

Notice to Members

JUNE 2007

SUGGESTED ROUTING

Corporate Financing
Executive Representatives
Legal & Compliance
Senior Management
Operations

KEY TOPICS

Affiliates
Control Entity
Institutional Accounts
Member Private Offerings
Private Placements
Private Placement Memorandum
Regulation D

REQUEST FOR COMMENT

Member Private Offerings

NASD Requests Comment on Proposed Rule 2721 to Regulate Member Private Securities Offerings; **Comment Period Expires July 20, 2007**

Executive Summary

NASD is issuing this *Notice to Members* to solicit comments from members and other interested parties on proposed Rule 2721 pertaining to private placements of unregistered securities issued by a member (Member Private Offerings or MPOs), which would require that:

- ▶ a private placement memorandum (PPM) be provided to each investor with information regarding risk factors, intended use of proceeds, offering expenses and any other information necessary to ensure that required information is not misleading;
- ▶ the PPM be filed with NASD's Corporate Financing Department at or prior to the time it is provided to any investor; and
- ▶ at least 85 percent of the offering proceeds be used for the business purposes identified under the "use of proceeds" disclosure in the PPM.

Rule 2721 is proposed in response to problems NASD has identified in connection with the private offerings of members' securities or those of a control entity. The proposed Rule also contains several exemptions for offerings to certain types of institutional investors, offerings under various provisions of the federal securities laws for which NASD believes the protections of the proposed rule are not necessary, and offerings in which investors otherwise would be expected to have access to sufficient information about the issuer.

07-27

Action Requested

NASD encourages all interested parties to comment on the proposal. Comments must be received by July 20, 2007. Members and other interested parties can submit their comments through the following methods:

- ◆ Mailing comments in hard copy to the address below; or
- ◆ Emailing written comments to pubcom@nasd.com.

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method. Comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1506

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change (or certain policies) must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the Federal Register.²

Questions/Further Information

As noted above, hard copy comments should be mailed to Barbara Z. Sweeney. Questions concerning this *Notice* may be directed to Thomas M. Selman, Executive Vice President, Investment Companies/Corporate Financing, at (240) 386-4533; Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8104; or Joseph E. Price, Vice President, Corporate Financing, at (240) 386-4623.

Background and Discussion

In recent years, NASD has brought numerous enforcement cases concerning abuses in connection with Member Private Offerings.³ In addition, NASD conducted a sweep of firms that had engaged in MPOs and found widespread problems. Allegations in these cases include the failure to provide PPMs to investors, as well as misleading, incorrect or selective disclosure in PPMs that were provided, including omissions and misrepresentations regarding selling compensation and the use of offering proceeds.⁴

Typically, MPOs are private placements that rely on the SEC Regulation D exemption from the registration and disclosure requirements in the Securities Act of 1933 (Securities Act).⁵ Inasmuch as MPOs are *private* placements, they are not subject to the existing NASD rules governing underwriting terms and arrangements in *public* offerings and conflicts of interest by members that participate in *public* offerings.⁶

1. Proposed Rule 2721

A. Offerings by Members or a Control Entity

Proposed Rule 2721 (set forth in Attachment A) would establish disclosure and filing requirements and limits on offering expenses for private placements by members of their own securities or those of a “control entity.” A “control entity” for purposes of the proposed rule would be defined as an entity that controls, is controlled by or is under common control with a member or its associated persons. The term “control” for purposes of the proposed rule would be determined based on beneficial ownership of more than 50 percent of the outstanding voting securities of a corporation, or the right to more than 50 percent of the distributable profits or losses of a partnership.⁷ The power to direct the management or policies of a corporation or partnership alone (e.g., a general partner)—absent meeting the majority ownership or right to the majority of profits—would not constitute “control” for the control entity definition in the proposed rule.

B. Disclosure Requirements

Proposed Rule 2721 would require members to provide each investor in an MPO (whether accredited or unaccredited) by a member or a control affiliate with a PPM that contains the following information:

- ◆ risk factors associated with the investment, including company risks, industry risks and market risks;
- ◆ intended use of offering proceeds;
- ◆ offering expenses and selling compensation; and
- ◆ any other information necessary to ensure that the required information is not misleading.

This requirement would help ensure that every investor in an MPO by a member or a control entity receives basic information concerning the nature of the offering.

C. Filing Requirements

The proposed rule also would require members to file the PPM with NASD at or prior to the first time the PPM is provided to any investor. In addition, any amendment or exhibit to the PPM would be required to be filed with NASD within ten days of being provided to any investor. However, unlike filings with NASD under Rules 2710, 2720 and 2810, a member could begin offering MPO securities immediately after filing the PPM.⁸

D. Use of Offering Proceeds

Proposed Rule 2721 would require that at least 85 percent of the offering proceeds of an MPO be used for the business purposes identified in the PPM. This condition is in response to abuses we have seen where substantial amounts of offering proceeds have been dedicated to purposes other than the business purpose identified in the PPM, including selling compensation and related party benefits.⁹ Consequently, under the proposed rule, offering and other expenses of the MPO could not exceed 15 percent of the offering proceeds. This figure is consistent with the limitation of offering fees and expenses, including compensation, in NASD Rule 2810 (Direct Participation Programs), and the North American Securities Administrators Association (NASAA) guidelines with respect to public offerings subject to state regulation. When a member engages in a private placement of its own securities or those of a control entity, investors should be assured that, at a minimum, 85 percent of the proceeds of the offering are dedicated to the business purposes described in the PPM. We request comment on whether this threshold is appropriate.

E. Proposed Exemptions

Proposed Rule 2721 would include several exemptions. Specifically, the proposed Rule would exempt MPOs sold solely to:

- ◆ institutional accounts (as defined in NASD Rule 3110(c)(4));
- ◆ qualified purchasers (as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940);
- ◆ qualified institutional buyers (as defined in SEC Rule 144A of the Securities Act);
- ◆ investment companies (as defined in Rule SEC Rule 144A);
- ◆ an entity composed exclusively of qualified institutional buyers (as defined in SEC Rule 144A); and
- ◆ banks (as defined in SEC Rule 144A).

In addition, the following types of offerings would be exempt from the proposed rule:

- ◆ offerings made pursuant to SEC Rule 144A or SEC Regulation S;
- ◆ offerings in which a member acts solely in a wholesaling capacity and sells unregistered securities to other unaffiliated broker-dealers;
- ◆ offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act; and
- ◆ offerings of subordinated loans under SEC Rule 15c3-1, Appendix D.

Finally, the proposed rule also would exempt MPOs in which investors would be expected to have access to sufficient information about the issuer and its securities in addition to the information provided by the member conducting the MPO. These include exemptions for:

- ◆ offerings of unregistered investment grade rated debt;
- ◆ offerings to employees and affiliates of the issuer; and
- ◆ offerings of securities issued in stock splits and restructuring transactions.

F. Scope of Proposed Rule 2721

Proposed Rule 2721 is intended to provide investor protections with respect to private offerings by a member that are parallel, but not identical, to the protections provided by Rule 2720 with respect to a member's public offerings.¹⁰ Therefore, Rule 2721, like Rule 2720, would apply only to private placements by a member or its control entities. The proposed rule would apply to offerings by an entity that is under common control with the member, or that the member firm or its associated persons control. For purposes of proposed Rule 2721, "control" is defined as beneficial ownership of more than 50 percent of the outstanding voting securities if the entity is a corporation, or in the case of a partnership, more than a 50 percent interest in its distributable profits or losses.¹¹

Consequently, proposed Rule 2721 would not apply to private placements by any entity that does not meet this control test, including investment partnerships, direct participation programs, and other private funds that the member might organize but in which the member, its associated persons, or any parent of the member does not beneficially own the requisite ownership position. NASD requests comment on whether the proposed rule should apply to these other entities.

Endnotes

- 1 See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or email addresses, will not be edited from submissions. Submit only information you wish to make publicly available.
- 2 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and the rules thereunder.
- 3 *E.g., Franklin Ross, Inc.*, NASD No. E072004001501 (settled April 2006), summarized in *NASD NTM Disciplinary Actions*, p. 1 (May 2006); *Capital Growth Financial, LLC*, NASD No. E072003099001 (settled February 2006), summarized in *NASD NTM Disciplinary Actions*, p. 1 (April 2006); *Craig & Associates*, NASD No. E3B2003026801 (settled August 2005), summarized in *NASD NTM Disciplinary Actions*, p. D6 (October 2005); *Online Brokerage Services, Inc.*, NASD No. C8A050021 (settled March 2005), summarized in *NASD NTM Disciplinary Actions*, p. D5 (May 2005); *IAR Securities/Legend Merchant Group*, NASD No. C10030058 (settled July 2004), summarized in *NASD NTM Disciplinary Actions*, p. D1 (July 2004); *Shelman Securities Corp.*, NASD No. C06030013 (settled December 2003), summarized in *NASD NTM Disciplinary Actions*, p. D1 (February 2004); *Neil Brooks*, NASD No. C06030009 (settled June 2003), summarized in NASD Press Release, NASD Files Three Enforcement Actions for Fraudulent Hedge Fund Offerings (August 18, 2003); *Dep't of Enforcement v. L.H. Ross & Co., Inc.*, Complaint No. CAF040056 (Hearing Panel decision January 15, 2005); *Dep't of Enforcement v. Win Capital Corp.*, Complaint No. CLI030013 (Hearing Panel decision August 6, 2004). In addition to these cases, NASD has numerous ongoing investigations involving MPOs.
- 4 SEC Regulation D does not require disclosure documents to be prepared or provided in offerings made solely to accredited investors. However, in some MPOs, NASD found that no PPM was prepared even though sales were made to persons who are not accredited investors. In others, a PPM was prepared, but it was not provided to certain investors, including those that were unaccredited.
- 5 In 1982, the SEC adopted Regulation D as a safe harbor from the registration requirements of the Securities Act. NASD members and their control entities raise capital under Regulation D in MPOs to finance their operations or to pool customer funds to create investment vehicles that provide revenue to the members. MPOs also can be offered privately pursuant to other available exemptions from registration under the Securities Act, such as Section 4(2).
- 6 NASD Conduct Rules 2710, 2720 and 2810 only govern member participation in *public* offerings of securities.
- 7 For purposes of quantifying the percent of profits or losses in a partnership attributable to the general partner, NASD will not include performance and management fees earned by the general partner. However, if such 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.
- 8 NASD would not issue a "no objections opinion." However, if NASD subsequently determined that disclosures in the PPM appeared to be incomplete, inaccurate or misleading, NASD could make further inquiries. The filing requirement also could facilitate the creation of a database on MPO activity that would be used in connection with the member examination process.

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- 9 The MPO sweep revealed that in some cases, offering proceeds were used for individual bonuses, sales contest awards, commissions in excess of 20 percent, or other undisclosed compensation.
- 10 Members would remain subject to other NASD rules that govern a member's participation in the offer and sale of a security, including Rules 2110, 2120 and Rule 2310. Members also are subject to the anti-fraud provisions of the Securities Act, including Sections 10(b), 11, 12 and 17.
- 11 Rule 2720 presumes control when there is beneficial ownership of 10 percent of an entity's outstanding voting securities if the entity is a corporation, or in the case of a partnership, more than a 10 percent interest in its distributable profits or losses. See Rule 2720(b)(1)(B).

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ATTACHMENT A

Proposed Rule Text

2721. Private Placements of Securities Issued by Members

(a) Definitions

(1) Member Private Offering or MPO

A private placement of unregistered securities issued by a member or a control entity in a transaction exempt from registration under the Securities Act and the filing requirements under Rules 2710, 2720 and 2810.

(2) Control Entity

Any entity that controls or is under common control with a member, or that is controlled by a member or its associated persons. The term "control" for purposes of this Rule means beneficial ownership of more than 50 percent of the outstanding voting securities of a corporation, or the right to more than 50 percent of the distributable profits or losses of a partnership.

(b) Filing Requirements

No member or associated person may offer or sell any security in a Member Private Offering unless the private placement memorandum has been filed with the Corporate Financing Department at or prior to the first time the private placement memorandum is provided to any investor. An amendment or exhibit to the private placement memorandum also must be filed with the Corporate Financing Department within ten days of being provided to any investor.

(c) Disclosure Requirements

No member or associated person may participate in a Member Private Offering unless a private placement memorandum is provided to each investor and the private placement memorandum discloses:

- (1) 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.

(d) Use of Offering Proceeds

At least 85 percent of the offering proceeds raised in a Member Private Offering must be used for the business purpose identified in the "intended use of the offering proceeds" disclosure in the private placement memorandum.

(e) Exemptions

The following Member Private Offerings are exempt from the requirements of this Rule:

- (1) offerings sold solely to:
 - (A) institutional accounts (as defined in NASD Rule 3110(c)(4));
 - (B) qualified purchasers (as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940);
 - (C) qualified institutional buyers (as defined in SEC Rule 144A);
 - (D) investment companies (as defined in Rule SEC Rule 144A);
 - (E) an entity composed exclusively of qualified institutional buyers (as defined in SEC Rule 144A); and
 - (F) banks (as defined in SEC Rule 144A).
- (2) offerings made pursuant to SEC Rule 144A or SEC Regulation S;
- (3) offerings in which a member acts solely in a wholesaling capacity and sells unregistered securities to other unaffiliated broker-dealers;
- (4) offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act;
- (5) offerings of subordinated loans under SEC Rule 15c3-1, Appendix D;
- (6) offerings of unregistered investment grade rated debt;
- (7) offerings to employees and affiliates of the issuer; and
- (8) offerings of securities issued in stock splits and restructuring transactions.

(f) Application for Exemption

Pursuant to the Rule 9600 Series, NASD may exempt a member or person associated with a member from the provisions of this Rule for good cause shown.