

of other safeguards built into the exceptions, this requirement should be deleted. Because an issuer's ability to negotiate at arm's length to raise capital directly from participating members may be particularly compromised once the members are actively engaged in soliciting investors in the public offering on behalf of the issuer, NASD believes it is appropriate to limit the exceptions to transactions that occur before filing a registration statement.

7. Preemptive Rights and Anti Dilution Rights

The exception for "acquisitions and conversions to prevent dilution" in paragraph (d)(5)(D) of Rule 2710 ("Exception 4") would not apply to any purchase or acquisition that increases the participating member's percentage ownership of the same generic class of securities of the issuer. Some commenters (Fried Frank, Goldman, Merrill, Morgan and SIA) suggested that NASD revise Exception 4 to permit passive increases in ownership that may be the result of another investor's failure to exercise its own preemptive rights. NASD has revised the proposed amendments to make this change.

8. Purchases Based on a Prior Investment History

The exception for "purchases based on a prior investment history" in paragraph (d)(5)(E) of Rule 2710 ("Exception 5") would provide an exception for acquisitions made in private placements during the Review Period by participating members in order to prevent dilution of a long-standing equity interest in the issuer. In order to be eligible for the exception, the investor must have made at least two prior purchases of the issuer's securities: One investment must have been made at least 24 calendar months before the required filing date and another more than 180 days before the required filing date. Commenters (Merrill, Morgan, SIA) suggested various shorter time period requirements for the initial acquisitions that would broaden the availability of the exception. NASD included Exception 5 in response to comments on the original proposal. The time periods correspond roughly to investments the Department has recognized in the course of its filing reviews as typical of early round financing by long-term venture capital investors in start-up companies in the late 1990's and 2000. According to NASD, the trend in the current market environment is that these time periods are being extended, not shortened. NASD believes that the proposed time periods are consistent with the purposes

of, and other protections in, Exception 5.

9. Financial Consulting and Advisory Arrangements

The exception for "financial consulting and advisory arrangements" in paragraph (d)(5)(F) of Rule 2710 ("Exception 6") addresses securities acquired in connection with financial consulting and advisory services. Codifying an exception for the receipt of securities as consideration for these services is in contrast to the proposed treatment of *cash* paid in connection with financial consulting and advisory services, which the Department proposed to continue to evaluate on a case-by-case basis to determine whether fees were in fact received in connection with underwriting services. A commenter (Fried Frank) suggested that the Department continue to evaluate whether the receipt of securities paid in connection with these services is underwriting compensation on a case-by-case basis, rather than relying solely on the proposed exception. NASD agrees that these arrangements are so fact specific that in many cases they do not fit well into the codified exception. Accordingly, the proposed amendments delete the codified exception. The Department will continue to analyze the receipt of both cash and securities in connection with financial consulting and advisory services based on the particular facts and circumstances in the arrangements.

10. Listed Securities

The amended proposal excluded from "items of value," listed securities of the issuer that are purchased in public market transactions. Commenters (Fried Frank, Goldman and SIA) suggest that the exclusion is too narrow and should instead extend to securities that are freely trading or acquired in transactions with persons unaffiliated with the issuer. Alternatively, one commenter (SIA) suggested that the definition of listed securities should be amended to specify the markets and exchanges on which securities may be listed to qualify for the exception. NASD has amended the Rule to specify eligible markets and exchanges. NASD believes that expanding the definition to include all freely trading securities or those acquired from unaffiliated persons would create unacceptable opportunities to evade the Rule and consequently NASD has not adopted the change.

11. When Securities Are Considered Received

The original and amended proposals provided that securities will be considered "received" as of the date of the closing of the private placement, not at the date a commitment letter is signed. One commenter (Fried Frank) suggested that one relevant date should be the date on which the buyer is unconditionally bound to purchase. The Department made several, ultimately unsuccessful attempts to review commitment letters and work with counsel to determine whether market-out and other termination clauses typically found in commitment letters render them binding contracts. The date of closing a private placement, when beneficial ownership is transferred, continues to be the best and most reliable indicator of when securities are received. Consequently, NASD has not made the recommended change.

12. Items of Value Received After Completion of an Offering

The amended proposal would require members to file information with the Department regarding the receipt of items of value by participating members during the 90 day period following the effective date of a registration statement. One commenter (Fried Frank) asserted that the provision would be too burdensome. NASD believes that the information is necessary to prevent fraudulent conduct and that the provision is a reasonable, narrowly defined mechanism to ensure that members comply with the Rule.

13. Non-Qualified Employee Benefit Plans

The amended proposal would have excluded from items of value securities acquired through certain plans that qualify under Section 401 of the Internal Revenue Code. Commenters (Fried Frank and Goldman) suggested that the provision be expanded to include securities received under non-qualified employee benefit plans. Under such a revision, the Department staff would be required to investigate and analyze who owns the assets, directs the trading and exercises control in the various non-qualified plans. NASD is not confident that the Department would always be provided with all necessary information on a timely basis from which it could conclude that a particular plan is not, for example, substantially an investment vehicle for employees in the investment banking or syndicate departments, or their relatives or nominees. Consequently, NASD has not made the recommended change.