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THE MONTHLY REPORT

APOs TEST RULE 2710

Changes to NASD Rule Could Impact Fees, Speed to Market

by Joe Gose

Proposed amendments to NASD's Corporate Finance Rule could prove most problematic for reverse mergers that include parallel PIPE financings or private placements that occur for up to three months after the combination. The suggested changes to the provision, known as Rule 2710, would require placement agents involved in such deals, or in the sale of shares of the surviving company, to seek pre-approval from the NASD for compensation.

That could prove costly in both time and money for small companies who typically pursue the alternative public offering (APO) route to the public markets, contend PIPE experts who have studied the changes. It also could put investors at a market disadvantage by making them wait at least a day or longer before they could sell shares of a newly trading company.

Ultimately, if passed, the proposals would slow down a route to the capital markets for an increasing number of companies, PIPE experts predict. Through late November this year, for example, nearly 60 reverse merger-PIPE transactions had closed raising a total of some $641 million, or about $10.7 million per deal on average, according to information gleaned from available company filings. In terms of transaction volume, that's almost double the number of APO deals that closed in all of 2004 and 2005.

"There has already been harm caused to the capital formation process [by burdensome regulations] as evidenced by the very small number of IPOs occurring these days," says Tim Keating, president of **Keating Investments**, a Denver-based

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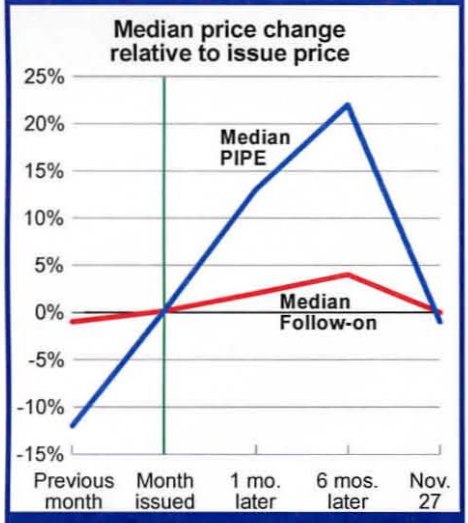
PIPE VS. FOLLOW-ON OFFERING PERFORMANCE



Source: ThinkEquity Partners; PrivateRaise

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TWO WORLDS COLLIDE

Comparing PIPEs and Follow-on Offerings

by Dan Carlson

Investment banks have long treated PIPEs and follow-on offerings as very different capital-raising tools. Companies that could complete a follow-on would be advised to do so—PIPEs were the higher cost option for lower quality companies, placed by second tier banks.

But there has been increasing acceptance of PIPEs as a creative and viable finance structure by larger and higher quality issuers and bankers alike. Instead of companies being predetermined to be either follow-on or PIPE candidates, there now are two buckets from which many companies can choose.

The companies that fall squarely into the sweet spot of being both PIPE and follow-on candidates are those with market caps in the $50 million to $500 million range. In the second half of 2005 there were over 250

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investor in shell companies and adviser to reverse mergers that also facilitates PIPEs through its Keating Securities broker-dealer affiliate. "The reverse merger-plus-PIPE has filled that void, and it would be a disaster to subject reverse mergers to Rule 2710."

Pricing Approval

Rule 2710 regulates the underwriting terms and arrangements of most public offerings of securities sold through broker-dealers or NASD members. Under the rule, NASD members that participate in a public offering are required to notify the NASD of the proposed underwriting compensation and other information. The NASD's corporate finance department must bless the member's plans with a "no objection" opinion in order for the broker-dealer to participate in the offering.

Since 2004, however, the NASD has been proposing changes to the rule to "modernize and clarify" when broker-dealers had to make a filing in conjunction with a resale registration statement in shelf offerings, according to Joseph Price, NASD's vice president of Corporate Financing. That has put the PIPE market on alert because PIPE funds rely on the timely filing of effective resale registration statements in order to secure returns for their investors.

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The latest proposed changes—known as Amendment No. 4—remain in limbo, however, after the NASD filed them with the Securities and Exchange Commission in April. Although the NASD and PIPE experts expected the SEC to publish the proposals for comment late last summer, so far the commission has failed to address the issue. While the SEC could send the draft back to NASD for further revision if it considers the changes too harsh, Price contends that the SEC hasn't contacted the NASD about any concerns over Amendment No. 4.

Meanwhile, a commission spokesman says he doesn't know where the proposal stands and adds that he'd be unable to comment if he did know. In fact, the broad consensus among alternative investment industry experts is that the SEC has moved Amendment No. 4 to the end of the line as it busies itself with other potential reforms or clarifications to rules such as Regulation SHO, the Sarbanes-Oxley Act of 2002 and – PIPE players hope – Rule 415. The NASD, too, is likely throwing much of its energy behind plans to consolidate its regulatory operations with those of the New York Stock Exchange to create one organization that will oversee some 5,100 securities firms in the U.S.

"Until the SEC really gets behind this in the context of resale registration statements, I believe the necessity to make the Rule 2710 filings may continue to fall on deaf ears as historically a good percentage of broker-dealers have not made the filings in this context," says Steven Uslaner, a partner with the law firm of **Littman Krooks** in New York, who has followed the NASD's circuitous route to change Rule 2710 for the last couple of years. "But when the time comes that the SEC consistently reviews a resale registration statement and inquires whether 2710 clearance has been received, the NASD will then see a major increase to the volume of these filings."

APO Worries

Yet the fact that the proposals could someday become part of the regulations has hardly been lost on PIPE players. In line with the NASD's aim, Amendment No. 4 leaves no doubt that shelf offerings—and PIPEs—are public offerings within the context of Rule 2710 and will require filings by NASD members in deals that include placement agents unless an exemption is available. Historically, broker-dealers qualify for an exemption if they charge no more than the 5% commission ceiling for ordinary stock sales on behalf of clients. Generally, the proposed changes add some conditions for PIPE players seeking exemptions.

But while Amendment No. 4 was tailored to the 2005 Securities Offerings Reforms and addressed comments criticizing earlier proposals in 2004—the NASD backed away from a plan to disallow any exemptions for OTC and Pink Sheet companies, for example—it did not include exemptions for companies executing reverse mergers and simultaneous PIPEs or private financings soon thereafter. Indeed, the suggested changes to Rule 2710 glaringly fail to provide exemptions for companies who execute shelf offerings that are an initial offering of an issuer's equity securities or that occur within 90 days of an IPO.

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Thus, if approved, the changes to Rule 2710 would require placement agents who facilitate a reverse merger and a concurrent private financing, or a subsequent PIPE within 90 days of the transaction, to seek pre-approval of their compensation from the NASD. Plus, any broker-dealer approached to sell securities off the resale registration statement covering such PIPEs would have to file with NASD before executing any trades.

Among other pitfalls related to the Rule 2710 filing process, NASD members generally have few guidelines when assigning value to an underwriter's right of first refusal, underwriter warrants or other items of potential value, says Keating, who is one of a handful of founders of the newly formed Reverse Merger Association. And frequently the NASD's review procedures prove time consuming and inefficient, he adds.

In fact, whether an NASD member participates in an APO or in a subsequent sale of securities on behalf of a client, its involvement in either case can occur in minutes. So seeking the NASD's approval for compensation may be unrealistic given rapidly changing market conditions, Uslaner notes. Additionally, while the NASD has assured members that it will put in place an Automatic Review and Clearance system (ARC) to help facilitate the clearance of Rule 2710 filings within 24 hours, Uslaner and other PIPE experts say that it's not up and running yet and question how effective it will be.

Indeed, the hassles surrounding the Rule 2710 filing process helped convince Keating to walk away from the underwriting business. Typically, Keating Investments acquires shares in shell corporations and acts as an adviser to private company clients in the reverse merger process. Separately, Keating Securities may facilitate a concurrent or subsequent PIPE for those issuers. In one case, when Keating Securities was facilitating a follow-on offering of registered securities for a company that had previously completed a reverse

merger, the NASD considered shares that Keating Reverse Merger Fund still owned in the company as Keating Securities compensation.

"We've literally elected to exit the underwriting business," Keating says. "We didn't want to be part of such an arbitrary process."

Other Concerns

Beyond the lack of exemptions for APOs, the NASD's proposed changes to Rule 2710 in some cases could subject placement agents to filing requirements if they receive warrants or other items of value from issuers in conjunction with a PIPE and then subsequently broker sales of securities listed with the corresponding resale registration statement.

Placement agents who receive warrants in a PIPE are currently required to file under Rule 2710 if the underlying stock of the warrants is included in the resale registration statement, assuming that the broker-dealer will earn no more than the 5% commission via resale agency transactions. But under the current rules, if the underlying securities were not included on the resale statement, the placement agent could argue that it did not need to file. The proposed rules, however, would require a filing.

All told, PIPE experts suggest, Amendment No. 4 could add some $5,000 to $10,000 or more to the cost of doing business through legal and NASD fees associated with each filing under Rule 2710. But, they predict, NASD members will likely pass those expenses onto small companies filing the resale registration statement.

Large companies, on the other hand, don't face the same pressures: Broker-dealers involved with a shelf offering of well-known seasoned issuers typically receive an automatic exemption. Those are Form S-3 eligible companies that have issued an aggregate of $1 billion or more in fixed-income securities in primary registered offerings over the last three years or in which non-affiliates own at least $700 million of the common equity market capitalization.

"It's the issuers in the micro cap space that will get hurt again," Uslaner says. "It's going to increase the cost of doing these transactions, as I would expect that the broker-dealers will push the cost of these filings to the issuers."