

affiliated entity in a transaction that qualifies under Exception 1 or 2.

Exception 1 would apply the 25% threshold to all securities acquired during the Review Period, while Exception 2 would apply the 25% threshold to each acquisition of securities under that exception. Exception 1 is available for private placements and loans in which the only parties are the member's affiliate and the issuer. Accordingly, under Exception 1 a member's affiliate could structure a single financing as a series of transactions, each of which enable it to acquire no more than 25% of the issuer's total equity securities, but in combination would bring the affiliate's acquisitions well over the 25% level. By contrast, because the issuer's board of directors must approve each transaction in Exception 2, the amount of equity an issuer must provide as consideration for a particular mezzanine level financing would be certain and discrete. Consequently, Exception 1 would apply the 25% threshold to all securities acquired during the Review Period, while Exception 2 would apply the threshold on a transaction by transaction basis.

3. Entity Definition

A. New Partnerships. Exceptions 1 and 2 require entities to meet certain capital requirements and to be engaged in the business of making investments in or loans to other companies. Some commenters (Goldman and SIA) pointed out that many sponsors routinely carry out investment programs through a series of similar funds, although each individual fund may not meet the capital requirements in the exceptions. Other commenters (Fried Frank and Morgan) noted that a fund whose first investment is in the issuer would not be able to establish that it is engaged in the business of making investments and loans and thus it could not qualify for the exceptions, even though the fund is part of the investment program. These commenters recommended that NASD amend the Rule to treat as one entity all funds in a series of funds that are created to engage in the same business as prior funds in the series. The fund's capital and operating history thus would reflect those of the entire investment program for purposes of these exceptions. NASD does not support this change because it would introduce a highly subjective consideration (*i.e.*, whether a fund is part of an investment program) and would undermine the requirements that a qualifying entity demonstrate through its operating history that it is a bona fide

business, and that it alone meets the capital standards in the exception.

B. Group of Legal Persons. The definition of "entity" for purposes of Exceptions 1 and 2 includes "a group of legal persons" that are contractually obligated to make co-investments and have previously made at least one such investment. This provision permits a group of entities to combine their capital for purposes of the exceptions, and thus permits certain joint ventures and partnerships that would not otherwise be deemed entities to take advantage of the exceptions. Some commenters recommended that the definition be broader and include: (1) entities that have entered into a co-investment agreement, but have not yet made a co-investment; or (2) entities that do not have a co-investment agreement, but have made previous co-investments. Given the potential abuse that could arise from an illegitimate "grouping" of different entities, the proposed amendments preserve the requirements of both a co-investment history and an agreement.

C. Bank and Insurance Company Subsidiaries. The amended proposal added insurance companies and banks as qualifying entities in Exception 1. These entities are separately regulated and engage in a line of business that is distinct from the underwriting business. Commenters (Goldman and SIA) suggested that because the definition of "entity" includes a wholly owned subsidiary of a qualifying entity, subsidiaries of banks and insurance companies could enjoy a competitive advantage over broker/dealer subsidiaries if they were not required to meet the capitalization requirements. The proposed amendments clarify that in order to qualify for the exception, subsidiaries and affiliates of banks and insurance companies that are not themselves regulated banks and insurance companies must separately meet the requirements in Exception 1.

4. Institutional Investor Definition

Rule 2710(d)(4)(B) defines "institutional investor" for purposes of Exception 2 and the exception for "private placements with institutional investors" in paragraph (d)(5)(C) of Rule 2710 ("Exception 3"). Under the amended proposal, no participating member could have any equity interest or management responsibility in an entity intending to qualify as an "institutional investor." One commenter (Fried Frank) suggested that NASD amend the definition of "institutional investor" to permit some part of the equity interest in the entity to be held by participating members. The

commenter claims that the application is otherwise too restrictive, especially with regard to widely held institutional entities like publicly owned companies or mutual funds.

In response to the comment, NASD proposes to amend the definition of "institutional investor" to permit a member to qualify for the exceptions so long as it holds no more than 5% of a publicly owned entity and no more than 1% of a non-public entity, such as a hedge fund.

5. Private Placements With Institutional Investors

Exception 3 addresses private placements in which: (1) Institutional investors acquire at least 51% of the total offering of the issuer's securities; (2) an institutional investor is the lead negotiator or lead investor with the issuer and establishes the terms of the private placement; and (3) underwriters and related persons do not acquire more than 20% of the total offering. Some commenters (Fried Frank and Goldman) claimed that it should be presumed that institutional investors participated in the negotiation of the transaction to the extent necessary to protect their interests if they acquire as much as 51% of an offering of privately placed securities, and that the "lead negotiator" or "lead investor" requirement is unnecessary. Some commenters further asserted that the 20% limitation is too low.

NASD does not propose any change to these provisions. NASD agrees that institutional investors generally will protect their interests, but the requirement that an unaffiliated institutional investor lead the negotiation or serve as lead investor is designed to prevent the potential overreaching that could occur if a member that is underwriting an issuer's public offering or its affiliate sets the price and terms of a private placement undertaken during the Review Period. Because the 20% limitation permits participating members to acquire only a relatively small portion of the issuer's equity in a private placement compared to the unaffiliated institutional investors, NASD views the limitation as reasonably designed to minimize the incentive for participating members to pressure an issuer to conduct the private placement for the member's benefit.

6. Transactions Completed Before Filing

Exceptions 1–3 require that the issuer's securities be acquired in transactions that occur before the required filing date of the public offering. Commenters (Fried Frank, Merrill, Morgan) suggested that, in view