ABA

AMERICAN BAR ASSOCIATION

Defending Liberty
Pursuing Justice

Section of Business Law
321 North Clark Street
Chicago, IL 60610
(312) 988-5000

July 20, 2007

Via E-mail: pubcom@nasd.com

Ms. Barbara Z. Sweeney
Office of the Corporate Secretary
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20036-1506

Re: Proposed Rule 2721 Relating to Member Private Offerings

Dear Ms. Sweeney:

This letter is submitted on behalf of the Committee of Federal Regulation of Securities of the American Bar Association's (the "ABA") Section of Business Law (the "Committee")[1] in response to the request of the National Association of Securities Dealers, Inc. (the "NASD") for comments on the above-referenced rule proposal (the "Proposal"), as published for comment through NASD Notice to Members 07-27 (the "NTM"). This letter was prepared by the Committee's Subcommittee on NASD Corporate Financing Rules.

The comments expressed in this letter represent the views of the Committee only and have not been approved by either the ABA's House of Delegates or Board of Governors, and therefore do not represent the official position of the ABA. In addition, these comments do not represent the official position of the ABA Section of Business Law, nor do they necessarily reflect the views of all members of the Committee.

We welcome the opportunity to comment on the Proposal. Capitalized terms used herein are defined in the Proposal, except as otherwise set forth herein.

---

[1] References herein to "we" or "our" refer to the Committee.

1. Description of the Proposal

The NASD is proposing for the first time to impose filing, disclosure and use-of-proceeds requirements on a Member Private Offering, which is defined as a "private placement" of "unregistered securities" issued by an NASD member or a "control entity"[2] in a transaction that is exempt from registration under (i) the Securities Act of 1933 (the "Securities Act") and (ii) the filing requirements of NASD Rules 2710, 2720 and 2810 (together, the "Corporate Financing Rules").[3] The Proposal is designed to address problematic practices that the NASD had identified in a "sweep" of NASD member firms. Proposed Rule 2721 would require that the following disclosures be made in a private placement memorandum (a "PPM") relating to a Member Private Offering:

(1) the risk factors associated with the investment, including company risks, industry risks and market risks;
(2) intended use of the offering proceeds;
(3) offering expenses and the amount of selling compensation that will be paid to the member and its associated persons; and
(4) any other information necessary to ensure that required information is not misleading.

In addition, at least 85% of the offering proceeds raised in a Member Private Offering must be used as identified in the "intended use of the offering proceeds" disclosure of the PPM.

A PPM subject to the new rule must be filed with the NASD's Corporate Financing Department (the "Department") at or prior to the first time it is provided to any investor. In addition, any amendment or exhibit to the PPM must be filed with the Department within 10 days of being provided to any investor. According to the Proposal, although the Department will not issue a "no-objections opinion" on the filing, if the NASD subsequently determines that the disclosures in the PPM "appeared to be incomplete, inaccurate or misleading," the NASD could "make further inquiries."

---

[2] Pursuant to proposed Rule 2721(a)(2), a "control entity" means any entity that controls or is under common control with an NASD member, or that is controlled by such a member or its associated persons. The term "control" is proposed to be defined for these purposes to mean the "beneficial ownership" of more than 50% of the outstanding "voting securities" of a "corporation," or the right to more than 50% of the distributable profits or losses of a "partnership."

[3] The NASD's Corporate Financing Rules do not apply to, among other things, private offerings by an issuer that are exempt from registration under the Securities Act by reason of Section 4(2) thereunder, including by reason of the safe-harbor exemption set forth in Rule 506 of Regulation D thereunder. *See*, NASD Rule 2710(b)(8)(A) (which also applies to NASD Rule 2810) and NASD Rule 2720(a), including the definition of "public offering" in NASD Rule 2720(b)(14).

2. General Comments

We appreciate the opportunity afforded by the NASD to comment on the Proposal published for comment in the NTM. Although we acknowledge the challenges that the NASD faces in addressing problematic private offerings by NASD members or "control entities," we question whether the imposition of filing and substantive disclosure requirements on all private offerings is the most effective regulatory solution. We believe that the Proposal might impose a compliance burden on NASD members that far exceeds the regulatory benefits to be obtained. Well-publicized enforcement actions, with clear and forceful delineations of the questionable conduct, put members on notice of the unacceptable conduct. A vigorous examination program lets members know that the problematic practices will be subject to scrutiny. Although we recognize that an ad hoc enforcement program can create its own problems, we are concerned that the creation of an entirely new regulatory scheme for private placements may create significant burdens that the Proposal does not appropriately take into account.

a. Additional Scheme of Private Placement Regulation

We believe that the Proposal would inappropriately establish an additional scheme of regulation for private placements that will operate separately from that of the SEC.[4] The NTM expressed concern that some private offerings had not complied with current federal securities law requirements for disclosure in securities offerings. To the extent that Member Private Offerings do not currently comply with the SEC's antifraud and other disclosure standards, we believe that the answer is not for the NASD to adopt its own rules regulating private placements and that, in any event, the new standards proposed by the NASD are unnecessary to facilitate better compliance with the SEC's requirements.

The SEC's rules do not mandate specific disclosures for private placements made solely to accredited investors,[5] nor does the SEC mandate that required disclosures be in the form of a PPM. We do not believe that the NTM sets forth any compelling reason why these requirements should be placed on Member Private Offerings, particularly those made solely to accredited investors. Instead, as previously stated, we believe that the NASD should enforce NASD members' compliance with the federal securities laws applicable to private placements of securities through its NASD member examination program.

b. Scope of NASD Regulation

We are particularly concerned that the Proposal goes significantly beyond the historical scope of NASD regulation – regulating the underwriting terms and arrangements of public offerings of securities, including regulation of conflicts of interest that may occur when an

---

4 *See,* our more complete comments on this issue under "Disclosure Requirements" in Part 3.b. below.

5 To the extent a private placement is offered and sold solely to accredited investors, information provided to investors must meet the requirements of the federal antifraud rules and regulations. The NASD's Proposal would not exempt private placements sold solely to accredited investors.

NASD member underwrites a public offering of its own securities or those of an affiliate. The disclosures required by the NASD Corporate Financing Rules are generally limited to matters relating to the fairness of underwriting terms and arrangements, the nature of certain conflicts of interest involving an NASD member, and, in the case of NASD Rule 2810, the suitability standards applicable to an offering of a direct participation program ("DPP"). We note, in particular, that although Rule 2720 (in certain circumstances) and Rule 2810 also require that a member conduct a review of the prospectus or other offering document to ensure that all material facts are adequately and accurately disclosed, these rules do not mandate the kind of broad disclosures of issuer- and offering-related information that the NASD is proposing to adopt in Rule 2721.[6]

The scope of the Proposal would have the NASD reviewing disclosure about a member solely in its capacity as an issuer of securities, not as an agent. As noted above, proposed Rule 2721(c) would permit the NASD to require an issuer to disclose "risk factors associated with the investment, including company risk, industry risks, and market risks" and "any other information necessary to ensure that required information is not misleading." This expansion of scope is dramatic and has the potential to open the door to the NASD conducting a "merit review" of Member Private Offerings. We believe that such a potentially momentous step should only be taken after it is clear that less burdensome alternatives are not effective.

Finally, we would note that the regulatory trend, as evidenced by the recent SEC proposals on capital raising, seems to be moving in favor of reducing the burdens on companies seeking to raise capital. We believe that the Proposal needs to be examined in that light.

c. Scope of the Proposal

Despite the NASD's efforts to limit the Proposal to affiliates that are "control entities" and to exclude certain types of offerings, we also believe that the NASD's Proposal would operate in a manner that would inhibit legitimate private capital-raising activities by well-capitalized NASD members and in the types of offerings by NASD members and their control entities that have not presented issues of compliance with the SEC's private placement rules and regulations nor with the federal antifraud rules and regulations. Although we have some

---

[6] NASD Rule 2710(c)(2)(C), for example, requires that all items of underwriting compensation be disclosed in the underwriting section of the prospectus. NASD Rule 2710(h)(2) requires that, subject to certain exceptions, if more than 10% of net offering proceeds will be paid to participating NASD members and/or their affiliates, the underwriting section of the prospectus must disclose that the offering is being made pursuant to the provisions of NASD Rule 2710(h) and, if applicable, set forth the name of the NASD member which is acting as a qualified independent underwriter (the "QIU") and that the QIU is assuming the responsibility of acting as a QIU in the pricing of the offering and conducting due diligence in respect of such offering. NASD Rule 2720(d) requires similar disclosures where an NASD member is participating in an offering of its own securities or those of an "affiliate" or other issuer with which the member has a "conflict of interest," as such terms are defined in NASD Rule 2720. NASD 2810(b)(2)(A) requires disclosure of the suitability standards employed in the offering of any DPP and Rule 2810(b)(3)(ii) requires that a member conduct a review of the prospectus or other offering document to ensure that all material facts are adequately and accurately disclosed and provide a basis for evaluating the DPP.

difficulty ascertaining the various fact situations that have raised regulatory compliance issues in the context of Member Private Offerings, we believe that the principal problematic area has been in the context of a member raising capital for the operation of the member firm or its control entity. In NASD Investor Alert, June 14, 2004, the NASD warned investors regarding NASD member practices with respect to "broker-dealer self-offerings" ("BDOs"), which the NASD described as offerings where a brokerage firm raises private placement capital "to finance their operations or those of an affiliate."[7] In light of the significant compliance burdens imposed by the Proposal, we are concerned that the Proposal is overbroad in reaching to the types of Member Private Offerings that are not of concern to the NASD. Thus, for example, the Proposal would apply to Member Private Offerings by NASD members that are or are affiliated with public reporting companies, whereas problematic Member Private Offerings appear to have occurred only in the case of non-reporting companies. Further, we believe that the Proposal could apply to an NASD member's participation in the sale of 100% of the business of a control entity in the form of corporate stock to a single purchaser because both the investor and the transaction may not qualify for one of the proposed exemptions from the rule.[8] Also, although unintended, the Proposal may be broad enough to reach private offerings by a private investment vehicle sponsored by an NASD member or its affiliate for the purpose of purchasing specific assets, *e.g.*, investments in real estate or securities, such as private DPPs, real estate investment trusts ("REITs"), limited liability companies ("LLCs"), closed-end funds, and other collective investment vehicles (referenced herein together, when appropriate, as "private investment vehicles").

3. Specific Comments on the Proposal

a. Definition of Control Entity

NASD is proposing to define the term "control" for the purposes of the definition of "control entity" in proposed Rule 2721(a)(2) to mean the "beneficial ownership" of more than 50% of the outstanding voting securities of a corporation, or the right to more than 50% of the distributable profits or losses of a partnership. In addition to our recommendations to clarify the definition, we are, in general, concerned that this definition is over-broad in its application and would reach situations that do not present the kind of problematic Member Private Offerings that is the basis for the NASD's Proposal.

---

[7] NASD Investor Alert dated June 14, 2004 entitled "Brokerage Firm Private Securities Offerings: Buying Your Brokerage" (the "Alert"). The Alert related risks associated with BDO and stated that if an investor participates in such an offering, the investor would "share in the risks that the business will be unsuccessful or unprofitable or you could participate in successful operations of the firm or its affiliates when the increased value of the firm or affiliate's equity is reflected in the value of its securities." The Alert further notes that "[i]nvesting in a private BDO can involve significant risk. And BDOs that are publicized through spam emails or cold calling are often fraudulent or otherwise problematic."

[8] In a sale of a business that was effected by a 100% transfer of stock, the U.S. Supreme Court affirmed in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (May 28, 1985) that the stock transfer constituted a sale of business that is subject to the protection of the federal securities laws – known as the "sale of business doctrine."

Corporations. A corporation could have multiple classes of stock, such as common stock and preferred stock, each with voting rights attached thereto, although preferred stock may have more limited voting rights. Outstanding debt securities of an issuer may be subject to certain "negative" consent rights that confer voting-type rights on the holders thereof with respect to certain actions by the issuer. We recommend that the definition of control for purposes of determining a "control entity" be clarified to reference "common stock" and "voting power," similar to Nasdaq Rule 4350(i)(1)(D), so that control is based on an ownership of more than "50% of the common stock or 50% of the voting power" of a corporation. We believe that the common stock of a corporation will, generally, be the class of security with the broadest voting rights of any other class of security of such corporation.

Other Legal Entities. The definition of "control" appears to contemplate only issuers that are "corporations" or "partnerships." However, because an issuer may also be, for example, a limited liability company, a business trust, or, if organized offshore, some other form of legal entity, we believe that in the case of an issuer which is not a corporation, the term "control" should mean the right to more than 50% of the distributable profits or losses of any "partnership or other non-corporate legal entity."

Elimination of Common Control Entities. Similar to Rule 2720, the definition of "control" for purposes of determining whether an entity is a "control entity" of a member would encompass "[a]ny entity that controls or is under common control with a member, or that is controlled by a member of its associated persons." Under this definition, a control entity would include an investment vehicle formed by an NASD member's holding company and a member's sister-subsidiary even though the member does not have a controlling interest in the issuer. Although the NASD states in the NTM that Rule 2721 is intended to parallel the protections afforded public investors in Rule 2720, we believe that Rule 2721 is and should be significantly different in scope and application as the NASD clearly intends Rule 2721 to regulate conflicts of interest that arise from offerings of securities in which an NASD member has a continuing self-interest in the operation of the issuer – and not where the conflict of interest relates to the member's role in underwriting an offering of an affiliate's securities.

Therefore, we recommend that the definition of "control" be revised to eliminate its application to common control situations. This recommended change would limit proposed Rule 2721 to "[a]ny entity that controls or is controlled by a member or its associated persons."

Restriction to Parent Entities. Moreover, proposed Rule 2721 would apply to a private offering by a holding company and a remote holding company of an NASD member, even though such holding company is not primarily engaged in the securities business through its subsidiary or down-stream subsidiary broker-dealer. In light of what appears to be the narrow circumstances of brokerage firm fund-raising that the Proposal contemplates, we recommend that the definition of control entity should only apply to a holding company that controls an NASD member if that entity meets the 50% voting control/distributable profits test contained in the Proposal and also meets the definition of being a "parent" in NASD Rule 2720(b)(10), *i.e.*,

derives at least 50% of its gross revenues from the member or employs at least 50% of its assets in such member.[9]

Calculation on a Post-Transaction Basis. Under the Proposal, the determination of whether an issuer is a "control entity" of an NASD member is calculated prior to the transaction. This methodology of calculation would result in the application of the Proposal to a broad range of offerings that do not raise the kind of problematic issues that the NASD intended to address, including to the sale of a business through a stock transaction and to a member's sale of interests in an investment vehicle where the NASD member will retain less than a 50% voting control interest or interest in less than 50% of the profits of the entity after the private placement of securities. For example, the definition of control would encompass, a newly-formed investment vehicle, which, prior to the first closing may be technically wholly-owned, or more than 50% owned, by an NASD member or affiliate of an NASD member. After the completion of the offering, however, the investment vehicle is likely to be more than 50% owned by unaffiliated, third-party investors. We do not believe that the NASD intended to encompass such offerings in the definition of Member Private Offering.

For purposes of NASD Rule 2720, the NASD calculates an NASD member's interest in an issuer on a pre-public offering basis in order to address the conflicts-of-interest that may exist when a member underwrites an offering of an affiliate's securities. In such cases, the NASD will apply Rule 2720 to an offering of securities where a member has a greater-than-10% interest in the securities of an issuer, even though the public offering by the issuer will dilute the member's interest. As previously stated, we believe that Rule 2721 should be significantly different in scope and application than NASD Rule 2720 and should apply only to offerings of securities in which an NASD member has a continuing self-interest in the operation of the issuer. As stated in the Alert, referenced above, the NASD was concerned about offerings where a brokerage firm raises private placement capital "to finance their operations or those of an affiliate."

We believe, therefore, that proposed Rule 2721 should be limited to situations where the investment is in the member itself, in the parent of a member or in a private investment vehicle in which the member or the parent of a member will continue to hold voting control of more than 50% or derive more than 50% of the entity's profits after the closing of the private placement. Therefore, we recommend that the NASD revise the Proposal to calculate the 50% ownership standard on a post-transaction basis for purposes of determining whether a private placement issuer is a "control entity" of an NASD member. Thus, if an issuer forms a reasonable belief that the private investment vehicle will be more than 50% owned by

[9] References hereafter to a "parent" of an NASD member are meant to encompass only a holding company that beneficially either owns more than 50% of the outstanding voting securities of an NASD member or has the right to more than 50% of the distributable profits or losses of a member that is a partnership, and either derives at least 50% of its gross revenues from the member or employs at least 50% of its assets in the member.

unaffiliated third-party investors after the closing of the private placement, Rule 2721 should not apply to the offering.[10]

Beneficial Ownership Standard. "Beneficial ownership," as used in the definition of "control entity", is not defined. Although endnote 7 to the NTM states that the NASD will not include performance and management fees earned by "the general partner," we believe that the latter is too narrow and seems to, literally, contemplate the receipt of a performance and/or management fee by a general partner of a limited partnership and, thus, would not necessarily encompass the receipt of a management and/or performance fee by managers of other legal entities, such as limited liability companies or offshore entities. We recommend, instead, that the Proposal be revised to include or reference the definition of "beneficial interest" in NASD Rule 2790(i)(1), which specifically provides "[t]he receipt of a management or performance based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity, shall not be considered a beneficial interest in the account."

In addition, endnote 7 to the NTM states that if performance and management fees are subsequently re-invested "in the partnership," thereby increasing "the general partner's" ownership interest, then such interests would be considered in determining whether the "partnership is a control entity." The managers of many hedge funds, for example, defer the receipt of their management and/or performance fees for a specified period of time. Because such fees have been earned by the manager, the deferral of the payment of such fees to the manager becomes, or creates, an unsecured obligation of the hedge fund. Typically, the fund, but not the manager, will hedge its obligation by investing the deferred payments in the fund. Because such deferral does not increase the manager's equity "ownership" interest in the fund, we believe that a deferred compensation arrangement, as described above, should not count towards the 50% ownership threshold set forth in the definition of control entity.

b. Disclosure Requirements

Alternative Scheme of Regulation. As set forth above, we are particularly concerned regarding the NASD's proposal in Rule 2721(c) to adopt disclosure requirements for private placement offerings and, in connection therewith, impose a requirement that such disclosures be provided in a PPM, even though the offering may be sold solely to accredited investors. While certain of the items of disclosure are those normally provided in public and private offerings (*i.e.*, risk factors, intended use of offering proceeds, and offering expenses and amount of underwriting compensation), a "catch-all" requirement that would mandate disclosure of "any other information necessary to ensure that required information is not misleading" would significantly expand the disclosure requirements in a manner that cannot be anticipated.

Although the required disclosures appear to track the disclosures generally required under the federal securities laws, we believe that the NASD's enforcement and interpretation of such disclosure requirements will likely create an inconsistent scheme of

[10] Generally, the sponsor of a private investment vehicle retains no more than a 20% equity interest in the vehicle.

regulation with that developed by the SEC and the courts in interpreting the application of the federal securities laws to private placements. For example, the NASD is specifically mandating risk factor disclosure, specifying that such disclosure must pertain to company, industry and market risks. It is clear that the NASD will interpret what types of disclosure are appropriate in each private placement, depending on the facts and circumstances. We also note that the proposed requirement for disclosure of "market risks" may be intended by the NASD to require disclosure of the illiquidity of private placement securities. However, the NASD's requirement is likely to establish a different standard for disclosure than that contained in Regulation D, which requires that the securities be restricted from resale and that "written disclosure [be provided] to each purchaser prior to sale that the securities have not been registered under the Act and, therefore, cannot be resold unless they are registered under the Act or unless an exemption from registration is available."[11] In addition, in the case of offerings sold entirely to accredited investors, the extent of the issuer's offering disclosure may be affected by the level of due diligence being conducted by potential investors. Thus, the private placement documents specifically prepared for investors may not, in fact, reflect the entire information provided to and obtained by potential investors. We are concerned that the NASD, as an enforcement matter, may not consider the complete scope of the information provided to or obtained by investors in assessing whether the offering complies with the NASD's proposed disclosure standards.

Disclosure Requirements are Unnecessary. As discussed previously, since the disclosure requirements generally appear intended to ensure compliance with the federal securities law standards, we believe that none of these separate standards are necessary or appropriate to be adopted by the NASD and that, instead, the NASD should conduct its review of Member Private Offerings through its examination program.

Mandate for a PPM. As previously mentioned, the Proposal would require the filing of and certain disclosures in a PPM. A formal PPM is not mandatory for private placements. In some cases, the issuer will provide a term sheet and other relevant documents to potential investors and investors will also obtain relevant information through their own due diligence. We are concerned that the Proposal represents the first instance of a federal requirement for a form of disclosure document for a private placement.

Definition of "Participation." In addition, proposed Rule 2721(c) would require that no NASD member or associated person may "participate" in a Member Private Offering unless a PPM, meeting certain mandated disclosure requirements, is provided to each investor. The term "participate" is not defined and we seek clarification as to whether the NASD intends to employ the definition of "participation" set forth in NASD Rule 2710(a)(5), which definition encompasses not just marketing, but also, among other things, "[p]articipation in the preparation of the offering or other documents" and "in any advisory or consulting capacity to the issuer related to the offering." We believe that the concept of participation for purposes of Rule 2721 should be considerably narrower than that in Rule 2710(a)(5) and should only encompass

[11] SEC Rule 502(d)(2).

situations where an NASD member is acting in a distributing or selling capacity (subject to the exemptions discussed below, including the exemption for sales through another NASD member).

Application of the Rule to the "Relevant NASD Member." Further, the structure of proposed Rules 2721(b) and (c), and the exemption provided in Rule 2721(e)(3) raise the important issue of whether the NASD only intends the proposed rule to apply in the case of qualifying private placements in which the relevant NASD member[12] participates in a sales capacity or whether the NASD intends the rule to apply to any issuance by an NASD member or its control entity regardless of the relevant member's participation. The latter application of Rule 2721 would be more expansive than that of Rule 2720, which only applies in cases where the relevant member is participating in the offering, even if the member is issuing its own securities.

We urge the NASD (if it proceeds with the Proposal) to revise proposed Rule 2721 to make clear that the requirements in proposed Rules 2721(b) - (d) apply only in the case of a Member Private Offering if the relevant NASD member participates in the distribution of the securities. Thus, proposed Rule 2721 should not apply to a Member Private Offering if the issuer sells its securities through an unaffiliated NASD member. Such other NASD member, acting as placement agent for the Member Private Offering, will serve as an objective arbiter of the adequacy of the disclosure to prospective investors as well of the proposed business terms, such as the proposed use of proceeds of the offering.

In order to so limit the Proposal, we recommend that an introduction be added to proposed Rule 2721 indicating that the "The following requirements apply to an NASD member that participates in a sales capacity in a Member Private Offering of equity securities issued or to be issued by the member, the parent of the member, or other control entity of the member." This revision, and other changes to the substantive provisions, would address the apparent inconsistencies in the application of the requirements of Rules 2721(b) – (d) and ensure that they are only applicable to the relevant NASD member that participates in a selling capacity in a Member Private Offering of securities issued by an NASD member or by a control entity of a NASD member (subject to the exemptions provided in the rule).

c. Filing Requirement

Proposed Rule 2721(b) would prohibit an NASD member or associated person from offering or selling any security in a Member Private Offering, unless the applicable PPM has been filed with the Department at or prior to the first time the PPM is provided to any investor. In addition, any "amendment or exhibit" to such PPM must also be filed with the Department within 10 days of being provided to any investor.

Compliance Difficulties. We believe that there are considerable practical problems in complying with the NASD's proposed filing requirements and that, in general, the

[12] For purposes of this discussion, we will use the term "relevant NASD member" to refer to the member that is the issuer of the securities or in a control relationship with a "control entity" that is the issuer of the securities.

burdens imposed by the filing requirements far outweigh the intended benefits. Moreover, as set forth above, we believe that the NASD's purposes can be better achieved through the member examination program. As previously discussed, the filing requirement assumes the preparation of a formal PPM, whereas, in some cases, only a term sheet and other documents may be provided to investors. Further, many private placements involve a process of negotiation with potential investors and the terms are only finalized at the point of investment.. It is unclear how the proposed filing requirements would apply in these situations. Further, any filing requirement should not reach to amendments or exhibits, as these documents can be requested by NASD staff if necessary, and the filing of such documents would, in any case, be overbroad in possibly encompassing the types of sales literature and supplemental materials that would not be subject to filing with the Department in the context of a public offering.

NASD Action After Filing. The NASD NTM is also clear that the NASD will review filed Member Private Offerings for compliance with the federal antifraud rules and regulations, as well as the NASD's proposed disclosure requirements. Although the Proposal states that the NASD will not issue any form of "no-objections opinion" in connection with a filing under proposed NASD Rule 2721, the NASD states that it may make "further inquiries" if, "subsequently," the NASD has "determined that disclosures in the PPM appeared to be incomplete, inaccurate or misleading."[13] Once the NASD asserts its jurisdiction through a specific rule to conduct a review of Member Private Offerings, we believe that the lack of an NASD form of "clearance letter" creates an untenable regulatory compliance situation for the issuer and NASD members that conduct a Member Private Offering because of the potential liability concerns if the NASD were to subsequently determine that any of the disclosures in the PPM were "incomplete, inaccurate or misleading." Under these circumstances, we believe that the lack of a clearance letter will discourage issuers and NASD members from undertaking legitimate private placement capital-raising. In a similar situation involving NASD member advertising for mutual funds that are subject to filing with the NASD under Rule 2210, NASD members generally will not commence use of such advertisements until they receive a clearance letter from the NASD's Advertising Department even through permitted to do so.[14]

Confidentiality. Endnote 8 to the Proposal states that the NASD may create a "database of MPO activity." Because of the proprietary and sensitive nature of information that may be set forth in any PPM, amendment, or exhibit, that is required to be filed with the Department under the proposed Rule 2721, we believe, by analogy to NASD Rule 2710(b)(3), that the NASD should specifically provide that the NASD shall accord confidential treatment to all documents and information filed with the Department pursuant to proposed Rule 2721, and that the NASD shall utilize such documents and information solely for the purpose of review to determine compliance with the requirements of such proposed rule.[15]

---

[13] We also believe it likely that NASD staff will review whether a Member Private Offering complies with the claim of exemption from registration under the Securities Act.

[14] In comparison, for example, an issuer will file a Rule 424 prospectus for a public offering with the SEC and will go forward with the offering because such a filing is subject to a "no review" policy.

[15] In addition, the broad availability of such information could interfere with an issuer's obligation to control

d. Use of Offering Proceeds

Proposed Rule 2721(d) would require that at least 85% of the offering proceeds of a Member Private Offering be used for the business purposes identified in the PPM. The NASD notes in the NTM, that this requirement is "consistent with the [15%] limitation of offering fees and expenses, including compensation, in NASD Rule 2810. " We disagree that the proposed limitation in Rule 2721 on the use of offering proceeds is the same as or consistent with the 15% limitation on organization and offering expenses ("O&O") in NASD Rule 2810. The proposed 85% use-of-proceeds limitation is, we believe, intended to address potential misappropriations of offering proceeds rather than control the amount of O&O expenses. While an issuer may use offering proceeds for purposes that are not consistent with the intended use of proceeds disclosed to investors, we believe that redress is to the federal antifraud rules. Those rules make it clear that offering proceeds must be used for the purposes disclosed to investors and, therefore, it is neither necessary nor appropriate for the NASD to adopt such a requirement.

In any event, we are certain the NASD was limiting the amount of O&O expenses paid from proceeds of the offering, and did not intend to impose a 15% or any other limitation on the total amount of offering fees and expenses. Although the language in the Proposal does not impose such an overall limitation, the language in the NTM if taken out of context could be misinterpreted to that effect, and we suggest tightening up the language of the NTM to avoid such misinterpretation. In addition to the context, we are certain that the NASD did not intend to impose an overall cap on O&O expenses for several reasons. First, private offerings conducted in accordance with Section 4(2) of the Securities Act and/or Rule 506 thereunder are necessarily offered only to sophisticated investors who can negotiate their own terms and appropriately "fend for themselves." In addition, the NASD is not proposing through Rule 2721 to limit or establish the fairness of "underwriting compensation," but rather to ensure that up-front costs to investors do not exceed 15% of the investment.

We agree that the NASD has historically limited total O&O expenses of DPP and REIT offerings by issuers that are affiliated with a distributing NASD member to 15%, which standard seeks to regulate the aggregate amount of underwriting compensation and the total amount of issuer-only expenses paid from offering proceeds. However, unlike Rule 2810, Rule 2721 is seeking only to address misuse of offering proceeds; hence, clearly the 15% calculation should not include any part of the placement agent's compensation (including cash, expense reimbursements and securities) that is paid from a source other than the proceeds of the offering, and should not include any trail commission paid by a closed-end fund, DPP or REIT because such payments are an operational expense of the private investment vehicle that does not reduce the invested offering proceed.[16]

---

the dissemination of offering materials and not engage in general advertising or general solicitation**.** *See*, Rule 502(c) under the Securities Act.

[16] Moreover, trail commissions should not be deducted from the 85% calculation of the use-of-proceeds.

e. Exemptions

Proposed Rule 2721(a) states that the rule is intended to apply to "[a] private placement of unregistered securities . . . exempt from registration under the Securities Act and the filing requirements under Rules 2710, 2720 and 2810." Proposed Rule 2721(e) includes a number of exemptions from proposed Rule 2721 for offerings sold to certain types of investors and for certain types of offerings.

Scope of "Private Placement." Because certain offerings that are exempt from registration under the Securities Act and filing with the NASD under the Corporate Financing Rules are nonetheless public offerings, it is unclear what the intended scope is of the term "private placement." Further, the NASD's reference to such offerings being "exempt from the filing requirements under the Rules 2710, 2720, and 2810" is confusing, since offerings exempted under NASD Rule 2710(b)(7) are "public offerings" that remain subject to the substantive requirements of Rule 2710. Effectively, a private placement should only encompass those offerings of securities that are made in reliance on an SEC private placement exemption or that are treated like a private placement. Therefore, we recommend that the NASD Rule 2721 should include a definition of "private placement" for purposes of Rule 2721 and should define the term as offerings conducted in reliance on Sections 4(2) or 4(6) of the Securities Act, or SEC Rule 504 if the securities are "restricted securities" under SEC Rule 144(a)(3), or Rule 505 or Rule 506 adopted under the Securities Act, except offerings of exempted securities as defined in Section 3(a)(12) of the Exchange Act.[17]

Public Issuer Exemption. The major focus of the NASD Alert and the NTM appears to be on the inadequacy of disclosures by non-public companies that conduct private placements. We believe that the problematic types of private placements that are of concern to the NASD are not likely to occur in the case of private placements by a company that is itself a reporting company under the Exchange Act or is related to such a reporting company. Therefore, we strongly recommend that the Proposal be revised to exempt a Member Private Offering, including those of a non-reporting control entity, if the NASD Member, a holding company of the NASD member, or the issuer of the securities is a reporting company under Sections 12 or 15(d) of the Exchange Act. The rationale for extending this recommended exemption to any holding company of an NASD member, rather than to only the member's parent, is that the public disclosure requirements applicable to the holding company will encompass the member and any of its affiliates that are consolidated on the holding company's financial statements.

Limitation to Equity Offerings. We also recommend that the Proposal be revised to only apply to the issuance of an equity security, as defined in Section 3(a)(11) of the Securities Act, and that the definition should include the exemptions provided in NASD Rule 2790(i)(9)(B) – (J) (which may also be discussed separately below). Although the NASD proposed to exempt investment grade rated debt, we do not believe that the exemption from Rule 2721 should have the same scope as that contained in Rule 2720. Debt securities are an obligation of the issuer to

---

[17] *See*, Rule 2710(b)(8)(A) and Rule 2720(a)(14).

pay interest on a fixed schedule and to return principal by a fixed date. We believe that the problematic issues identified by the NASD with respect to BDOs are likely to have occurred in the context of equity offerings and not in the issuance of debt securities. Thus, we believe that the Proposal should be revised to only apply to equity securities, thereby obviating the need to establish a long list of exempted categories of non-equity securities.

Offerings to Accredited Investors. The Proposal would not exempt a Member Private Offering that is sold to even one accredited investor, even though the rest of the offering may be sold to the categories of investors included in proposed Rule 2721(e)(1)(A) – (F). These referenced exemptions are only available if sales are made "solely" to such types of investors, including institutional accounts, qualified purchasers, qualified institutional buyers, investment companies and banks. We believe that sales to investors meeting such standards also should encompass any accredited investors participating in the Member Private Offering. Therefore, we recommend that the NASD amend the introduction to Rule 2721(e)(1) to provide an exemption from the rule if a majority of the interests sold in the offering are sold to investors that are reasonably believed to meet the requirements for any of the exempt categories of investors. We also recommend that the exemption under Rule 2721(e)(2) for "offerings made pursuant to SEC Rule 144A or SEC Regulation S" be revised to be available in the case of offerings of securities that qualify under Rule 144A that are made to qualified institutional buyers ("QIBs") meeting the requirements of Rule 144A(a)(1), to non-U.S. persons under Regulation S, and to accredited investors under Regulation D.

Categories of Investors. The categories of investors in proposed Rule 2721(e)(1)(C) – (E) include investment companies, an entity composed exclusively of qualified institutional buyers and banks as defined in SEC Rule 144A. We believe that these categories of investors are confusing as the definition of qualified institutional buyer in Rule 144A(a)(1) encompasses those categories of investors, and others, *e.g.*, savings and loan associations, forms of trusts, investment advisers, and employee benefit plans. Thus, we believe that subprovisions (C), (D) and (E) are unnecessary. In addition, we believe that the investor categories should include an insurance company as defined in Section 2(a)(13) of the Securities Act.

Offerings Through Other Broker-Dealers. Proposed Rule 2721(e)(3) would exempt a private placement in which "a member acts solely in a wholesaling capacity and sells unregistered securities to other unaffiliated broker-dealers." Since private placement offerings are not generally purchased on a principal basis, we recommend that this exemption be revised to apply to offerings that are sold "through," rather than "to," other unaffiliated broker-dealers."[18]

Offerings to Employees and Affiliates of the Issuer. Proposed Rule 2721(e)(7) would exempt a private placement made to "employees and affiliates of the issuer." We believe that the term "affiliates" would only include legal entities and not natural persons. Further, we

[18] As recommended above, we believe that proposed Rule 2721 should not apply to a Member Private Placement unless the relevant member is participating in sales in connection with the offering. Thus, this exemption would only be necessary where the relevant NASD member is participating in a wholesaling capacity, but is selling through an unaffiliated NASD member or members.

believe that this exemption is overly narrow in not including directors and the immediate family of any such permissible persons. We recommend, therefore, that this exemption be clarified and expanded to include directors and employees and anticipated directors and employees (*e.g.*, a new chief executive officer), and their immediate family, as follows: "offerings to any affiliate of the issuer and to any current or anticipated employee or director of the issuer and of any affiliate, and the immediate family of such persons."

Other Exemptions. In addition, we believe that the following categories of offerings should also be exempt from the application of the Proposal as they do not represent that type of problematic capital-raising contemplated by the NASD in endnote 3 to the NTM and in the Alert:

- Offerings of equity derivatives, such as over-the-counter ("OTC") options, which are derivative of, or based upon, a security issued by an unaffiliated issuer. In an equity derivative transaction, the seller of the equity derivative, such as an OTC option, could be deemed to be the "issuer" of such option, although such issuer is not the issuer of the underlying security upon which the equity derivative is economically based.

- Offerings of structured notes and asset-backed (financing instrument-backed) securities.

- Financial products offered by state or federal-regulated bank affiliate of an NASD member, as these offerings are specialized products that are designed, and intended, for specialized and sophisticated investors.

- Offerings of a "real estate investment trust" as defined in Section 856 of the Internal Revenue Code, which are currently exempted from the NASD's conflict –of-interest rules in Rule 2710(h) and Rule 2720.

- Offerings of a "direct participation program" as defined in Rule 2810, which are also currently exempted from the NASD's conflict-of-interest rules.

- Offerings of commodity pools, which are operated by a commodity pool operator as defined under Section 1a(5) of the Commodity Exchange Act.

- Exchange offers.

- Offerings of securities exempt from registration under Section 3(a)(4) of the Securities Act.

f. Implementation and Compliance

Implementation of the Rule. We request that the NASD clarify that it will not apply proposed Rule 2721 to any offering that commenced prior to the effective date of such rule

and that the effective date will not be earlier than 90 days after the date of the publication of an NASD Notice to Members announcing adoption of the amendments.

Filing Methodology. The NTM does not address the manner in which the NASD is proposing to require that NASD members file private offering materials with the NASD. The NASD requires that NASD members and their counsel submit filings of public offerings for review by the Department via the COBRADesk system pursuant to the NASD's underwriting rules. COBRADesk is an Internet-accessed system that requires that each filing firm have a COBRADesk manager, that each user obtain a password, which password must be updated every six months, and that each user learn how to complete the COBRADesk templates for information submission. Although private placement materials could be submitted via COBRADesk and we anticipate that only minimal identifying information would be required to be input to the system, we believe that the burdens of using the COBRADesk system on NASD members and their counsel who do not usually submit public filings to the Department would be excessive. For example, the need to update a password every six months will effectively require many filers to get a new password every time a filing is to be made, as such filings are likely to be infrequent.

Therefore, we recommend that the NASD allow NASD members and their counsel to submit Member Private Placements via email to a specific email address established for that purpose in the form of either a Word or PDF document. To the extent that the issuer prepares a formal PPM, a Word or PDF version of the PPM can be submitted via email to the NASD via email. In the case of private offering materials that are provided to investors along with or in lieu of a PPM, such materials can be saved as a PDF file by the sender and also forwarded via email to the NASD. We also recommend that each such submission trigger an automatic response email from the NASD, which attaches the sent email and its attachments and acknowledges receipt of the filing. Thus, the submitting NASD member and its counsel will have a document that includes the date, time and documents submitted for purposes of maintaining a record in their files of the NASD member's compliance with the filing requirements of proposed Rule 2721.

* * *

We hope that these comments will be helpful to the NASD in its consideration of the Proposal. Due to the extensive nature of its concerns regarding the Proposal, the NASD Corporate Financing Subcommittee would be pleased to discuss any aspect of these comments with the staff of the NASD. Questions may be directed to Suzanne E. Rothwell at (202) 371-7216 or David M. Katz at (212) 839-7386.

Respectfully submitted,

/s/ Keith F. Higgins

Keith F. Higgins, Chair
Committee on Federal Regulation of Securities

Drafting Committee:

Suzanne E. Rothwell
David M. Katz
Peter W. LaVigne
Ellen Lieberman
Hugh Makens