

D. Exceptions to the General Rule

The proposed rule change provides five exceptions from the general rule that items of value received within 180 days of the required filing date of a registration statement or similar document will be considered to be underwriting compensation.

1. Purchases and Loans by Certain Entities

The first exception in subparagraph (d)(5)(A) is intended for acquisitions of the issuer's securities by certain entities that routinely make investments in or provide loans or credit facilities to other companies. The exception would be available to an entity that: (i) Manages capital contributions or commitments of \$100 million or more, at least \$75 million of which has been contributed or committed by persons that are not participating members; (ii) manages capital contributions or commitments of \$25 million or more, at least 75% of which has been contributed or committed by persons that are not participating members; (iii) is an insurance company as defined under Section 2(a)(13) of the Securities Act of 1933, or a foreign insurance company that has been given an exemption; or (iv) is a bank as defined in Section 3(a)(6) of the Act or is a foreign bank that has been granted an exemption. In addition to those requirements, the entity must: (i) Be a separate and distinct legal person from any member and not be registered as a broker-dealer; (ii) make investments or loans subject to the evaluation of individuals who have a contractual or fiduciary duty to select investments and loans based on risks and rewards, not on opportunities for the member to earn investment banking revenues; (iii) not participate directly in investment banking fees received by any participating member for underwriting public offerings; and (iv) have been primarily engaged in the business of making investments in or loans to other companies. Finally, all entities related to each member in acquisitions that qualify for this exemption cannot acquire more than 25% of the issuer's total equity securities during the review period.

The Commission believes that the proposed exceptions accommodate bona fide acquisitions by entities that regularly make venture capital investments. The Commission also believes that the limitations of the exception, such as the capital under management requirement, and the 25% acquisition limit, are reasonably designed to minimize the opportunity for abusive practices. The Commission

notes that the acquisition limitation was previously proposed to be 10% of the issuer's total securities. In response to the concerns of commenters, NASD has proposed to raise this limit to 25%. The Commission believes that the other conditions of the exception should help to ensure that the transactions are bona fide investments or loans, and the 25% limitation is sufficient as a reasonable additional protection against overreaching and unfair arrangements.

2. Investments in and Loans to Certain Issuers

The second exception in subparagraph (d)(5)(B) is intended for acquisitions of securities of issuers that have significant institutional investor involvement in their corporate governance. Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility would be exempt if each entity: (i) Manages capital contributions or commitments of at least \$50 million; (ii) is a separate and distinct legal person from any member and is not registered as a broker/dealer; (iii) does not participate directly in investment banking fees received by the member for underwriting public offerings; and (iv) has been primarily engaged in the business of making investments in or loans to other companies. The following additional requirements would apply: (i) Institutional investors must beneficially own at least 33% of the issuer's total equity securities, calculated immediately before the transaction; (ii) the transaction was approved by a majority of the issuer's board of directors and a majority of any institutional investors, or the designees of institutional investors, that are board members; and (iii) all entities related to each member in acquisitions that qualify for this exception do not acquire more than 25% of the issuer's total equity securities, calculated immediately following the transaction.

The Commission believes this exception is reasonable and should permit bona fide investments in issuers with significant institutional investor involvement in their corporate governance. The Commission believes that the limitations of this exception, such as the requirement of substantial involvement of institutional investors, should minimize the potential for overreaching and abuse. As stated above, the Commission notes that the acquisition limitation was previously proposed to be 10% of the issuer's total securities. In response to the concerns of commenters, NASD has proposed to raise this limit to 25%. The Commission believes that the other conditions of the

exception should help to ensure that the transactions are bona fide investments or loans, and the 25% limitation is sufficient as a reasonable additional protection against overreaching and abuse.

a. Definition of "Entity"

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 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. NASD determined not to adopt the suggested amendment because it believed that it would introduce a highly subjective consideration (*i.e.*, whether a fund is part of an investment program) and would undermine the requirement 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. The Commission believes that the proposed definition of "entity" is an objective standard that should be more easily administered by the Department than the standard suggested by comments. The Commission also believes that it is reasonable for the NASD to retain the requirement that each qualifying entity demonstrate through its operating history that it is a bona fide business.

In addition, 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. 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. NASD determined not to make this change because of the potential abuse that could arise from an illegitimate "grouping" of different entities; the proposed rule preserves the requirements of both a co-investment history and an agreement. The Commission believes that the proposed definition is reasonable and should minimize any potential for abuse.

3. Private Placements With Institutional Investors

Exception 3 would permit acquisitions in private placements that have significant institutional investor participation. This exception would permit private placements in which: (1)