February 1, 2005

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1500

Re: Request for Comment 04-83: Fairness Opinions Issued By Members

Dear Ms. Sweeney:

Houlihan Lokey Howard & Zukin Capital, Inc. ("Houlihan Lokey") is pleased to have this opportunity to respond to the November 2004 Request for Comment (*see* Notice To Members 04-83 (the "Notice")) on whether NASD should propose a new rule to regulate the identification and disclosure of conflicts by members that provide fairness opinions in corporate control transactions. Our response to the Notice reflects Houlihan Lokey's thirty years' experience in providing fairness opinions to Boards of Directors, Special Committees of Boards consisting of independent directors and other fiduciaries.

Issues Identified

The Notice raises the possibility that an investment bank rendering a fairness opinion:

> "…may find that [a] transaction is fair from a financial viewpoint if the transaction is favored by the company's management, and, alternatively, opine that the financial terms are not fair if management opposes the transaction."

The potential for conflict is particularly strong when:

> "a transaction that is supported by management is also one in which the investment bank acted as the financial advisor to the company in recommending or structuring the transaction and/or where the investment bank will receive financial advisory fees upon successful completion of the transaction."

The Notice indicates NASD's concern regarding a number of other issues, including:

- whether proxy statement disclosures are sufficient to inform investors about the "subjective nature of some opinions and their potential biases";
- the multiplicity of valuation methodologies employed in fairness opinions;
- the sensitivity of results to small changes in underlying assumptions;
- a "perceived tendency to make judgment calls that support management"; and

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- disproportionate benefits received in a transaction by insiders who were involved in "hiring the investment bank or are in a position to direct future business to the investment bank."

Proposed Rule

Specifically, the Notice describes a potential new rule (the "Rule") that could require:

- a "clear and complete" description of any "significant conflicts of interest" by the member, including, if applicable, the nature of compensation that the member will receive upon the successful completion of the transaction;
- disclosure of the extent to which the firm relied upon key information supplied by a company or its management, and whether such firm independently verified certain information;
- specific procedures to guard against conflicts of interest, including procedures which address:
  - the process by which fairness opinions are approved by member firms;
  - the appropriateness of the valuation analyses underlying a fairness opinion; and
  - whether disproportionate benefits to company insiders as a result of the transaction were a factor in reaching a fairness determination.

Enhanced Disclosure

In general, we believe that it would be appropriate to enact a Rule to require "clear and complete" disclosure of all significant relationships between a member firm, and its client, or any other party to the transaction. Such disclosure, if made at the earliest possible point in time, would enable a Board of Directors to evaluate (i) the extent to which any such relationship constitutes, or could give rise to, an actual or potential conflict of interest, or the appearance of a conflict, and (ii) whether, in light of any perceived conflict, it would be appropriate for the Board to take steps to address the conflict.

Given the multifarious and complex commercial relationships that can exist between an investment bank and its clients, and the subjectivity inherent in determining the presence of a "conflict of interest," we believe that any Rule should require disclosure to a company's Board of Directors of all "significant relationships," rather than "significant conflicts of interest," as suggested in the Notice. We strongly believe that the ultimate determination of whether a particular relationship constitutes a disabling conflict is rightfully a matter for the business judgment of a company's Board of Directors. The Rule should require member firms to provide, at the earliest possible point in time, the pertinent and objective information regarding all "significant relationships" to its client's Board of Directors, rather than permit the member to make the normative determination as to whether a "significant conflict of interest" exists.

Again, given the breadth of relationships that may exist between a member firm and its clients, we believe that the Rule should not attempt to exhaustively specify the range of significant relationships that might be appropriate for disclosure. Instead, the Rule should incorporate the same "materiality" standard that is the keystone of the disclosure system under both generally accepted accounting principles and the federal securities laws. Thus, the Rule could require disclosure to the member's client of all "material" relationships existing between the member and any party to the transaction (including its client). In this context, a relationship would be "material" if there were a substantial likelihood that a reasonable director would consider it important in deciding what weight to accord a fairness opinion rendered by a member firm. Examples of material relationships could include:

- The specific nature of the compensation arrangement between the fairness opinion provider and the company with respect to the present transaction, and, particularly, the relative size of the fee earned in connection with the fairness opinion vis-à-vis the fees earned upon the consummation of the transaction for all services render by the member firm.
- Any existing or prospective lending relationship between the member firm and one of the parties to the transaction; especially in the context of so-called "stapled financing" where the investment banker to one party to the transaction is providing financing to another party to the transaction.
- Direct or indirect investments by the investment bank in the debt or equity securities of one or more of the parties to the transaction.
- Derivative and structured finance arrangements with any party to the transaction.
- Recent past, current or prospective investment banking assignments with one or more parties to the transaction.
- A directorship with any party to the transaction held by a member firm's employees.

In addition to very timely disclosure of all such material relationships to the client's Board of Directors, we believe that such material relationships ought be disclosed to the company's shareholders in the relevant disclosure document circulated in connection with the transaction. We note that the foregoing recommended disclosures are generally consistent with those already required under Item 1015 of Regulation M-A under the Securities Exchange Act of 1934, as amended (the "Act").

Management or Insider Compensation Biases

As is recognized in the Executive Summary to the Notice, a fairness opinion typically addresses "the fairness, from a financial point of view, of the consideration involved in a transaction." Accordingly, it is indeed possible for the consideration to be received in a transaction by the unaffiliated shareholders of a company to be fair, from a financial point of view, even though the transaction provides for a substantial payment to a group of senior executives, which payment has the effect of reducing the proceeds otherwise available to the public stockholders.

While insider arrangements are generally considered as part of a fairness opinion provider's review of the overall facts and circumstances surrounding a transaction, fairness opinions typically eschew explicit assessment of the appropriateness of benefits received by insiders inasmuch as such matters are, more often than not, the subject of preexisting contractual relationships between the parties - be they embodied in a company's charter (as between different classes of securities), or in employment agreements with key members of the company's management. The fairness opinion provider is not the appropriate party, ex post facto, to assess the merits of such contractual relationships.

Although there may be a need, given the facts and circumstances of a transaction, for an assessment of any potential management or insider bias in connection with such transaction, we believe that any such assessment is best, and most appropriately, undertaken by the company's Board of Directors (or by the Compensation Committee thereof on an ongoing basis or potentially a Special Committee of independent directors in the context of a particular transaction). The issue of the relative benefits to management or other insiders requires the judgment of the importance of management/insiders (whether in the past or future), the negotiation positions of management/insiders and executive compensation expertise, all of which are best evaluated by the Board of Directors or its Compensation Committee or a Special Committee.

We believe NASD's concern regarding disproportionate payments to insiders is best addressed through enhanced disclosure by the company. The company, as opposed to the fairness opinion provider, is the appropriate party to describe any arrangements that might give rise to a potential bias, and to explain the business rationale for such arrangements and their impact on the distributions pursuant to the transaction. We note that existing rules under the Act require extensive disclosure of change of control payments in connection with M&A transactions.

Internal Review Procedures

As set forth previously, material relationships between a member firm and any party to a transaction (including its client) have the potential to result in "conflicts" that may affect the weight that a client's Board of Directors might accord a fairness opinion rendered by such firm. In recognition of the importance of potential conflicts, most major Wall Street investment banks, including Houlihan Lokey, have processes in place to identify and address such potential conflicts. In this regard, it is common for investment banks to maintain fairness opinion review committees consisting of senior bankers who are well versed in valuation theory and practice and who have not been part of the deal team that worked on the transaction (or the associated fairness opinion). These committees typically evaluate carefully each transaction, including the supporting documentation and underlying analyses, prior to a fairness opinion being rendered by the firm.

Given the large number of NASD members, however, it is not clear that there is uniformity of practice in respect to identification of conflicts and internal review processes. Accordingly, it is appropriate for NASD generally to require fairness opinion providers to have documented procedures designed to (i) effectively and expeditiously identify any and all material relationships (as described above under "Enhanced Disclosure") so that they can be disclosed to the client at the earliest possible point in time and (ii) ensure integrity of the process by which fairness opinions are approved by a member firm.

We strongly believe that it would be inappropriate to attempt to regulate the underlying methods and analytical considerations relevant to the fairness opinion itself. A Rule seeking to regulate the technical financial analyses would be very difficult to craft, hard to enforce, and could preclude a particular methodology in a circumstance where such methodology, either alone or in conjunction with other methods, might help to highlight the strengths or weaknesses of the transaction.

Reliance On Information Supplied by the Client

In all their professional activities, investment bankers customarily rely on information provided by the client, be it the management and/or the Board, regarding the company's past and recent financial performance as well as future prospects. Investment bankers are not auditors or accountants who are professionally trained to confirm the validity of financial statements, The practice of reliance on company generated information is standard and is generally acknowledged and accepted by both client and banker. This reliance is typically disclosed in both the fairness opinion as well in the language in the body of the SEC filing to which the fairness opinion is an exhibit. For example, the following (or similar) language appears in many fairness opinions:

> *"We have not independently verified the accuracy and completeness of the information supplied to us with respect to the [client] and do not assume any responsibility with respect to it. We have relied upon and assumed, without independent verification, that the financial forecasts and projections provided to us have been reasonably prepared and reflect the best currently available*

> *estimates of the future financial results and condition of the [client], and that there has been no material change in the assets, financial condition, business or prospects of the [client] since the date of the most recent financial statements made available to us."*

Fairness opinions also routinely contain a detailed list of the due diligence items that were considered most relevant by the opinion provider, and therefore other sources of information would be listed if material. Accordingly, the reader of a fairness opinion or proxy statement is generally put on notice as to the extent of the investment bank's investigation and its reliance on information provided by the company. To the extent that NASD believes that there is lack of uniformity among members in disclosing their reliance on information supplied by a company or its management, it would not, in our view, be inappropriate for a Rule to require disclosure in the fairness opinion of the extent to which the member firm relied, with or without independent verification, on key information supplied by the company.

Conclusion

In the current regulatory and judicial environment, the directorial decision-making process has come under increasing and intense scrutiny. As the Notice accurately observes, fairness opinions are a regular feature of corporate control transactions that assist directors in fulfilling their fiduciary duties. Given the importance of fairness opinions to the deliberations of corporate directors, we applaud NASD's consideration of ways in which to ensure the integrity of fairness opinions and the processes by which they are provided.

Houlihan Lokey would welcome the opportunity to further discuss with you the concepts raised in the Notice. If you have any questions or would like to discuss our comments further, please contact either of the undersigned.

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