IA-2333 (December 2, 2004), 69 FR 72054 (December 10, 2004).

investment company under the laws of the country other than the United States. The Institute believes this definition would clarify the scope of the exemption in a more efficient manner than the proposed technical amendment and would promote uniformity between NASD and Commission rules relating to what constitutes a publicly offered foreign investment company.

Revising the exemption for foreign investment companies in this manner would be consistent with the goals of Rule 2790 articulated by the NASD – protecting the integrity of the public offering process by ensuring that, among other things, industry insiders do not take advantage of their “insider” position to purchase new issues for their own benefit at the expense of public customers.

Application of Rule 2790 to Foreign Pension Plans and Foreign Charitable Organizations

Rule 2790 contains exemptions for pension plans¹⁰ and charitable organizations¹¹ organized under applicable U.S. law. The rule, however, does not contain corresponding exemptions for foreign pension plans or foreign charitable organizations.

For the reasons discussed above in connection with the exemption for foreign investment companies, the Institute believes that an exemption from Rule 2790 should be provided for these entities. Specifically, we recommend creating an exemption for foreign pension funds and foreign charitable organizations that would contain conditions requiring that these entities were created or organized under the laws of a foreign jurisdiction, were not created or operated for the purpose of circumventing Rule 2790, and were regulated, as applicable, by the foreign jurisdiction.

Such an exemption would promote investment by these entities in IPOs in the U.S. market and could prove beneficial to the U.S. capital formation process. At the same time, an appropriately constructed exemption would eliminate the possibility that these entities could be formed to circumvent the rule.

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The Institute appreciates the opportunity to comment on the proposed rule change. Any questions regarding our comments may be directed to the undersigned at 202-326-5826 or to Ari Burstein at 202-371-5408.

Sincerely,

/s/ Mary S. Podesta

¹⁰ See NASD 2790(c)(7) (exemption for an ERISA benefits plan that is qualified under Section 401(a) of the Internal Revenue Code, provided that such plan is not sponsored solely by a broker-dealer).

¹¹ See NASD Rule 2790(c)(9) (exemption for a tax exempt charitable organization under Section 501(c)(3) of the Internal Revenue Code).

Mary S. Podesta
Senior Counsel

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
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About the Investment Company Institute

The Investment Company Institute's membership includes 8,541 open-end investment companies ("mutual funds"), 653 closed-end investment companies, 143 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about \$7.838 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 87.7 million, representing 51.2 million households. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 188 associate members, which render investment management services exclusively to non-investment company clients. These Institute members and associate members manage a substantial portion of the total assets managed by registered investment advisers.