

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 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 did not propose any changes in response to these comments. The Commission believes that the 20% limitation and the requirement that an unaffiliated institutional investor lead the negotiation or serve as lead investor are reasonable limitations designed to prevent the potential for 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.

a. Definition of "Institutional Investor"

For purposes of exceptions 2 and 3, "institutional investor" is defined as any individual or legal person that has at least \$50 million invested in securities in the aggregate in its portfolio or under management, including investments held by its wholly owned subsidiaries; provided that no participating members direct or otherwise manage the institutional investor's investments or have an equity interest in the institutional investor, either individually or in the aggregate, that exceeds 5% for a publicly owned entity or 1% for a nonpublic entity. Under a previous version of the proposal, no participating member could have any equity interest or management responsibility in an entity intending to qualify as an "institutional investor." Commenters stated that the definition of "institutional investor" should be amended to permit some part of the equity interest in the entity to be held by participating members. Other commenters stated that equity interest should not be the determinative factor, but rather control. In response to comments, NASD decided to amend the definition to allow an equity interest in the institutional investor, either individually or in the aggregate, of up to 5% for a publicly owned entity or 1% for a nonpublic entity. The Commission believes that this limitation is

reasonable and should help to ensure that only institutional investors that are independent of the influence of members will count for purposes of exceptions 2 and 3.

4. Acquisitions and Conversions To Prevent Dilution

Under the proposal, securities of the issuer would be excluded from underwriting compensation if the securities were acquired as the result of: (i) A qualifying right of preemption or a stock-split or a pro-rata rights or similar offering, or (ii) the conversion of securities that have not been deemed by NASD to be underwriting compensation. In addition, the only terms of the purchased securities that could be different from the terms of securities purchased by other investors would be pre-existing contractual rights that were granted in connection with a prior purchase. Further, the opportunity to purchase must have been provided to all similarly situated securityholders. Finally, the amount of securities purchased or received must not have increased the recipient's percentage ownership of the same generic class of securities of the issuer, except in the case of conversions and passive increases that result from another investor's failure to exercise its own rights.

Under a previous version of the proposal, this exception would not have applied to any purchase or acquisition that increased the participating member's percentage ownership of the same generic class of securities of the issuer. In response to comments, NASD revised the exception to permit passive increases in ownership that may be the result of another investor's failure to exercise its own preemptive rights.

The Commission agrees with NASD that this exception does not raise concerns about overreaching and abusive practices that the Rule was designed to address because purchases pursuant to a right of preemption are based on a purchase right granted to the purchaser in a prior investment and thus, the acquisition is not compensation for a subsequent public offering. The Commission further believes that the limitations of the exception should help to ensure that only securities acquired pursuant to a valid right of preemption will be eligible to be excluded from the underwriting exception. The Commission also believes that it is reasonable to permit passive increases in ownership that may be the result of another investor's failure to exercise its own preemptive rights. The Commission notes that shareholders frequently must decide

whether to exercise their preemptive rights without knowing whether other shareholders will do the same. Consequently, without an exception for passive increases, it would be virtually impossible to determine in advance whether shares acquired pursuant to a right of preemption would be deemed underwriting compensation.

5. Purchases Based on a Prior Investment History

This exception would exempt 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 be made at least 24 calendar months before the required filing date and another more than 180 days before the required filing date. Commenters suggested various shorter time period requirements for the initial acquisitions that would broaden the availability of the exception. NASD included this exemption in response to comments on the original proposal. NASD has stated that 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. The Commission believes that this exemption is reasonable and would codify NASD's historic practice of exempting such securities from underwriting compensation. In addition, the Commission believes that the proposed time periods are reasonable in that they reflect NASD's experience with such acquisitions.

6. Financial Consulting and Advisory Arrangements

Prior versions of the proposal contained an exemption that addressed securities acquired in connection with financial consulting and advisory services. A commenter suggested that the Department continue to evaluate whether the receipt of securities paid in connection with these services are underwriting compensation on a case-by-case basis, rather than solely relying on the proposed exception. NASD determined that these arrangements are so fact specific that in many cases they do not fit well into a codified exception and, thus, proposed to delete this exception. Consequently, the Department would continue to analyze the receipt of both cash and securities in connection with financial consulting