



## Hong Kong Investment Funds Association

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June 22, 2005

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
450 Fifth Street, NW, Washington, DC 20549.

Dear Mr. Katz,

**Re: Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2  
Thereo Relating to NASD Rule 2790 (File Number SR-NASD-2004-165)**

On behalf of the Hong Kong Investment Funds Association (“HKIFA”), the professional body that represents the investment fund industry in Hong Kong, I would like to express the grave concerns of our members with respect to NASD’s proposed rule change relating to Rule 2790 (“Rule”), in particular the part relating to the exemption provided for foreign investment companies.

(A) *Implications of the proposed amendments relating to the “Foreign Investment Company Exemption” and compliance problems identified*

Rule 2790 generally prohibits NASD members from selling new issues (“IPOs”) to any account in which a “restricted person” has a beneficial interest.

The Rule contains exemptions for sales and purchases by an investment company registered under the Investment Company Act of 1940, as well as exemptions for pension plans and charitable organizations recognized under the applicable US laws. It also contains certain exemptions for non-US investment companies, but the exemption requirements, in particular relating to holdings by restricted persons in the fund, are extremely difficult, if not impossible, for a fund manager to comply with. The amendments, if implemented, would effectively prevent non-US funds from participating in an IPO in the US market.

In Hong Kong, there are close to 2,000 HKSFCA-authorized funds (i.e. retail public funds), with total assets of over US\$500 billion. In addition, there are pension assets of close to US\$40 billion. A substantial portion of these assets is dedicated to international investing, including in the US market. The Rule would deny fund managers access to a major category of investment; and would impair their ability to fulfill their fiduciary duty to act in the best interests of their clients and investors. Quite a number of our members indicate that they have declined or will not be able to participate in an IPO because of this Rule and we

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believe that this is detrimental to the capital formation process in the US as well as prejudicial to the interests of overseas investors.

Problems identified with respect to the “Foreign Investment Company Exemption”:

1. Definition of “restricted persons”

The definition of “restricted persons” is so broad that it covers all entities, affiliates and employees in the broking industry all over the world. A practical problem for compliance is that fund managers cannot ascertain whether the fund shareholders are “restricted persons”. We understand that even if a fund shareholder is not directly related to the brokers, if his/her spouse works in a brokerage firm, the shareholder could still be regarded as a “restricted person”. It is also unclear whether fund managers need to look through a pension fund for a school or for a small private Hong Kong company to determine whether a teacher of the school or a senior executive of the company is a “restricted person”. In most jurisdictions, including Hong Kong, it is unusual to log investors' association with a broker/dealer. Asking the investor for an undertaking is also not practical given the complexity of the Rule.

2. The 5% threshold to qualify for the exemption

Under the proposed amendments, no restricted person may own more than 5% of the shares of the investment. In Hong Kong, public funds are primarily distributed through third party distributors, which account for over 80% of fund sales. Investors will typically invest through the distributors’ nominee accounts, and distributors will neither disclose the information on their underlying clients nor give a blanket confirmation that the nominee accounts comply with the Rule. As such, it is impossible for a fund to identify the number of beneficial owners, let alone their details so as to calculate the 5% threshold.

(B) Proposal

Overall approach:

As stated in section (A) above, Rule 2790 contains exemptions for US mutual funds and pension plans and charitable organizations registered or recognized under the applicable US laws. We believe that non-US funds should enjoy the same treatment if they are set up for similar purposes and carry similar features. However, this is not the effect of the proposed amendments. We understand that this can probably be attributable to the authorities’ concerns that restricted persons may circumvent the rule by using under-regulated overseas jurisdictions to establish vehicles to access other-wise restricted IPOs.

To address these concerns effectively so as to protect the integrity of the public offering process, we believe the Rule can focus on two key areas, i.e. where the funds are regulated; and who controls the investment decisions of the funds. If the fund is regulated in a properly-regulated jurisdiction; and there are

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mechanisms to ensure that the management of the accounts (including subscriptions in IPOs) by fund managers are done on a discretionary basis on behalf of clients, i.e. the investment powers have been given to the fund managers, we believe these concerns are adequately addressed.

### Proposal for retail public funds:

We propose to use the conditions in new Investment Advisers Act Rule 203(b)(3)-1(d)(1) to craft an exemption for non-US public funds. A “foreign public fund” could be defined for the purposes of exemption 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,
- is offered based on the investment advisory skills, ability or expertise of the investment adviser that is regulated in a jurisdiction that is a member of IOSCO [it is generally accepted that IOSCO has in place a robust set of criteria for membership];
- is not created for the purpose of circumventing the Rule;
- the investment adviser has investment discretion over the account and makes specific investment decisions.

### Proposal for pension funds and charitable organizations:

We propose that exemptions should be granted to foreign pension funds and charitable organizations on a similar basis. In addition, it can be prescribed that the pension funds, etc. are created or organized under the laws of a foreign jurisdiction, and that there is a confirmation that the subscriptions in IPOs by fund managers are done on a discretionary basis on behalf of clients, i.e. the beneficial owners do not have any investment powers, which have been given to the fund managers via the investment management agreements.

### Other comments:

In addition, a fund manager should not be required to confirm that it is not a restricted person. Most of the fund managers are within a global financial group which may consist of a broker. In a global financial group, the fund management unit is usually subject to the group's chinese wall policy and its investment decisions are totally independent from other business units including broking. For example, companies usually have a policy to insulate the investment decision process from influence by other business units of the group in order to fulfill their fiduciary obligations to clients. Thus, for IPOs subject to the Rule, fund managers should only be asked to confirm new issues are purchased on behalf of clients to whom discretionary investment management services are provided, and that their investment decisions are made independent of other business units including any broker/dealer within the group.

## **Hong Kong Investment Funds Association**

In view of the practical difficulties that the proposed amendments give rise to and the negative implications to the US market, we strongly exhort the SEC to revisit the proposal. We welcome opportunities to discuss the above and please feel free to contact me on 852-2537-9912 if you have any questions or need additional information.

Yours faithfully,

Sally Wong  
Executive Director  
Hong Kong Investment Funds Association

c.c. Mr Ethiopis Tafara, Director, Office of International Affairs,  
US Securities and Exchange Commission