

precludes approval of the NASD's proposal. The Commission acknowledges that it is reasonable for hedge fund investors to seek to align the interests of hedge fund managers with their own. Contrary to the view taken by these commenters, however, the new rule will not significantly impede that effort. NASD Rule 2790 does not prohibit a hedge fund manager from holding an interest of greater than 10% in a hedge fund that he or she manages because of the availability of the carve-out procedures. These carve-out procedures, which exist under the Interpretation and will be carried over in the new rule, allow the fund to segregate the interests of restricted from non-restricted persons and to direct the proceeds of the fund's investments accordingly. Thus, the rule merely prohibits such a fund from purchasing new issues in a manner that allows the hedge fund manager (and other restricted persons) to receive from such purchases an indirect, *pro rata* benefit that exceeds the lesser of 10% or their actual percentage interest in the fund. NASD Rule 2790 places no restrictions on the ability of a hedge fund—whatever its ownership structure—to purchase any other type of asset. The investors will still be able to align the interests of hedge fund managers with their own with respect to every type of investment opportunity other than new issues. The Commission believes that the potential adverse consequences of preventing the alignment of investor and manager interests with respect to this class of investment are minimal.

By contrast, allowing hedge fund managers unlimited participation in the benefits of new issues through the funds that they manage would be much more likely to compromise investor protection and the public interest. A portfolio manager is in a position to direct business to a member and might be willing to do so in return for having received new issues. The larger a hedge fund manager's interest in the fund, the greater the manager's notional *pro rata* benefit from any particular investment made by the fund and the greater the incentive for the member to sell new issues to that fund in hopes of receiving future business. Furthermore, allowing a portfolio manager to have unlimited participation in a hedge fund that purchases new issues would further the appearance that an industry insider was receiving a disproportionate benefit from new issues. The Commission believes that the proposed rule furthers the appearance, as well as the reality, of fairness in the IPO process and thus will

strengthen investor confidence in the securities markets.

The Commission concludes that deeming hedge fund managers and other portfolio managers as restricted persons, subject to the 10% *de minimis* exemption for collective investment accounts, represents a reasonable balance between the principles underlying the new rule and consideration of the structure of the hedge fund industry.

#### D. Other Provisions

The Commission finds that the preconditions for sale provisions strike a reasonable balance between, on the one hand, ensuring that accounts to which NASD members sell new issues are in fact eligible and, on the other hand, minimizing the administrative burdens on both members and their customers. Specifically, the Commission believes that 12 months is a reasonable time frame within which members should update eligibility information. The Commission also believes that the NASD's proposed use of negative consent procedures is reasonable and consistent with the Act.

With respect to the anti-dilution provisions of the proposed rule, the Commission believes that the acquisition of new issues by restricted persons for the purpose of preventing their existing interests from being diluted does not run counter to either the purposes of the rule or the provisions of the Act. The Commission also believes that the holding period requirements of the anti-dilution provisions are a reasonable means to prevent abuse of these provisions.

The Commission finds that the provisions of the new rule relating to stand-by purchasers and under-subscribed offerings are consistent with the Act. These provisions are a reasonable means to facilitate the distribution of new issues and, although allowing restricted persons to hold beneficial interests in new issues in some circumstances, do not run counter to the purposes of the new rule.

Finally, the Commission believes that it is reasonable for paragraph (h) of new NASD Rule 2790 to allow NASD staff to exempt any person, security, or transaction from the rule, to the extent that such exemption would be consistent with the purposes of the rule, the protection of investors, and the public interest. However, the Commission reminds the NASD that exemptions of general applicability that would impose substantive binding requirements should be done through the notice-and-comment rulemaking process prescribed by Rule 19b-4 under

the Act.<sup>178</sup> The only circumstance in which exemptive authority of the NASD should be exercised without employing this process is where the circumstances are truly unique. In most instances, the circumstances involved are so common that the same exemption would in fact be granted to all other similarly situated persons and thus must be handled through the notice-and-comment rulemaking process.<sup>179</sup>

#### E. Effective Date

The Commission believes that it is reasonable and consistent with the Act to allow NASD members the transition period specified above<sup>180</sup> in which to adjust their compliance programs to accommodate the new rule. The Commission notes that it has approved similar transition periods in previous cases.<sup>181</sup> Accordingly, the proposed rule change will take effect upon the issuance by the NASD of a Notice to Members discussing the new rule, and the NASD has represented that it will publish this Notice to Members no later than 60 days following Commission approval. NASD members may comply with either the Interpretation or new NASD Rule 2790 for three months following publication of the Notice to Members.

#### F. Accelerated Approval

Pursuant to Section 19(b)(2) of the Act,<sup>182</sup> the Commission finds good cause for approving the proposal, as revised by Amendment No. 5, prior to the thirtieth day after the date of publication of notice of the amended proposal in the **Federal Register**. The Commission believes that Amendment No. 5 does not materially alter the operation of the rule and is intended only to respond to comments and to make certain technical corrections pointed out by certain of the commenters. Accordingly, the Commission is accelerating approval of the proposal, as amended.

#### G. Impact on Efficiency, Competition, and Capital Formation

In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital

<sup>178</sup> 17 CFR 240.19b-4.

<sup>179</sup> See letter to T. Grant Callery, NASD, from Annette L. Nazareth, Division of Market Regulation, SEC, dated March 27, 2003.

<sup>180</sup> See *supra* note and accompanying text.

<sup>181</sup> See, e.g., Securities Exchange Act Release No. 44499 (June 29, 2001), 66 FR 35819, 35822 (July 9, 2001) (SR-NASD-2001-14) (allowing Nasdaq issuers a short period of time to comply with either the old or newly approved listing standards).

<sup>182</sup> 15 U.S.C. 78s(b)(2).