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National Association of Securities Dealers
Attention: Ms. Barbara Z. Sweeney
Office of the Corporate Secretary
1735 K Street NW
Washington, DC 20006-1500

By email: **pubcom@nasd.com**

February 1, 2005

Dear Ladies and Gentlemen:

Re: NASD Notice to Members 04-83 – Request for Comments:
Procedures, Disclosure and Conflicts of Interest in the Context of
Fairness Opinions in Corporate Control Transactions

We respectfully submit the following comments in response to National Association of Securities Dealers ("NASD") Notice to Members 04-83 requesting comments concerning possible rule-making to address procedures, disclosure requirements and conflicts of interest in the context of fairness opinions in corporate control transactions (the "RFC"). For the reasons set forth below, we believe that additional rule-making by the NASD is neither necessary nor appropriate. The views expressed in these comments are based on our experience in thousands of transactions in which fairness opinions were rendered, on behalf of hundreds of clients – both opinion-providers and opinion recipients.

As described in more specific detail below in this letter, the factual and legal consideration underlying our belief that additional rule-making by the NASD is neither necessary nor appropriate comprise five principal areas:

A. In contrast to other areas of recent regulatory, legislative and other initiatives (e.g., Sarbanes-Oxley, accountant independence and accounting methodology, independent research, and improper market-timing practices), there is no evidence of any perceptible (much less material or widespread) need for regulation in this area or of any abusive or questionable practice by member firms in the area.

B. Existing rules of the NASD and of the Securities and Exchange Commission ("SEC") already provide a fully adequate basis for regulation of the subject area and related issues; and the SEC's rules are applied uniformly, without discrimination, to all types of opinion-providers, rather then member firms alone.

C. The highly situation-specific nature of corporate transactions and related fairness opinions are better regulated by existing, extensive judicial precedent and individualized judicial scrutiny, rather than a “one-size-fits-all” scheme of regulation that applies only to member firms.

D. Any perceived questions of conflicts of interest arising from the nature of advisory and opinion assignments, compensation structure or compensation policy are best addressed by uniform disclosure requirements, since there is no evidence that any particular type of opinion engagement or compensation arrangement is to any degree more prone to opinion bias or a lower standard of quality or objectivity.

E. The NASD’s existing range of regulatory experience and expertise does not extend to the substance or processes involved in the preparation, review and rendering of fairness opinions; in addition, as a matter of regulatory priorities, additional regulation of the subject area would not constitute a rational allocation of regulatory resources.

If, however, the NASD does determine to propose an NASD initiative relating to fairness opinions or conflicts of interest in that context, we believe that the form of such an initiative should be a non-binding statement of principles, because of the nature of the subject matter and NASD’s lack of experience in regulating this or any substantively similar or related area. Moreover, if NASD does determine to propose any NASD initiative relating to the subject area, we believe it is critical that NASD undertake a detailed process for the request and further consideration of comments on any such regulatory proposal, given the lack of substantively similar precedent and the fact that NASD does not have experience or expertise in the area. In addition, because of the absence of any similar precedent or experience in the area on the part of NASD, we also believe that it is essential to have the active and full involvement of a working group of industry representatives, prior to any decision to promulgate regulation, in the drafting of any rules and in their review prior to proposal for comment. If, however, NASD does to include to promulgate a position on issues relating to fairness opinions, it is respectfully suggested that an appropriate first step, given the absence of NASD expertise or experience in the area, would be the adoption of a statement of principles or guidelines for the rendering of fairness opinions and related disclosure, to be effective upon SEC adoption of parallel rules applicable to both non-member and member firm opinion-providers

These general reasons why we believe that additional regulation of fairness opinions, engagements, disclosure, compensation, methodology and review processes is not necessary or appropriate are more fully explained below.

1. **Existing NASD Rules Adequate.** The NASD’s existing rules provide a more than adequate basis for promoting high standards of conduct, and for punishing any improper conduct, in the engagement, analysis, conflict, disclosure and opinion review functions:
   (a) Rule 2110. Standards of Commercial Honor and Principles of Trade**.** A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.
   (b) Rule 2120. Use of Manipulative, Deceptive or Other Fraudulent Devices. No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.
   (c) Rule IM-2310-2. Fair Dealing with Customer. (a)(1) Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing.

Every relevant aspect of the fairness opinion process – from retention through preparation and review of opinions– is fully regulated by these existing NASD rules.

2. **No Evidence of Any Need for Regulation.** There is no factual evidence that there is any need for additional regulation of any portion of the subject area. The documented instances of possible fairness opinion problems reported in the two articles cited in the RFC[1] occurred – at the most recent – 17 years ago, and the total number of such problems – four in total (two of which are totally undocumented as well as unsubstantiated) – must be measured against the thousands and thousands of fairness opinions that are rendered by NASD member firms each and every year. The overwhelming evidence, therefore, leads inevitably to a conclusion exactly contrary to that suggested in the articles cited in the RFC: over many decades of time, involving scores of thousands of opinions, there have been infinitesimally few, if any, instances of documented or substantiated problems of any kind, whatsoever. The actual empirical evidence shows that there is simply no problem (much less any misconduct or abuse) to be fixed and no objective reason to believe there is any incipient or even covert danger to be avoided.

3. **SEC Rules Already Mandate Relevant Disclosure.** The SEC already mandates comprehensive and detailed disclosure relating to fairness opinions in all contexts for public companies, including under Rule 13e-3, Rule 13e-4, Rule 14a, Rule 14d, Rule 14e-2, Schedule 13E-3, Schedule A, Schedule C, Schedule TO, Schedule 14D-9, and Reg. S-K, Item 1015. Even beyond the stated requirements of these rules, the SEC has, by staff positions over the past 15 years, greatly expanded and continues to expand the required substantive disclosure concerning fairness opinions and their providers, as well as matters relating to advisor compensation and potential conflicts of interest. There is no empirical evidence or indication that the SEC is not properly or fully enforcing these rules or that the SEC's rules, as applied in practice, are not both adequately comprehensive and sufficiently detailed. For these reasons, incremental NASD regulation would be superfluous. Moreover, the SEC's existing regulations have the advantage of not discriminating against member firms, in that they apply equally and uniformly to all providers of fairness, valuation and similar advice and opinions.

4. **NASD Regulation Would Improperly Discriminate against Member Firms.** In contrast to the neutral application by the SEC of its existing rules, additional regulation by the NASD would inappropriately discriminate against member firms, since non-member providers of valuation advice and opinions (e.g., solvency, engineering, reserve estimate and tangible and intangible property appraisal and valuation firms) would not be subject to the NASD rules.[2]

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1. The two articles cited by the RFC refer to – at most – two instances of possibly defective fairness opinions or procedures, both of which occurred in or prior to 1988, 17 years ago. The other instances of supposedly questionable fairness opinions or practices to which the NASD-cited articles refer involved either (a) situations in which investment banks' fairness opinions were questioned, but found to have been properly rendered, or (b) a personal and totally unsubstantiated view of the author(s). In this connection, and in assessing the credibility and underlying motivations of the authors of the articles cited by the NASD's RFC, it is worth noting that one article author, who is also quoted prominently in the other of the two NASD-cited articles, purports, through his firm, to provide fairness opinions for merger and acquisition transactions, but it appears from the NASD internet site that neither the author nor his firm is registered as a member of the NASD.

2 Such affirmatively discriminatory regulation applicable only to member firms is a possible, if not probable, explanation of the motivation for some authors' stated views implying criticism of member firms in the rendering of fairness opinions. See, e.g., Footnote 1, above.

5. **<u>Member Firms Already Uniformly Conform to High Standards.</u>** Consistent with the SEC's existing rules and those of the NASD (including NASD Rules 2110 and 2120), member firms already conform to high standards of conduct and disclosure, including disclosure relating to possible conflicts of interest, and high standards of quality control designed to protect against opinion bias. For example, typical opinions refer to potential conflicts, past, present and future, as well as compensation arrangements relating to the instant opinion and other assignments. Under these circumstances, and given the facts that (a) the area is already adequately regulated by the NASD and SEC and (b) there is no empirical evidence of misconduct or lurking potential for misconduct, it would appear that additional NASD regulation is neither necessary nor appropriate, since there is no apparent need and no empirical basis for additional regulation.

6. **<u>Existing Judicial Precedent and Oversight Are More Effective Controls.</u>** Over many years, the courts have developed extensive experience and sophistication in evaluating every aspect of member firms' fairness opinions and the expertise, quality and objectivity of the advice which they reflect.[3] The judicial precedent which has resulted has recognized the intimate relationship between financial advice (and fairness opinions) and directors' fiduciary duties and business judgment and has also recognized that fairness opinions and directors' decisions cannot be divorced or isolated from the fact-specific situation in which opinions are given and decisions made. Because of the situation-specific nature of financial advice and fairness opinions, uniformly recognized by the courts, and the inseparable relationship between financial advice and opinions and related director decisions, it is the courts, rather than a new NASD regulatory initiative in territory uncharted by the NASD, which can provide optimal control over the quality, independence and objectivity of financial advice and fairness opinions. The courts have consistently recognized that a one-size-fits-all formula is highly inappropriate to apply to fairness opinions, yet that is the result that mandating uniform rules by the NASD would force. The result would be a degradation, rather than an improvement, in the quality, objectivity and independence of advice and opinions, while the courts would view the NASD's efforts at regulation as self-serving or as imposing methods or standards inconsistent with those imposed by existing judicial precedent.

7. **<u>Mandatory Methodology, Procedures and Process are Incompatible with High Standards of Quality and Service.</u>** Given the unique, situation-specific nature of transactions in the context in which fairness opinions are rendered, and the differing, variable and sometimes subjective factors that must therefore be considered in designing the methodology, procedures and process for rendering a fairness opinion, the subject area is not susceptible to beneficial regulation which imposes uniform methodologies, procedures or processes.

8. **<u>NASD Regulation Would Interfere with Directors' Fiduciary Duties.</u>** Because directors are, ultimately, the primary recipients of fairness opinions, and are responsible (and potentially liable) for decisions made based on those opinions, regulation by the NASD which could affect the content of fairness opinions or the process by which opinions are rendered expose both corporate directors and member firms to potentially irreconcilable conflicts between new NASD

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3 See, for example, the voluminous case citations in "Comment: The Fiduciary Responsibilities of Investment Bankers in Change-of-Control Transactions: In re Daisy Systems Corp.", 74 NYU LR 277 (1999); "Fairness Opinions: How Fair Are They and What Can Be Done About It?", 1989 Duke LJ 27; and "Note: Investment Bankers' Fairness Opinions in Corporate Control Transactions", 96 Yale LJ 119 (1986).

rules, on the one hand, and – on the other hand – the business judgment and fiduciary duties of directors and the financial expertise and expert judgment of the directors' chosen advisor – the opinion-provider. In this respect, as well, additional NASD substantive or procedural regulation could conflict not only with directors' exercise of their business judgment but also with state corporate laws applicable to directors' fiduciary duties and with SEC rules as well. It is respectfully submitted that the NASD does not have the expertise (or any empirical foundation on which) to substitute its own judgment, on a wholesale basis, for the judgment of corporate directors at thousands and thousands of public and other companies.

9. **NASD Discrimination among Types of Engagements Could Lead to More Conflicts, Lower the Quality of Financial Advice and Impose Higher Costs on Shareholders and Companies.** NASD regulation which favors opinion-only engagements (or implies a value judgment in favor of such opinions) is likely, in fact, to create more potential for conflicts of interest. This is the case because the limited scope of the opinion-only engagement means that the client has no other relationship (financial and structuring advisory, for example) with the opinion-provider by which to judge whether or not to continue to retain the opinion-provider or to retain the opinion-provider in the future. As a result, there is the potential that the client would, in the context of an opinion-only engagement, make its retention decision solely on the basis of whether or not the provider has delivered a favorable opinion, rather than on the basis of the quality of the opinion-provider's related non-opinion work. Similarly, an opinion-only engagement may (because of its limited scope) expose the opinion-provider to a greater potential conflict of interest if it hopes to be retained in the future.

   Moreover, if NASD regulation were to introduce or cause a bias in favor of opinion-only engagements, the effect could be both (a) to cause companies to forego the more involved and knowledgeable advice that a broader financial advisory engagement can engender and (b) to cause higher aggregate transactional costs for companies and their shareholders from engaging an additional opinion-only advisor, since fairness opinions are otherwise often provided without separate or additional compensation as part of an overall financial advisory assignment. (It is also worth noting that NASD regulation in this respect would operate discriminatorily against member firms, while non-member firms would be unaffected or differentially benefited.)[4] Given that there is no empirical evidence of a problem or any incipient danger in the different kinds of assignments, and that directors and companies can freely choose whether they wish to have advice of one or both types, it would clearly seem to be both unnecessary and inappropriate for NASD to introduce an extraneous, unsupported element of favoritism or bias into the decisions by directors and companies as to what kind of advice and what kind of engagement they prefer.

   Moreover, so long as the nature of the engagement (opinion-only or otherwise) is disclosed (which is uniformly the case), shareholders will have a full opportunity to consider that fact when evaluating a fairness opinion.

10. **Regulation of Advisor Compensation Could Increase Potential Opinion Bias.** Regulation which discriminates against outcome-dependent compensation or which otherwise favors compensation dependent only on the delivery of an opinion, may in fact be more likely to increase the potential for opinion bias, since the advisor is only being compensated for delivery

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4 See Footnotes 1 and 2, above.

of an opinion and its business reputation and potential for future retention may be assessed based solely on the single factor of whether it provides a favorable opinion, rather than its overall contribution or the quality of its advice. In any event, so long as the nature of the compensation arrangement is disclosed, shareholders will have a full opportunity to consider that fact when evaluating a fairness opinion.

11. **Mandatory Consideration of Management's Interests is Not Appropriate.** Regulation which would mandate that an opinion-provider consider or evaluate management's interests in relation to the transaction in issue would force member firms to consider factors which (i) are extraneous to the financial analysis and fairness of the transaction, (ii) are or may not be susceptible to financial evaluation, (iii) are outside the scope of member firms' expertise, (iv) are, as a matter of corporate law, the legal responsibility of directors, and (v) directors, in the exercise of their own business judgment, have determined are not relevant or material to the transaction in issue or the financial advice which they wish to receive.

12. **Mandatory Processes for Internal Opinion Review Would Be Speculative.** The imposition of prescribed processes for member firms' internal opinion review function would be speculative, inasmuch as there is no empirical data for the optimal design of such processes. In addition, the absence of any evidence of any need for such mandated processes and the fact that review processes vary from firm to firm and may be appropriately varied to suit particular circumstances militate strongly against any NASD initiative to impose mandatory regulation on an area and process with which it is not familiar. Moreover, imposition of mandatory processes could encourage the adoption of lowest-common-denominator standards, rather than promoting efforts to develop and apply best practices.

13. **Regulation Relating to Compensation of Opinion Review Committee Members Could Lead to Lower Quality Standards.** Regulation or mandatory disclosure concerning the compensation of opinion review committee members would be inappropriate for several reasons. First, there is no evidence of any potentially problematic practices; but more importantly, there is no basis on which to assume (or imply) that any particular compensation structure would promote the highest quality in the opinion review process, inasmuch as the process has a number of objectives, including not only the quality and objectivity of the final opinion, but also the appropriateness and completeness of the underlying analysis and advice, which are the essential predicate for the final opinion. These, too, are critical functions of the opinion review process and benefit from the involvement and input of experienced, motivated professionals. External regulation which affects (directly or indirectly through disclosure requirements) the compensation of those who contribute to this process would likely lead to the exclusion, or discourage the participation, of the most experienced professionals, with consequent adverse effects on the overall quality of the advice rendered, and therefore the quality of the final opinion which is based on that advice. Regulation (directly or indirectly, through disclosure requirements) of this type would also operate discriminatorily, both as between member firms and non-member opinion-providers and also within member firms' themselves – an unnecessarily arbitrary and adverse outcome, given the absence of any evidence of any need for regulation of the area.

14. **Mandatory Procedures Have the Potential to Cause Reduced Standards of Quality.** In the context of the highly situation-specific nature of financial advice and opinions, and the difficulty

in formulating rules which are both sufficiently objective and uniform, the current regulatory regime, embodied in Rules 2110 and 2120, is a superior route to the achievement and maintenance of high standards of quality and objectivity. The imposition of mandatory procedures, methodology or conflicts policies will, because the adopted rules must necessarily be specific, inevitably encourage lowest-common-denominator conduct rather than adherence to the high standards of Rules 2110 and 2120, and would permit conduct which may be literally compliant with the new rules but does not as faithfully aspire to meet the high standards of Rules 2110 and 2120.

15. **Regulatory Priorities Militate Against Further Regulation of Member Firms' Fairness Opinions.** Since the NASD and SEC already adequately and comprehensively regulate the area, and because there is no empirical evidence of any current problem or need for regulation, it would not be a wise allocation of regulatory resources for the NASD to try to formulate and promulgate additional regulation in this area. In addition, this is an area which is already subject to careful and sophisticated scrutiny by the courts – an area in which the NASD does not appear to have any comparable level of experience or expertise. Moreover, the highly situation-specific nature of financial advisory and opinion services is not a suitable candidate for the imposition of uniform rules at the necessary level of specificity and precision. We believe that there are many other areas of the financial markets which would benefit far more from the rational application of regulatory resources, and without the same adverse consequences.

For these reasons, we believe that the areas suggested for regulation in the RFC are not appropriate for additional regulation and that the suggested regulation would not meaningfully benefit shareholders or their companies but would, instead, have a number of material and adverse consequences on member firms, on companies and on shareholders.

Very truly yours,

Peter R. Douglas

cc: Mr. Joseph E. Price, Vice President, Corporate Financing
Mr. Gary L. Goldsholle, Esq., Associate Vice President and Associate General Counsel