

# THE PIPES REPORT

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## TREND

*Watch*

## NASD SEEKS (AGAIN) TO CLARIFY CORPORATE FINANCE RULE

by Steven Uslaner, *Littman Krooks, LLP*

The NASD recently filed a proposed rule change with the Securities and Exchange Commission to amend NASD Rule 2710—the Corporate Finance Rule. The long awaited proposals come on the heels of strong opposition by players in the PIPE community in response to prior attempts by the NASD to amend the rule. The proposals may be published for comment by the SEC by the end of the month and reflect the NASD's efforts to modernize the filing requirements and improve the regulation of shelf offerings. In other words, the NASD wants their member firms to start complying with the rule in the context of shelf offerings, which include primary offerings by large issuers who sell their shares "off the shelf" from time to time and resale registration statements which follow most PIPE offerings.

*Continued from front page*

Rule 2710 regulates the underwriting terms and arrangements of most public offerings of securities sold through broker-dealers or NASD members. Prior to participating in a public offering, NASD members are required to make a filing with the NASD setting forth proposed underwriting compensation and other required information. Members are required to receive an opinion of "no objection" from the corporate financing department of the NASD prior to participating in the offering.

There has long been confusion in the application of the Corporate Finance Rule to shelf offerings made pursuant to Rule 415 under the Securities Act of 1933. There were questions as to who makes the filing if more than one member participates in the offering, what types of transactions trigger the filing and the manner in which underwriting compensation is calculated in this context. This confusion has resulted in violations of the rule and has continued to the present time even though the NASD has made it clear since at least 1988 that they consider shelf offerings to be public offerings within the scope of the Corporate Finance Rule.

The proposals make it absolutely clear that the NASD will regulate compensation paid to broker-dealers participating in shelf offerings, including PIPE resale registration statements. The broad definitions contained in the proposals provide that "participation" can include selling securities in a principal transaction (a selling shareholder) or on an agency (executing a trade in the normal course for a retail customer) or any other basis. It is certainly not clear what the NASD means by the term "any other basis."

Requiring a filing in the context of an unsolicited agency transaction has met substantial resistance from PIPE practitioners and although addressed in part by the proposal, serious concerns remain. "These proposals represent real progress, but they continue to

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punish investment banks whose clients also trade securities through the bank," says Joseph Smith, a partner with **Feldman Weinstein & Smith**, who submitted comments to the earlier proposals.

In general, an unsolicited agency transaction such as when a retail customer calls his broker to sell his stock that was included in a PIPE resale registration statement would be exempt from the 2710 filing under the Shelf Take-down Exemption contained in the proposals, provided that the broker earns no more than a standard markup of 5%. However, that same broker would have a difficult time relying on the STE if it had received placement agent warrants from the issuer since those warrants would in most cases be deemed to be "items of value" received in connection with his "participation in the public offering."

A related practical area of concern not addressed by the proposals is when the broker makes its 2710 filing and discloses that it will earn a 5% markup with respect to these ordinary trading transactions. The NASD will typically

assume that the 5% commission will be earned on the entire offering despite the fact that the member may only have brokerage accounts with a small minority of the selling shareholders listed in the registration statement. This may be problematic when the NASD values the other compensation (e.g., placement agent warrants, rights of first refusal, etc.) earned in connection with the shelf offering.

Critics of the prior proposals also voiced displeasure concerning the inability of stocks of OTC Bulletin Board or Pink Sheet issuers to qualify for an exemption to avoid the 2710 filing. Previously, a Market Transaction Exemption was only available to Nasdaq or national exchange issuers. Critics argued that this disparate treatment would result in a substantial increase in the cost of raising capital to those who could least afford it. Based on these comments, the MTE was eliminated in the proposal and replaced with the STE which is available to small issuers. The STE includes provisions respecting ordinary market transactions, solicited agency transactions and principal transactions that meet volume thresholds based on Rule 144.

In addition, the STE would only be available to issuers who have been reporting companies under the Exchange Act for at least 90 days and are current in their reporting requirements. Thus, an NASD member participating in a shelf offering that is filed within 90 days of the consummation of an initial public offering (including a company becoming public through a reverse merger transaction) would always be required to make a 2710 filing to clear its com-

pensation prior to participating in such an offering. The inherent difficulty that many member firms will have in qualifying for the STE apparently reflects the NASD's longstanding view that shelf offerings present an opportunity for abuse, thus justifying the NASD's interest in reviewing compensation earned by member firms in this space.

It is likely that the proposals will continue to meet strong resistance from smaller issuers and broker-dealers representing this segment of the PIPE market since shelf offerings of large issuers (known as seasoned issuers and well known seasoned issuers) will not generally be subject to a Rule 2710 fil-

ing. While the exemption available to these large issuers was inherently necessary given the SEC's securities offering reform amendments, this will provide little consolation to PIPE players who provide capital to smaller issuers.

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"Once again, it's the little guy that gets hurt," says Brian Friedman, director of corporate finance at **National Securities Corporation**, an active PIPE placement agent. "The filing requirements set forth in the proposals will result in an

increased cost for small issuers looking to access capital in one of the few markets available to them."

While the Corporate Finance Rules are designed to protect issuers from abusive practices by underwriters, it remains to be seen whether the proposals create unnecessary complexities and burdens for members in an area where the NASD has yet to provide any empirical evidence of abuse by its members. Stay tuned to see how the SEC responds to the proposals. ■

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