

June 9, 2000

Jonathan Katz, Secretary
Securities & Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: SR-NASD-00-04; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to its Corporate Financing Rule.

Dear Mr. Katz,

The Securities Industry Association (“SIA”)¹ appreciates the opportunity to express its views on the proposed amendments to the NASD’s Corporation Financing Rule (Rule 2710).

The NASD Corporation Finance Rule (“the Rule”) is intended to ensure that the underwriting terms and arrangements of a public offering in which an NASD member participates are fair and reasonable. SIA commends the NASD on its efforts to bring clarity and consistency to the underwriting compensation review process. We strongly agree that the rule should accommodate the legitimate advisory and investing activities of NASD members while continuing to protect investors from unreasonable underwriting activities. We believe, however, that these goals can be achieved through a more narrowly tailored rule.

SIA believes that the policy concerns underlying Rule 2710 are not present in the context of all offerings of securities covered by the rule and that there should be an exemption from the rule for larger transactions. This letter cites vigorous competition among underwriters for issuance business and the difficulty of “retrofitting” a prior financing into one of the rule’s safe harbors as reasons for broadening the exemptions from the Rule. SIA also offers specific suggestions for improving the safe harbors proposed by the NASD to make them more harmonious with actual finance practice.

¹ The Securities Industry Association brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. The industry generates more than \$300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals.

I. EXEMPTION REQUEST

SIA believes that the concern the rule was designed to address – ensuring fair and reasonable underwriting terms – is simply not at issue in many equity offerings currently covered by the Rule. There is much more transparency in the financing of corporations at all stages than there was forty years ago when the first Corporation Finance rule was promulgated. There are, for example, many media outlets that cover early stage private companies and provide comprehensive information about individual venture capital transactions. Moreover, much of the improper activity of that time period has been attributed to the absence of a free-riding and withholding rule which came into being around the same time as this rule. Therefore, it is appropriate to reexamine the extent of the problem sought to be addressed and to determine whether the burdens of the compliance are appropriately directed.

Rule 2710 already exempts some types of offerings, presumably because the terms of the underwriting agreement are assumed to be fair and reasonable. For example, it is understood that the reason why corporations with outstanding investment grade securities currently have an exemption from filing with the NASD is because “corporations of this caliber are assumed to have the economic clout to assure that the underwriting spread will be reasonable. The underwriters will be the major investment banking houses that do not request or accept warrants or cheap stock in connection with public offerings.”²

Also, secondary offerings that qualify as actively traded securities are exempt from the proposed lock-up provision of the rule because they “generally trade on exchanges or other organized markets with high levels of transparency and surveillance.”³

These precedents should allow the NASD to assume fair and reasonable underwriting terms in the case of offerings of larger well-financed companies coming to the capital markets for the first time and companies that have met the qualifications for exchange listing. Companies of this caliber find underwriters competing intensely for the opportunity to take them public. Underwriters cannot extract and issuers need not offer any inducement in the form of special or excessive compensation in order to obtain underwriting services. As one commenter has noted, “review by the Corporation Financing Department is a matter of concern principally for first time issuers and companies whose circumstances compel them to deal with the more flamboyant underwriters.”⁴

² Charles J. Johnson, Jr. & Joseph McLaughlin, *Corporate Finance and the Securities Laws*, p.327 (2nd ed. 1997)

³ SEC Release No. 34-42619, 65 Fed. Reg. 19418 (April 11, 2000)

⁴ Johnson & McLaughlin, *supra* note 2

The rule should recognize the leverage that issuers have by providing an exemption. One way to accomplish this is by expanding the exemption available under Rule 2710 (b)(7) to cover companies with exchange-listed securities or securities that are to be listed or quoted on the Nasdaq National Market System upon offering. Alternatively, the NASD could craft an exemption based on size – *i.e.*, expected market capitalization of \$75 million or over (the current standard for Form S-3 eligibility).

Another reason for considering an exemption for certain offerings is the savings to be realized in time and resources. Determining whether an item of value should be considered compensation and whether it falls under one of the safe harbors will still be an exceptionally difficult task given today's increasingly complex pre-IPO financing arrangements. Applying the detailed safe harbor criteria across a range of customized financing arrangements will consume a disproportionate amount of the NASD's resources and will result in many more honest misinterpretations of the rule. This, in turn, will prompt follow-up requests for review, further consuming NASD resources and hampering access to the capital markets for issuers.

The backwards-looking nature of the rule is also problematic from both compliance and capital-raising standpoints. At the time a venture capital commitment is under consideration, an IPO may or may not even be contemplated. Clearly, a lender in such a transaction is going to receive some consideration in exchange for the commitment of capital. Determining proper valuation at this stage is difficult enough. Trying to predict whether the consideration received is going to be deemed an item of value or qualify for safe harbor treatment under some rule that may or may not apply at some unknown point in the future is practically impossible. This makes it very difficult to plan for compliance and creates new hurdles to start-up financing for young companies.

The SEC seemed to acknowledge that the rule's principal focus should be on compensation received in connection with each *individual* transaction in the 1992 adopting release. There, the SEC wrote that the rule furthers investor protection by "ensuring that the percentage of investment capital going toward underwriter compensation remains fair and reasonable."⁵ We do not argue that prior arrangements should not be reviewed as part of the rule. Rather, we are suggesting that the Commission understood the difficulty of considering as a single transaction, financings that occur at different points in time and have unconnected underlying considerations.

Finally, in addition to rules like the Free Riding and Withholding rule, other provisions of this rule work to ensure that the terms of an underwriting are fair and reasonable. For example, the rule acknowledges the inverse relationship between the length of the lock-up period and the underwriters' incentive to profit from compensation.

⁵ Order Approving Proposed Rule Change Relating to Codifications of the Corporate Financing Interpretation, SEC Release No. 34-30587 (April 21, 1992)

Even if an underwriter has received securities from an issuer in connection with a previous financing arrangement, longer lock-up arrangements work to ensure that underwriters cannot actually profit until a public market has established the true value of an issuer's security. Thus, to the degree that part of the rule is premised on the belief that underwriters may be improperly incentivized to perform underwriting services for an "immature" company, the lock-up restrictions work to ensure that the public market has its say on what a company is worth before anyone associated with the underwriter can profit from an investment. The deterrent effect of the lock-up rule should allay any concern about widening the exemption.

II. COMMENTS ON THE PROPOSED SAFE HARBORS

SIA endorses the following comments that have been suggested by other commenters with respect to the language of the proposed safe harbors.

General Comments

The 90-day restriction is unnecessary for the first three safe harbors because of the other protections in place; there should be no time limit. For one, the other conditions ensure that this is not a method for disguising compensation. Second, the 90-day test is ineffective for the purpose of distinguishing acquisitions entered into for legitimate investment purposes from acquisitions intended to circumvent limits on underwriting compensation. Finally, there are legitimate financing and other purposes justifying the acquisitions described in the first three exceptions during the 90 days before filing. For example, some companies need to finance operations during the period leading up to the offering.

All time limits, including the 180-day limit for review of compensation, should be for the period preceding the *date of first distribution of the preliminary prospectus*, not the date of filing. The date of first offering is more predictable to underwriters, from the perspective of the pre-public offering investment, than the filing date.

Paragraph (c)(4)(B)(i) provides that securities of the issuer acquired by the underwriter and related persons will be considered to be received as of the date of closing of a private placement, if the securities were purchased from or received as compensation for the private placement. There may be circumstances in which the investor will be contractually obligated to make additional capital contributions at a later date if requested by the issuer, for which it will receive securities. This is really a variation of the preemptive right, but one in which the investor has no choice or a choice with serious negative consequences under the contract. Securities received as a result of such capital calls should be considered to have been received at the date of the closing of the original private placement, not the later capital call.

The definition of entity in 2710(c)(4)(D)(i)(a) permits a group of entities to be treated as a single entity if they are contractually obligated to make co-investments and have previously made at least one such investment. The requirement that the group have previously made at least one such investment appears to be a test of the bona fide nature of the group. However, the group should be permitted to demonstrate its bona fide identity as a group through the terms of its contractual obligations, the occurrence of subsequent investments or otherwise.

The definition of entity in 2710(c)(4)(D)(i)(b) recognizes as an entity a group that has filed a Schedule 13D or 13G that identifies the entities as members of the same group in connection with a previous investment. The definition should be expanded to include entities that would be 13D or 13G groups, but for the fact that they have not yet invested in a public company, or in an amount sufficient to trigger the filing requirement, and entities that intend to file such form in connection with the investment under consideration or a subsequent investment.

The rule should clarify that securities acquired in a transaction not involving or arranged by the issuer or its related persons should not be included in compensation.

Purchases and Loans by Certain Entities

This exception would be available for investment entities having at least \$25 million in capital contributions, in which at least the lesser of \$75 million or 75% of the capital has been committed by persons that are not underwriters or related persons, the entity is engaged primarily in the business of making investments in or loans to private or start-up companies or companies in the early process of developing products or services, or participating in leveraged buy-out transactions, and certain other requirements are met.

The “engaged primarily” provision is too narrow. It should be enough that the business of the fund is to make investments without specific categories of investment targets. The phrase “engaged primarily in the business” should be replaced by “organized for the purpose . . .” to allow for the possibility that the investing entity may not yet have commenced to be engaged in the business for which it was organized.

Proposed Rule 2710(c)(4)(E)(ii)(c) requires that an institutional investor be a member of the issuer’s board of directors. Amend to read “an institutional investor or a representative thereof is a member . . .”.

Proposed Rule 2710(c)(4)(E)(ii)(d) should be amended to read “the transaction was approved by [a majority of] the issuer’s board of directors and by the affirmative vote of a majority of institutional investors, or the designees of institutional investors, that are board members.” [Deletion in brackets.]

Investments in and Loans to Certain Issuers.

This exception focuses on the issuer, and the fact that the issuer is substantially owned and advised by institutional investors. As a preliminary matter we note that the “engaged primarily” and “separate entity” comments from the previous two sections of this letter apply here as well.

Under the proposed safe harbor, institutional investors must “beneficially own at least 33% of the total number of the issuer’s equity securities outstanding on a fully diluted basis.” In most other areas of securities law, however, the more meaningful test is control, rather than ownership. We suggest that institutional investors be required to control at least 25% of the vote of the issuer’s voting equity, whether by ownership or agreement.

In addition, we believe the calculation of “fully diluted” should not include out-of-the-money options or employee options. Also, percentages of voting right or ownership should be calculated as of a particular date, preferably the date of investment. Finally, the transaction must have been approved by a majority of the issuer’s board of

directors and “by the affirmative vote of institutional investors that are board members.” An affirmative vote of a majority of institutional investors, rather than all of them, should suffice.

The rule also provides that the total amount of securities received by all entities related to each member may not exceed 5% of the issuer’s equity securities. We read this as meaning that an entity related to Member A may own 5% of the issuer’s equity securities and an entity related to Member B may own an additional 5%. If institutional investors effectively control the decision to enter into the transaction, the issuer has the sophistication to decide whether an entity related to a member should receive a greater than 5% interest. A 10% interest should be permitted at the least instead of the 5% stated in the proposed rule.

Private Placements with Institutional Investors

Institutional investors must have purchased at least 51% of the total offering, for which the member received securities as fees or for consideration. We agree that the 51% standard is appropriate.

The “lead negotiator” test is subject to serious evidentiary problems. The test should be whether an institutional investor was significantly involved in negotiations with the issuer to establish the terms of the private placement.

Also, we would suggest deleting the limit on participation by underwriters to more than 20% of the offering, which would effectively raise it to the 49% not purchased by unaffiliated institutional investors.

Finally, we note that the “same price and terms” test does not work in cases where securities are received in whole or part as private placement fees.

Purchases under a Preemptive Right.

There is no reason to limit exercise of preemptive rights to those acquired more than 180 days before the filing; preemptive rights are inherently non-compensating. If a time limitation must be maintained, it should be shortened to 90 days, with no time limitation if the right was received in any transaction described in the first three safe harbor exceptions. The rule should clarify that this provision applies to all kinds of options, shareholder agreements and other contractual rights that are for the purpose of permitting a holder to maintain its relative position when there is a subsequent issuance of securities.

The rule states that the transaction must not “increase the purchaser’s percentage ownership of the same class of securities of the issuer” -- but there are circumstances in which some rights holders elect not to purchase, with the result that other rights holders who elect to purchase experience an increase in their percentage ownership. This doesn’t

render the exercise of rights by members “compensation.” Holders may not know at the time of exercise what the others are doing; furthermore, underwriters and related persons should be permitted to purchase additional shares made available by the decision of other rights holders not to exercise, provided that all rights holders have the same opportunity to purchase the additional shares. Finally, in the pre-IPO period, investors may, for a variety of reasons, hold different classes of convertible securities that convert automatically upon the IPO. Exercise of the conversion right may increase the percentage interest in that class, but not the member’s percentage interest overall.

In addition, investors may have share indemnity clauses with issuers pursuant to which the investor has the right to receive more shares if it appears later that the issuer calculated its capital tables incorrectly at the time of the investment. The investor would then have the right to receive new shares sufficient to increase its ownership to the percentage intended at the time of the original investment. Such technical corrections should be permitted at any time.

The Loss of Flexibility in Determinations.

Section (c)(4)(A) currently provides that all items of value received by the underwriter and related persons during the 12-month period preceding the filing of the registration statement “will be examined to determine whether such items of value are underwriting compensation.” Under the proposed rule, such items “will be considered to be underwriting compensation. . . .” It is not clear what the phrase “considered to be” is supposed to signify: “considered for determination as” or “deemed to be.” The drafters did not use the phrase “presumed to be.” Members of the current staff have stated that they did not intend to treat cash fees like securities, and have invited recommendations for changes to restore the distinction. To resolve these discrepancies, SIA believes the following changes should be made: First, the rule should explicitly distinguish between cash fees and other items of value. Second, although the proposed rule drops language from the requirement that an advisory relationship have been in existence for at least 12 months, the following should be restored: “. . . or that the relationship, if established subsequent to that time, was not entered into in connection with the offering, and that actual services have been or will be rendered which were not or will not be in connection with or related to the offering.” Third, all cash fees paid by entities with significant institutional investor involvement in their corporate governance, as described in Safe Harbor No. 2, should be deemed reasonable.

Lockup Period

The transfer restrictions on securities held by underwriters and related persons are significantly ameliorated by the exception for any class of securities qualifying as an “actively traded security” for purposes of SEC Regulation M. The Rule should clarify

that the underwriter and its affiliates and associated persons can sell in the offering. The restriction provision appears to apply to all equity securities of the issuer, and debt securities convertible into equity, owned by members at the time of the offering (Rule 2710(c)(7)(A)(i)). The restriction should only apply to securities deemed to be underwriter's compensation.

Post-Offering Review.

Proposed section (b)(6)(A)(v)(b), requiring filing of information about "any new arrangement that provides for the receipt of any additional item of value by the underwriter and related persons . . . within 90 days immediately following the effective date of the public offering" will be unduly burdensome for underwriters, and could be burdensome for the NASD as well. This provision would apply to items of value received by such related persons as underwriter's counsel and their immediate family. It is not realistic to expect a post-offering filing concerning an item of value received from the issuer by the spouse of an attorney employed by underwriter's counsel.

Busted-Deal Expenses.

The exclusion of expenses received in prior busted deals should be excluded for participating members as well as non-participants. This is an item that one would expect the issuer and its accountants to monitor closely, and does not appear to be a fruitful area for abuse by underwriters.

No Different Security

The proposal makes a cosmetic change in paragraph (c)(5)(A), which prohibits underwriters from receiving a security as underwriting compensation unless (i) that security is identical to the security offered to the public or to a security with a public market, or (ii) the arrangement is permitted by the NASD on good cause shown. However, the rule should take into account that there are many circumstances in which the underwriter and related persons should be permitted to have securities different from those held by anyone else. One such type of security would be convertible preferred stock that converts automatically upon the occurrence of the IPO.

Underwriting Compensation Consisting of Convertible Securities.

Rule 2710(c)(6)(viii)(b) treats as unreasonable compensation convertible securities that are exercisable or convertible at a price below either the public offering price of the underlying security or, if a bona fide independent market exists for the security or the underlying security, the market price at the time of receipt

This provision would bar an underwriter from purchasing convertible preferred securities even if it were willing to have the securities counted as underwriting compensation, because the securities underlying such preferred is likely to be priced at a

discount to the market price at the time of receipt. Convertible securities should be eligible to be treated as compensation if they were purchased at the same price paid by persons who are not members or related persons. The rule should clarify that the securities should not be convertible or exercisable at a price below *the lower of* the public offering price or the bona fide independent market price.

Where available (i.e., where there is sufficient market data regarding the underlying security), the appropriate price for purposes of valuing the security should be derived according to the Black-Scholes method, which is the universally accepted standard and properly accounts for the time value and other attributes of the security. In addition, the rule should view more favorably those warrants that are used as an adjunct to a debt financing. Adding a small equity component to a predominately debt arrangement is a common practice and does not raise the same concerns as financings in which warrants are the primary consideration.

Convertible Securities Other Than Warrants.

The Rule should distinguish between warrants and other types of convertible securities, such as convertible preferred stock and convertible debentures. One place this should be done is in paragraph (c)(5)(C), relating to valuation of options, warrants and convertible securities.

NEW CHANGES FOR CONSIDERATION

Although not the subject of proposed changes, SIA supports the following changes that have been suggested by other commenters.

Underwriters are required by subparagraph (b)(6)(A)(iii) to provide information about the association or affiliation with any member of any securityholder of 5% or more of any class of the issuer's securities and, in an IPO, of any security holder of the issuer. We propose two exemptions from this requirement: (1) Holders who acquired securities in the market and not from the issuer; and (2) Holders who acquired their securities as employee compensation, and do not own more than 1% of the securities of the same class.

Subparagraph (b)(7)(C)(i) exempts from filing offerings of securities registered with the SEC on registration statement Forms S-3 or F-3 "pursuant to the standards for those forms prior to October 21, 1992 and offered pursuant to SEC Rule 415." For ease of use, and to reduce unnecessary complexity and burden, the exemption should use the standards of the current Forms S-3 or F-3. In NASD Notice to Members 93-88, the NASD advised members that the exemption is not available for every qualified Form S-3 or F-3 filing for which the Rule 415 box had been checked, but only those for which there

is a genuine intention to make a delayed offering. Either the NASD's interpretation should be dropped, or the restriction should be stated explicitly in the Rule.

The formula in paragraph c(5)(C) for calculating the value of options, warrants or convertible securities does not work properly for many convertible securities. The NASD has, in the past, used a different method for calculating the value of, for example, convertible preferred stock. That different treatment should be made clear in the rule.

CONCLUSION

SIA believes that a revised corporation finance rule should reflect the reality that offerings of more substantial companies (e.g., those that meet the listing criteria for listing on an exchange or Nasdaq) do not raise concerns of unfair or unreasonable underwriting terms. We, therefore, urge the NASD and the SEC to consider amending the rule proposal to exempt certain offerings based on the value of the offering and exchange-traded status.

We believe that such an exemption will allow for thorough scrutiny of those offerings in which valid questions about the terms are most likely to be raised. An exemption will also promote efficiency in the capital-raising process by eliminating burdensome analysis and compilation requirements for certain offerings. SIA believes that the exemption, along with the recommended changes to the safe harbors, will produce a fair and efficient rule.

We appreciate the opportunity to comment on the proposal. If we can answer any questions or provide any further information, please contact Scott Kursman, Assistant General Counsel, at 212-618-0508.

Very truly yours,

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