

# Notice to Members

OCTOBER 2005

## SUGGESTED ROUTING

Corporate Financing  
Executive Representatives  
Institutional  
Legal & Compliance  
Operations  
Senior Management  
Syndicate  
Trading & Market Making  
Training

## KEY TOPICS

Business Development Company  
Direct Participation Program  
Foreign Investment Company  
IPO Distribution Manager  
IPOs  
New Issue Definition  
New Issue Rule  
Real Estate Investment Trust  
Rule 2790

## GUIDANCE

### “New Issue” Rule

SEC Approves Amendments Relating to Rule 2790;  
**Effective Date: November 2, 2005**

#### Executive Summary

On August 4, 2005, the Securities and Exchange Commission (SEC) approved amendments to subparagraph (i)(9) of 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).<sup>1</sup> The SEC also approved a technical change to the exemption for foreign investment companies in subparagraph (c)(6) of Rule 2790 to clarify the scope of the exemption as reflected in an NASD staff memorandum dated August 6, 2004 (Staff Memorandum). In addition, the SEC approved amendments to Rule 2790 to codify the filing requirement for distribution information.

The rule, as amended, is set forth in Attachment A. The amendments become effective on **November 2, 2005**.

#### Questions/Further Information

Questions concerning this *Notice* may be directed to Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel (OGC), Regulatory Policy and Oversight (RPO), at (202) 728-8104; or Afshin Atabaki, Counsel, OGC, RPO, at (202) 728-8902.

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## Background and Discussion

Rule 2790 (Restrictions on the Purchase and Sale of IPOs of Equity Securities), which has been in effect on a mandatory basis since March 23, 2004 and replaces the Free-Riding and Withholding Interpretation (IM-2110-1), is designed to protect the integrity of the public offering process by ensuring that: (1) NASD members make bona fide public offerings of securities at the offering price; (2) members do not withhold securities in a public offering for their own benefit or use such securities to reward persons who are in a position to direct future business to members; and (3) industry insiders, including NASD members and their associated persons, do not take advantage of their insider position to purchase “new issues” for their own benefit at the expense of public customers. The rule plays an important part in maintaining investor confidence in the capital raising and public offering process.

### Securities Offerings of BDCs, DPPs and REITs

Since its adoption, the definition of “new issue” in subparagraph (i)(9) of Rule 2790 has excluded, among other things, securities offerings of closed-end investment companies registered under the Investment Company Act of 1940 (the Investment Company Act). This exclusion is based on the fact 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 the initial public offering trades consist of the capital the fund has raised through the offering process. Moreover, if there is a premium, it is generally small. Including such offerings within the scope of Rule 2790 would do little to further the purposes of the rule and, moreover, may impair the ability of such companies to obtain capital. For similar reasons, as discussed below, NASD has amended subparagraph (i)(9) of Rule 2790 to exclude from the definition of “new issue” securities offerings of BDCs as defined in Section 2(a)(48) of the Investment Company Act,<sup>2</sup> DPPs as defined in NASD Rule 2810(a)(4), and REITs as defined in Section 856 of the Internal Revenue Code (the Code).<sup>3</sup>

### BDCs

Through the passage of the Small Business Investment Incentive Act of 1980 and the corresponding amendments to the Investment Company Act, Congress enacted a regulatory structure for BDCs in an effort to encourage capital investment in small, developing businesses and financially troubled businesses.<sup>4</sup> 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 SEC of its election to be subject to the provisions of Sections 55 through 65 of the Investment Company Act.<sup>5</sup> 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.<sup>6</sup> Section 55 of the Investment Company Act,<sup>7</sup> in part, describes the securities in which a BDC can invest. These securities generally must comprise at least 70 percent of the value of the BDC’s investment assets and include securities of certain companies, cash, cash items, U.S.

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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,<sup>8</sup> which generally include small, developing businesses and financially troubled businesses. Further, BDCs are similar to registered closed-end investment companies in that a BDC’s primary asset at the time its initial public offering trades is the capital it has raised through the offering process. Thus, like registered closed-end investment companies, BDCs generally commence trading at their public offering price and premiums, if any, tend to be very small.

### **DPPs and REITs**

A DPP, as defined in 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.

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.<sup>9</sup> 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.<sup>10</sup>

Nearly all DPPs and a few REITs, at the time of their initial public offering, have no invested assets. Like registered closed-end funds, the primary asset of these DPPs and REITs immediately following the public offering is the capital raised in the offering. As such, the initial public offerings of *these* DPPs and REITs typically do not open at a premium. By contrast, most REITs making an initial public offering have invested assets upon consummation of the offering. Nevertheless, because these assets (e.g., rental properties or mortgage portfolio) generally have a reasonably determinable market value, it is rare that REITs, even those with invested assets, will commence trading at a significant premium. Moreover, investors typically invest in REITs for income rather than capital appreciation, which may further limit premiums in the immediate aftermarket.

For these reasons, NASD has amended the definition of “new issue” under subparagraph (i)(9) of Rule 2790 to exclude securities offerings of all BDCs, DPPs and REITs. 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, NASD would reconsider the appropriateness of a blanket exclusion for these types of offerings.

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### Foreign Investment Company Exemption

NASD also has amended the exemption for foreign investment companies in subparagraph (c)(6) of 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.<sup>11</sup> NASD staff further 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 percent of the company's shares.

The Staff Memorandum also reiterated the position in *Notice to Members (NTM) 03-79* that a foreign investment company that is limited to select investors would not be considered as "for sale to the public." NASD staff has explained that foreign investment companies that are limited to high net worth individuals are not eligible for the foreign investment company exception. 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 Rule 2790. None of the reasons underlying the exemption for U.S. registered investment companies, such as broad public ownership, the 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, the purposes of 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). 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 Rule 2790. While the text of Rule 2790, *NtM 03-79* and the rulemaking history of the foreign investment company provision support the interpretation provided in the Staff Memorandum, NASD has amended subparagraph (c)(6) of Rule 2790 to expressly state that the foreign investment company exemption is available to an investment company organized under the laws of a foreign jurisdiction, provided that 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 that no person owning more than five percent of the shares of the investment company is a restricted person.

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## Filing Requirement for Distribution Information

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 using a companion system, "Compliance Desk."<sup>12</sup> To coincide with the implementation of Rule 2790, NASD replaced NASDesk/Compliance Desk with a new system for members to submit new issue distribution information named "IPO Distribution Manager."<sup>13</sup> 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 initial public offerings under the Corporate Financing Rule (Rule 2710). NASD has amended Rule 2790 to codify the requirement for the book-running managing underwriter to file distribution information as announced in *NtM 04-20*.

## Endnotes

- 1 See Securities Exchange Act Release No. 52209 (August 4, 2005), 70 FR 46557 (August 10, 2005) (Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to NASD Rule 2790; File No. SR-NASD-2004-165).
- 2 15 U.S.C. 80a-2(a)(48).
- 3 26 U.S.C. 856.
- 4 See Investment Company Act Release No. 11493 (December 16, 1980), 45 FR 83479 (December 19, 1980).
- 5 See Section 2(a)(48) of the Investment Company Act; 15 U.S.C. 80a-2(a)(48).
- 6 For example, in December 2003, the SEC 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).
- 7 15 U.S.C. 80a-54.
- 8 15 U.S.C. 80a-2(a)(46).
- 9 See Section 856 of the Code; 26 U.S.C. 856.
- 10 *Id.*

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11 In *NTM 97-30* (May 1997), 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* (December 2003), which announced the SEC's approval of 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."

12 See *NTM 96-18* (March 1996).

13 See *NTM 04-20* (March 2004).

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## ATTACHMENT A

New language is underlined; deleted language is in brackets.

### 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

(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;

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- (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.

**(j) 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.