The Bond Market Association
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Securities Industry Association
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November 1, 2006

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

Re: NASD Notice to Members 06-52
Proposed Amendments to Conduct Rule 2720

Dear Ms. Sweeney:

The Bond Market Association and the Securities Industry Association (the "Associations")[1] appreciate this opportunity to comment on the above-referenced proposed rule changes filed by NASD. The proposed rule changes (the "Proposal")[2] would substantially modify Conduct Rule 2720 (the "Rule").

I. Introduction

The Rule affects the manner in which NASD members may participate in the public distribution[3] of securities in specific circumstances. The Rule currently

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[1] On November 1, 2006, the Bond Market Association and the Securities Industry Association consolidated into a new trade organization, the Securities Industry and Financial Markets Association. The Securities Industry and Financial Markets Association bring together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] The Proposal is the subject of NASD Notice to Members 06-52 (the "Notice").

[3] The Associations note that the Proposal often refers to "offerings" rather than "public offerings" of securities. The Associations also note that both the Rule and the Proposal apply only to public offerings of securities. For the sake of clarity, the Associations believe that references to "offerings" of securities, as applicable, within the Rule should refer specifically to "public offerings" in each case.

concentrates on three circumstances: (i) self-underwriting of NASD members' own securities, (ii) acting as participant in the public distribution of securities of an affiliate, and (iii) acting as participant in the public distribution of securities of an issuer with which the prospective distribution participant has a conflict of interest. The Proposal also relates to NASD Conduct Rule 2710(h), which requires specified compliance in the event that 10% or more of the proceeds of a public offering (not including underwriting or similar compensation) are intended to be paid to NASD members participating in the distribution, or their affiliates.

The Proposal represents a substantial change to the Rule, combining these circumstances into a single defined concept, "conflict of interest," and changing the required compliance for conflicts of interest as they arise.

The Rule's purpose is to ensure that certain aspects of the public offering process, and in particular the pricing of securities, are regulated where circumstances create conflicts of interest that may affect the pricing of securities. The rule generally requires disclosure of such conflicts of interest, as well as concurrence as to pricing and other support through the appointment of a "qualified independent underwriter" ("QIU"), the existence of a "bona fide independent market" for the equity security being issued, or the investment grade rating of the debt security being issued.

Rule 2710, which is also affected by the Proposal, is an issuer protection rule commonly known as the "Corporate Financing Rule." The Corporate Financing Rule requires NASD review of information relating to the underwriting terms and conditions of certain public offerings, including all offerings subject to the Rule.

Generally, the Associations applaud the Proposal, because the Proposal:

- Consolidates a number of previously separate regulatory concepts, thus simplifying both the drafting of the Rule and the number of different applicable provisions that affect compliance with NASD rules during the underwriting process;
- Modernizes aspects of the Rule relating to exemption from filing and review of offerings of securities by issuers that are mature and known to the marketplace, and where pricing is supported by factors that mitigate any apparent conflict of interest; and
- Simplifies the compliance required by NASD members acting as QIU.

The Associations have a number of comments relating to the Proposal. In general, the Associations are of the view that the Proposal should:

- Simplify the required compliance in circumstances where conflicts of interest are mitigated by existing factors relating to the issuer of the securities;
- Further coordinate the Rule with the Corporate Financing Rule in order to maximize the efficiency of NASD regulation;

- Ensure that the incorporation of (current) Corporate Financing Rule 2710(h) into the Rule does not create an unnecessary regulatory burden; and
- Ensure that the Rule properly takes into account the global and diverse nature of modern financial institutions, and creates compliance systems flexible enough to take into account apparent conflicts of interest that relate to affiliates of NASD members (or the investments of such affiliates) over which the prospective participating NASD member has no control.

These comments are described more fully below. In addition, certain specific comments relating to interpretation or drafting of the Proposal are also included below. In general, the comments below follow the order of the Proposal's provisions, as found in the Notice.

II. Requirements for Participation in Certain Public Offerings

Under the Proposal, no NASD member that has a conflict of interest may participate in a public offering unless the offering complies with one of proposed provisions (a)(1) or (a)(2).

A. Proposed section 2720(a)(1) should be expanded to include existing exemptions under the Rule, and to exempt offerings of securities where conflicts of interest are mitigated.

Proposed section (a)(1) provides three circumstances in which disclosure is the applicable compliance requirement (*i.e.*, no QIU is required), and, by operation of proposed section (d), in which no review is required by NASD under the Corporate Financing Rule notwithstanding the existence of the conflict of interest.

The Associations believe that proposed section (a)(1) should be expanded to include additional circumstances where conflicts of interest are mitigated by certain factors. Specifically, the Associations believe that proposed section (a)(1) should exempt offerings of securities:

- By well-known seasoned issuers. The Associations are particularly concerned that the Proposal may create a different result than the proposed changes to Corporate Financing Rule 2710, which seek to eliminate all filing requirements for so-called "WKSIs." For example, a WKSI issuer of non-investment grade debt may find itself subject to the filing requirements of the Rule 2720 under the current Proposal when it would otherwise be exempt under the proposed changes to Rule 2710.[4]

[4] The Associations are concerned that any application of the Rule to well-known seasoned issuers might unnecessarily slow the offering process in a manner inconsistent with the SEC's guidance and direction.

- Currently exempted by Rule 2710(b)(7)(A), because the investment grade rating of an issuer's debt signals that the issuer is sophisticated, seasoned, and able to protect its interests in an offering. Further, the existence of an investment grade rating in respect of existing securities shapes the pricing of additional debt securities and thus further mitigates apparent conflicts of interest.[5]
- Currently exempted by Rule 2720(a)(3), which exempts reorganizations, and merger and acquisition transactions, as no reason exists or has been given for the expansion of the Rule to such currently excluded offerings. In addition, the Associations believe that the existing exclusion from exemption found at Rule 2720(a)(3)(B) is not warranted because the corporate governance concerns of the Rule have been made obsolete (and consequently have been eliminated in the Proposal).
- By a governmental entity, or guaranteed by a governmental entity, because the existence of a conflict of interest cannot be expected to affect pricing of the sovereign offering, or to result in abuse of the sovereign issuer. The Associations note that exemption of most governmental offerings from review is one of NASD's proposed changes to the Corporate Financing Rule, and as such exemption of such offerings under proposed provision (a)(1) of the Rule will ensure consistency between the Rule and the Corporate Financing Rule.
- Currently exempted by Rule 2710(h)(3)(B) and 2720(b)(7)(D)(i), because the pricing for offerings exempted by Section 3(a)(4) is unlikely to be subject to unusual behavior as a result of the conflict of interest (*e.g.*, offerings by a person organized and operated exclusively for enumerated purposes and not for pecuniary profit), and because NASD has sufficient enforcement and investigative authority to prevent and remedy abuse.
- Currently exempted by other provisions of Rule 2720(b)(7)(D) inasmuch as those provisions are not fully incorporated into proposed section (f)(4), and in particular proposed section (f)(4)(c). The Associations believe that these are valuable and reasonable exclusions from the definition of "conflict of interest" generally, and in particular see no reason to withdraw exclusions to the definition of "conflict of interest" currently found in the Rule.[6]

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[5] The Proposal would, among other things, exempt from the filing and QIU requirements of the Rule offerings of investment grade securities, while Rule 2710(b)(7)(A) currently exempts offerings of issuers who have certain outstanding investment grade securities from the filing requirements of the Corporate Financing Rule, except when such offerings are subject to the Rule.

[6] Under the Proposal, exemptions found in current Rule 2720(b)(7)(D) are incorporated only to the extent that the provision of the conflicts of interest definition under consideration relies upon the definition of "entity." For example, under the existing Rule, real estate investment trusts would not be considered as "entities" that could have conflicts of interest. However, under the Proposal, a real estate investment trust may be an issuer which intends to pay proceeds from an offering to a NASD member, thus giving rise to a

- Conducted pursuant to the multi-jurisdictional disclosure system, because such offerings are already subject to prominent disclosure and conflict of interest regulation under the Canadian system.

B. Additional comments in respect of the proposed text of section 2720(a)(1).

In addition, the Associations have the following three comments in respect of proposed section (a)(1).

First, the provision should recognize that many offerings are managed by multiple book-running managers, each of which will conduct diligence they consider reasonable in respect of the offering. This can be achieved by changing the clause "the book-running lead-manager" to "any book-running manager, including any co- or joint book-running manager."

Second, references to the securities being offered found in proposed sections (a)(1)(B) and (a)(1)(C) should be modified to refer to the issuer of the securities. In making this recommendation, the Associations seek to ensure that the Proposal is precisely drafted to achieve its goal of identifying conflicts among market participants. That change is consistent with both the proposed definition of "bona fide public market," which properly focuses on the ADTV of the securities of the issuer, and not on the specific security in question, and also the issuer-based exemption found in Corporate Financing Rule 2710(b)(7)(A).

Third, NASD should ensure that a NASD member acting as lead manager of a "best efforts" offering qualifies for the treatment afforded by proposed section (a)(1)(A). Such NASD members are often referred to as other than book-running lead-manager.

C. The proposed requirement that a QIU participate in "usual standard" of due diligence raises a legal defense to a regulatory requirement and opens questions as to what constitutes "usual" diligence.

Proposed section (a)(2) permits NASD members subject to a conflict of interest to participate in a public offering of securities where the offering is one in which a QIU participates.

In this regard, the Associations recommend the modification of the references to "due diligence" and to "usual standards of due diligence" found in proposed section (a)(2). While this text is present in the existing Rule, the Associations view it as inappropriate because due diligence is a defense that can be asserted by underwriters in relation to claims that an omission or misstatement was made in respect of a securities offering. Creating a requirement that the QIU has exercised usual standards of due diligence raises the due diligence defense to the level of a regulatory requirement.

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conflict of interest under the Proposal. This would be an expansion of existing regulation, as the scenario described would currently be excluded by operation of 2710(h)(3).

Though it is likely that any NASD member acting as QIU will conduct a diligence investigation prior to acting, the reference to "usual standards" of diligence increases the possibility that the QIU will be held to an unwarranted and/or excessive standard.

The reference to "usual standards" of due diligence suggests that such standards exist. In reality, standards of diligence vary across NASD member firms and according to the nature of the issuer and the public offering in question. Diligence is a defense and should be judged in that context. The reference to "usual standards" of due diligence invites judgment of the diligence conducted in order to determine compliance with the Rule. The standards of diligence should be left to the QIU, which remains responsible for that standard.

The Associations recommend that references to "usual standards of due diligence" and "due diligence" in proposed sections (a)(2)(A) and (a)(2)(B)(iii) be replaced with language such as "conducting a reasonable investigation subject to standards customary to public offerings similar to the offering giving rise to the conflict of interest" in order to recognize the nature of diligence in the offering process.

D. Offerings in which a QIU participates should be exempt from filing requirements, as are those described by proposed Rule (a)(1).

The Associations believe that the participation of a QIU in an offering creates protection for the issuer and for investors so that the apparent conflict of interest is mitigated. The QIU has both reputational and liability concerns, and the prominent disclosure required by the Proposal ensures that investors will be aware of any conflict of interest. This is particularly the case for offerings in which proceeds are being directed to a participating member. The Associations note that such offerings are not subject to NASD filing and review at present, and know of no abuses that would suggest that filing and review is required where disclosure of the intended use of proceeds is contained in the offering document, and, if required, a QIU participates in the offering. In addition, NASD's resources are scarce, and NASD has enforcement authority with which it may investigate and take action.[7] Consequently, the Associations recommend that the participation of a QIU serve to exempt an offering from filing and review with the NASD.

III. Application of Rule 2710

The Associations are concerned that the language of Rule 2710(b)(7), namely that any offering "subject to" the Rule is not eligible for the exemptions from filing and review found in that provision, does not clearly exempt those offerings which are intended to be exempted from filing and review by virtue of proposed section (a)(1). The Associations recommend the amendment of Rule 2710(b)(7) – and the deletion of Rule 2710(h) – in order to ensure operation of the Proposal as intended.

[7] In this regard, the Associations note that offerings exempt from filing pursuant to NASD Rule 2710(b)(7) are not exempt from the substantive provisions of the Corporate Financing Rule, or where applicable, the Rule.

IV. Definition of "Bona Fide Public Market"

The Associations believe that the proposed definition of "bona fide public market" is an improvement over the current definition of "bona fide independent market" inasmuch as it is easier to ascertain compliance with the applicable criteria. The Associations request, however, that NASD clarify the drafting of the definition to state that it is the issuer, and not a particular security, that has a bona fide public market. This is consistent with the Proposal's focus on conflicts of interest as they exist between issuers and NASD-member broker-dealers that are publicly distributing the issuer's securities. Specifically, the Associations request clarification that:

- The phrase "whose securities are traded on a […] exchange with an ADTV […] of at least $1 million" refers to all listed securities of the issuer; and
- The phrase "provided that the issuer's common equity securities have a public float of at least $150 million" refers to all listed common equity of the issuer (*e.g.*, inclusive of voting and non-voting common equity).

The Associations believe that the bona fide public market definition should include equity securities of non-U.S. issuers that are listed on a non-U.S. exchange deemed comparable to a national securities exchange. At a minimum, the Associations believe that those markets enumerated as "designated offshore securities markets" for purposes of Regulation S should be included for purposes of determining the existence of a bona fide public market, along with a comparable ADTV standard. The Associations note that such markets are accepted under the Corporate Financing Rule for purposes of determining securities that are excluded from consideration as an "item of value." The Associations also believe that NASD should actively consider the case-by-case requests of member firms in respect of additional markets.

V. Definition of "Conflicts of Interest"

The definition of "conflict of interest" is at the heart of the Proposal. The Associations believe that both the Notice and the Proposal have properly refocused the definition of conflict of interest on those conflicts of interest that exist between NASD members and the issuer of the securities in the public offering under review.

As a preliminary matter, the Associations note that no conflict of interest should be presented as a consequence of ownership of any non-voting security, including, but not limited to non-voting preferred securities as well as subordinated debt.[8]

[8] Although the definition of "control" under the proposed Rule 2720(f)(5) excludes ownership of non-voting securities, including non-voting preferred securities, the Notice to Members states that "[t]he proposed amendments would eliminate ownership of subordinated debt as a basis for a conflict of interest." This suggests that more than 10% of an issuer's preferred stock, including non-voting preferred securities, would continue to be a conflict of interest.

A. The inclusion of offerings in which proceeds are intended to be paid to NASD members should be modified.

One of the key modifications to the Rule proposed by the Proposal is the inclusion of offerings in which proceeds are intended to be paid to NASD members under the definition of "conflict of interest." One reason that a high degree of care should be used in modifying the Corporate Financing Rule and the Rule in this manner is that Corporate Financing Rule 2710(h) is a provision focused on the possible abuse of unaffiliated issuers in respect of the use of offering proceeds and in respect of market practices, whereas other provisions of the "conflict of interest" definition are specific to the relationship between the issuer and the participating member. With this in mind, the Associations have the following four comments to proposed section (f)(4)(C):

First, the Associations request a revision of the Proposal to confirm that the percentage of the offering proceeds triggering the new provision is a percentage of net offering proceeds, as is currently the case with Corporate Financing Rule 2710(h).

Second, the NASD should not, through proposed section (f)(4)(C), include those offerings where participating NASD members or their affiliates are engaged, on arms length terms, to use the proceeds for the benefit of the issuer. Similarly, proposed section (f)(4)(C) should exclude offerings of securities in connection with forward sale contracts in which the underwriters or their affiliates use the proceeds received from short sales made in connection with the offering in their hedging of their respective obligations to purchase securities at a later time under the forward contract from the issuer. Likewise, proposed section (f)(4)(C) should also exclude other offerings of securities where the issuer will use proceeds of the offering to enter into an arms length derivative or other hedging transaction (such as a hedge to the security being issued or a derivative that hedges the economic risk to the issuer) with an underwriter or its affiliates either contemporaneously with or shortly following such offering. Such situations are not subject to conflicting interests that can result in behavior such as mispricing of the securities being distributed because such instruments are typically priced as a function of the market price, making the member/counterparty indifferent to varying price levels.

Third, the Associations believe that participating members that are not involved in pricing the securities being publicly offered should not trigger the application of proposed section (f)(4)(C). The term "participation in a public offering" is very broadly interpreted by NASD, and can include underwriters, selling agents, or selected dealers, whose role in a public offering can be very limited. In addition, the term "participation in a public offering" has not been defined by NASD to consider specifically the time at which the NASD member commences participation, and, in the case of selected dealers, such participation may not arise until after the offering has been priced.

Fourth, the Associations believe that, if proceeds directed to a member is to be included within the Rule at all, the proposed 5% threshold is too low. The Associations believe that the current 10% threshold, applied on an individual basis (as proposed in the Proposal), is an appropriate standard, identifying those offerings in which a specific

participating NASD member is intended to receive a substantial percentage of the proceeds, thereby raising the issuer protection concerns of the Corporate Financing Rule. In addition, raising the threshold from 5% to a more appropriate standard, such as 10%, will mitigate the fact that proposed section (f)(4)(C) may create a filing requirement where, currently, none exists. The Associations are unaware of abuses that justify the creation of a filing requirement for circumstances currently covered by Section 2710(h) and recommend that any changes to the Rule be carefully tailored not to expand the Rule to offerings for which disclosure (and, as required, the participation of a QIU) has proven to be an appropriate remedy. In addition, the Associations reiterate their earlier comment that offerings in which proceeds are directed to a member be excluded from NASD filing and review.

B. Proposed section (f)(4)(D)(iii) should exclude reorganizations.

Proposed section (f)(4)(D)(iii) would define conflict of interest to include participation in a public offering if, as a result of the public offering and any transactions contemplated at the time of the public offering, the issuer will become a member or form a broker-dealer subsidiary. The Associations are concerned that this clause may cause certain reorganizations to fall under the definition of "conflict of interest" notwithstanding that no change of significance to investors or the NASD is taking place in connection with the public offering. Pursuant to Section II.A above, the Associations have already recommended the retention of current Rule 2720(a)(3). The Associations also recommend that the provision be clarified to exclude reorganizations and restructurings in which no material change to the ownership of the issuer or the participating member is taking place. Since the corporate governance concerns of the Rule have been made obsolete (and consequently have been eliminated in the Proposal), reorganization, restructuring and merger transactions should no longer create a conflict of interest under the Rule. The Associations note that NASD Rule 1017 and/or NYSE Rule 321 will, in many cases, apply to such circumstances, further mitigating any concern that NASD may have in respect of reorganization transactions.

C. The "conflict of interest" definition should be structured as specific circumstances rather than as participation in certain offerings.

In this regard, the Associations believe that "conflict of interest" should be defined as the occurrence of specific circumstances, rather than "a member's participation in a public offering if any of the following applies[.]" The Associations therefore recommend that "conflict of interest" be "deemed to exist when" any of the enumerated clauses in (f)(4)(A) through (D) of the Rule occur. This formulation, which is the current formulation found in the Rule, is superior to the Proposal because it permits the member to argue in appropriate circumstances that no conflict of interest should be deemed to exist, and because it enumerates circumstances that give rise to deemed conflicts of interest rather than defining conflict of interest to be "a member's participation" in certain offerings.

D. Transactions in which a NASD member becomes a public company should not themselves create a conflict of interest.

The Proposal's definition of "conflict of interest" includes any transaction in which a member becomes a public company. The Associations believe that where a member participates in its own initial public offering, such transaction will be otherwise subject to the definition of "conflict of interest," and will always be subject to review based on the text of Corporate Financing Rule 2710(b)(7), which requires the review of the initial public offering of any issuer. Under the existing Rule, the regulatory purpose served by inclusion of transactions in which a NASD member becomes a public company (absent that member's participation as an underwriter) is corporate governance. Because the Proposal eliminates corporate governance as a regulatory objective of the Rule, the rationale for inclusion of such transactions is similarly eliminated. Therefore, a transaction by which a member becomes a public company should not, in the absence of its participation as an underwriter, be subject to the requirements of the Rule.

VI. Definition of "Qualified Independent Underwriter"

A. Suggestions in respect of the proposed QIU definition

The Associations commend NASD for seeking to simplify the QIU definition. However, the Associations believe that certain improvements to the definition can be made. Specifically, the Associations believe that:

- Ownership of 5% or more of the issuer's securities is too low a threshold in the case of issuers that are not under the actual control of the member or its parent organization. This is particularly the case given that many NASD members are part of large, global financial institutions that regularly make proprietary investments through entities (or divisions) that are separated from the underwriting function of member firms by appropriate ethical and physical walls. The Associations recommend that the applicable percentage at proposed section (f)(8)(B) be set at 10%.[9]
- Further, the Associations suggest that the standard described in proposed section (f)(8)(B) exclude those affiliates and natural persons that can be disaggregated from the member firm for purposes of filings made under Sections 13 and 16 of the Securities Exchange Act.
- The term "5% of the class of securities that would give rise to a conflict of interest" found at proposed section (f)(8)(B) improperly suggests that the member's conflict of interest is with the issuer's securities, rather than with the issuer. The Associations recommend that text be replaced with 5% of the issuer's "total equity securities,"

[9] The Association notes that ownership of non-voting preferred securities should not be considered in determining eligibility of a potential QIU.

drawing on the Corporate Financing Rule's definition of "total equity securities."

- Proposed section (f)(8)(D) should permit a prospective QIU to demonstrate on a case-by-case basis that it has acquired experience within the previous years involving the pricing and due diligence functions comparable to that of a manager or co-manager of public offerings of securities in the applicable amounts. This is particularly the case because small or new member firms may be comprised of persons who have substantial and demonstrable experience with underwriting, but may not be able to meet the technical requirements proposed by sections (f)(8)(D)(i) and (ii).

B. Changes are required to NASD procedures in respect of offerings in which QIUs are participating.

At present, NASD member broker-dealers wishing to act as QIU must qualify on an annual basis. This often leads to a prospective QIU finding that its annual qualification has lapsed and that it must hurriedly assemble the required information close in time to the pricing of an offering in order to act—and to permit the offering to move forward. The Associations recommend the elimination of the annual QIU qualification process. To its credit, the Proposal sets out objective criteria, and NASD members should be able to act as QIU – assuming the liability therefor – on the basis of their determination that they meet the required standard. NASD has examination, investigative and enforcement authority to review any such participation, which participation is disclosed to NASD through the COBRADesk system.

In addition, the Associations are concerned that the application of the QIU definition is complicated by the NASD's "COBRADesk" software, which requires that certain information – amounting to confirmation of the QIU's qualification – must be entered in respect of each offering in which a QIU is acting. When a participating member acts as QIU, that member represents by way of prospectus disclosure that it is qualified to act. NASD has examination, investigative and enforcement authority to review this representation, and should not require proof in each case as a condition to receiving the "no objections" opinion.

The Associations request that this detailed information be removed from COBRADesk as required information.

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The Associations thank NASD for affording them the opportunity to comment on the Proposal. If you have any questions concerning these comments, or would like to discuss

our comments further, please feel free to contact Mary Kuan of The Bond Market Association at 646-637-9220 or mkuan@bondmarkets.com or Amal Aly of the Securities Industry Association at 212-618-0568 or aaly@sia.com.

Sincerely,

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Vice President and
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Amal Aly
Vice President and Associate
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cc: NASD
Mr. Joseph E. Price, Director, Corporate Financing Department
Mr. Gary Goldsholle, NASD Associate Vice President and Associate General Counsel