

October 29, 2004

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-2004-165 – Proposed Rule Change Relating to NASD Rule 2790**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Gary L. Goldsholle, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8104; e-mail gary.goldsholle@nasd.com, or Afshin Atabaki, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8902; e-mail afshin.atabaki@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Marc Menchel
Executive Vice President
and General Counsel

File No. SR-NASD-2004-165
Consists of 27 Pages
October 29, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend 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”). NASD also is proposing 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 a recent staff memorandum. In addition, NASD is proposing to amend Rule 2790 to codify the filing requirement for distribution information. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are bracketed.

* * * * *

2700. SECURITIES DISTRIBUTIONS

* * * * *

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 15 U.S.C. 78s(b)(1).

(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;

(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.

(i) Information Required to be Filed

(1) The 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 days after the offering date.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Governors of NASD (“Board”) and authorized for filing with the SEC pursuant to a delegation of authority granted by the Board at the NASD’s Board meeting on January 23, 2003, to the General Counsel of NASD Regulatory Policy and Oversight (or his officer designee) to file, without further specific Board authorization, proposed administrative, technical, conforming, and non-substantive rule changes to amend NASD rules and to file, without further specific Board authorization, proposed rule changes to amend NASD rules to provide for exemptive relief (the “Delegation of Authority”). Counsel for The Nasdaq Stock Market and NASD Dispute Resolution were provided an opportunity to consult with respect to the general Delegation of Authority, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The staff will advise the Board of any action taken pursuant to the Delegation of Authority. Section 1(a)(ii) of Article VII of NASD’s By-Laws permits the Board of Governors of NASD to adopt amendments to NASD Rules without recourse to the membership for approval. No other action by NASD is necessary for the filing of the proposed rule change.

NASD will announce the effective date of the proposed rule change in a Notice to Members (“NtM”) to be published no later than 60 days following Commission approval. The effective date will be not more than 30 days following publication of the NtM announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Gary L. Goldsholle, Associate

Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8104; or Afshin Atabaki, Attorney, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8902.

3. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

I. Securities Offerings of BDCs, DPPs, and REITs

Currently, the definition of “new issue” under subparagraph (i)(9) of Rule 2790 expressly excludes, among other things, securities offerings of closed-end investment companies registered under the Investment Company Act of 1940 (the “Investment Company Act”). NASD staff has observed 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 of the offering are the capital it has previously raised.”² Moreover, if there is a premium, it is generally small. In light of these facts, NASD exempted securities of closed-end investment companies registered under the Investment Company Act from the definition of “new issue,” noting that 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.³ For similar reasons, as discussed below, NASD is proposing to exclude from the definition of “new issue” securities offerings of BDCs as defined in Section 2(a)(48) of the Investment

² Securities Exchange Act Release No. 48701 (October 24, 2003), 68 FR 62126, 62131 (October 31, 2003) (order approving File No. SR-NASD-99-60).

³ Id.; Securities Exchange Act Release No. 43627 (November 28, 2000), 65 FR 76316, 76321 (December 6, 2000) (notice of filing of Amendment No. 2 to File No. SR-NASD-99-60).

Company Act, DPPs as defined in NASD Rule 2810(a)(4), and REITs as defined in Section 856 of the Internal Revenue Code (the “Code”).

A. 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.⁴

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 Commission of its election to be subject to the provisions of Sections 55 through 65 of the Investment Company Act.⁵ 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.⁶

Section 55 of the Investment Company Act,⁷ in part, describes the securities in which a BDC can invest. These securities generally must comprise at least 70% of the value of the

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 Commission 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.

BDC's investment assets and include securities of certain companies, cash, cash equivalents, U.S. 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,⁸ which generally include small developing businesses and financially troubled businesses. Further, NASD staff understands that BDCs are similar to registered closed-end investment companies in that a BDC's primary asset at the time of its initial public offering 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.

B. DPPs and REITs

A DPP, as defined in NASD 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 tax advantages of a trust as long as certain asset, income, and distribution criteria have been satisfied as set forth in the Code.⁹ 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

⁸ 15 U.S.C. 80a-2(a)(46).

⁹ See Section 856 of the Code; 26 U.S.C. 856.

75 percent of the value of its total assets must be represented by real estate assets, cash and cash items, and Government securities.¹⁰

Nearly all DPPs and most REITs, at the time of their initial public offering, have no invested assets. The initial public offering raises capital, which is subsequently invested. As such, the initial public offerings of DPPs and REITs, like registered closed-end investment companies, are not expected to open at a premium. Like registered closed-end funds, the primary asset of DPPs and most REITs immediately following the public offering is the capital raised in the offering.

NASD staff is aware of several instances of a REIT making an initial public offering when it already had invested assets. Although the common stock of these REITs has a greater potential for immediate premiums in the secondary market, NASD staff's review of such offerings has shown that even in these cases, premiums, if any, tend to be small. Because the assets of REITs (e.g., rental property) generally have a readily identifiable market value, it appears less likely 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 is proposing to exclude securities offerings of all BDCs, DPPs, and REITs from the definition of "new issue" under subparagraph (i)(9) of Rule 2790. 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

¹⁰ Id.

securities in the immediate secondary market, however, the staff would reconsider the appropriateness of a blanket exclusion for these types of offerings.

II. Foreign Investment Company Exemption

NASD also is proposing 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 a staff memorandum dated August 6, 2004 (“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.¹¹ NASD staff further explained 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

¹¹ In NtM 97-30, 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, which announced the SEC’s adoption 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.”

“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.

The Staff Memorandum also reiterated the position in NtM 03-79 that a foreign investment company that is limited to select investors would not be considered as “for sale to the public.” As NASD staff explained, 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, NASD staff believes that the purposes of the Rule 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 the Rule.

While NASD staff believes 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 staff also believes that it is appropriate to amend the rule text.

Specifically, NASD is proposing to revise the foreign investment company exemption to state as follows:

(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.

III. Information Required to be Filed

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 (“IPOs”) using a companion system, “Compliance Desk.”¹² 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.”¹³ IPO Distribution Manager is a Web-based application that permits the 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 IPOs under the Corporate Financing Rule (Rule 2710).

¹² See NtM 96-18.

¹³ See NtM 04-20 (March 2004).

NASD is proposing to amend Rule 2790 to codify the requirement for the managing underwriter to file distribution information as announced in NtM 04-20.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁴ which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change to Rule 2790, as described herein, protects investors and the public interest by ensuring that member firms make a bona fide public offering of securities at the public offering price.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

¹⁴ 15 U.S.C. 78o-3(b)(6).

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD

BY: _____
Marc Menchel, Executive Vice President and
General Counsel, Regulatory Policy and Oversight

October 29, 2004

EXHIBIT 1

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

October , 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to NASD Rule 2790

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION’S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is filing with the Commission a proposed rule change to amend 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”). NASD also is proposing 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 a recent staff memorandum. In addition, NASD is proposing to amend Rule 2790 to codify the filing requirement for distribution information. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are bracketed.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

* * * * *

2700. SECURITIES DISTRIBUTIONS

* * * * *

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;

(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.

(i) Information Required to be Filed

(1) The 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 days after the offering date.

* * * * *

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Purpose

I. **Securities Offerings of BDCs, DPPs, and REITs**

Currently, the definition of "new issue" under subparagraph (i)(9) of Rule 2790 expressly excludes, among other things, securities offerings of closed-end investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act"). NASD staff has observed 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 of the offering are the capital it has previously raised.”³ Moreover, if there is a premium, it is generally small. In light of these facts, NASD exempted securities of closed-end investment companies registered under the Investment Company Act from the definition of “new issue,” noting that 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.⁴ For similar reasons, as discussed below, NASD is proposing to exclude from the definition of “new issue” securities offerings of BDCs as defined in Section 2(a)(48) of the Investment Company Act, DPPs as defined in NASD Rule 2810(a)(4), and REITs as defined in Section 856 of the Internal Revenue Code (the “Code”).

A. 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.⁵

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 Commission of its election to be subject to the provisions of

³ Securities Exchange Act Release No. 48701 (October 24, 2003), 68 FR 62126, 62131 (October 31, 2003) (order approving File No. SR-NASD-99-60).

⁴ Id.; Securities Exchange Act Release No. 43627 (November 28, 2000), 65 FR 76316, 76321 (December 6, 2000) (notice of filing of Amendment No. 2 to File No. SR-NASD-99-60).

⁵ See Investment Company Act Release No. 11493 (December 16, 1980), 45 FR 83479 (December 19, 1980).

Sections 55 through 65 of the Investment Company Act.⁶ 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.⁷

Section 55 of the Investment Company Act,⁸ in part, describes the securities in which a BDC can invest. These securities generally must comprise at least 70% of the value of the BDC's investment assets and include securities of certain companies, cash, cash equivalents, U.S. 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,⁹ which generally include small developing businesses and financially troubled businesses. Further, NASD staff understands that BDCs are similar to registered closed-end investment companies in that a BDC's primary asset at the time of its initial public offering 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.

B. DPPs and REITs

⁶ See Section 2(a)(48) of the Investment Company Act; 15 U.S.C. 80a-2(a)(48).

⁷ For example, in December 2003, the Commission 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).

⁸ 15 U.S.C. 80a-54.

⁹ 15 U.S.C. 80a-2(a)(46).

A DPP, as defined in NASD 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 tax advantages of a trust as long as certain asset, income, and distribution criteria have been satisfied as set forth in the Code.¹⁰ 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.¹¹

Nearly all DPPs and most REITs, at the time of their initial public offering, have no invested assets. The initial public offering raises capital, which is subsequently invested. As such, the initial public offerings of DPPs and REITs, like registered closed-end investment companies, are not expected to open at a premium. Like registered closed-end funds, the primary asset of DPPs and most REITs immediately following the public offering is the capital raised in the offering.

NASD staff is aware of several instances of a REIT making an initial public offering when it already had invested assets. Although the common stock of these REITs has a greater

¹⁰ See Section 856 of the Code; 26 U.S.C. 856.

¹¹ Id.

potential for immediate premiums in the secondary market, NASD staff's review of such offerings has shown that even in these cases, premiums, if any, tend to be small. Because the assets of REITs (e.g., rental property) generally have a readily identifiable market value, it appears less likely 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 is proposing to exclude securities offerings of all BDCs, DPPs, and REITs from the definition of "new issue" under subparagraph (i)(9) of Rule 2790. 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, the staff would reconsider the appropriateness of a blanket exclusion for these types of offerings.

II. Foreign Investment Company Exemption

NASD also is proposing 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 a staff memorandum dated August 6, 2004 ("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.¹² NASD staff further explained 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.

The Staff Memorandum also reiterated the position in NtM 03-79 that a foreign investment company that is limited to select investors would not be considered as “for sale to the public.” As NASD staff explained, 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

¹² In Notice to Members (“NtM”) 97-30, 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, which announced the SEC’s adoption 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.”

interest of any single restricted person, are likely to be present with a foreign investment company offered only to high net worth individuals. Moreover, NASD staff believes that the purposes of the Rule 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 the Rule.

While NASD staff believes 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 staff also believes that it is appropriate to amend the rule text. Specifically, NASD is proposing to revise the foreign investment company exemption to state as follows:

(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.

III. Information Required to be Filed

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 (“IPOs”) using a companion system, “Compliance Desk.”¹³ 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.”¹⁴ IPO Distribution Manager is a Web-based application that permits the 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 IPOs under the Corporate Financing Rule (Rule 2710).

NASD is proposing to amend Rule 2790 to codify the requirement for the managing underwriter to file distribution information as announced in NtM 04-20.

(2) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁵ which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change to Rule 2790, as described herein, protects investors and the public interest by ensuring that member firms make a bona fide public offering of securities at the public offering price.

(B) Self-Regulatory Organization’s Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as

¹³ See NtM 96-18.

¹⁴ See NtM 04-20 (March 2004).

¹⁵ 15 U.S.C. 78o-3(b)(6).

amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. SR-NASD-2004-165. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications

relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Margaret H. McFarland
Deputy Secretary

¹⁶

17 CFR 200.30-3(a)(12).