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Via e-mail: pubcom@nasd.com

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, N.W.
Washington, D.C. 20006-1506

RE: NASD Proposed Rule 2721 - Comments for Consideration

Dear Ms. Sweeney:

MGL Consulting Corporation ("MGL") is a provider of regulatory and compliance solutions to broker/dealers, investment advisors and insurance companies. To this end, we represent NASD member firms in their efforts to comply with the various securities laws and regulations promulgated by the Securities and Exchange Commission ("SEC"), National Association of Securities Dealers ("NASD"), Municipal Securities Rulemaking Board ("MSRB"), and various other regulatory bodies. The NASD's proposed Rule 2721 (the "Proposed Rule") would affect many of these clients and MGL desires to seek clarification and submit comments regarding the proposed rule.

Negotiated Investments

The Proposed Rule appears to be focused on private placement investments that have historically been referred to as DPPs, and or "Pooled Investments" (such structures being referred to herein as "Pooled Investments"). In these investment structures, the sponsor generally structured the transaction (investment objectives, organizational structure, ownership structure, etc.), prepared the private offering memorandum or other disclosure document (collectively the "POM"), subscription documentation, and the marketing program, including documenting the arrangements for best efforts selling group participants and involvement in and or production preparation of the marketing material. When the above had been completed, theoretically, the Sponsor would commence the marketing of the specific program, hopefully in conformity with the disclosures set forth in the POM and related documentation.

Notwithstanding that, the Proposed Rule, as currently drafted, will have a significant and adverse affect on broker/dealers that are not engaged in the typical "Pooled Investment" products, but are engaged in negotiated private placement transactions with both qualified purchasers and accredited investors, in conjunction with their legal and accounting

professionals (such transactions being referred to herein as "Negotiated Transactions"). In Negotiated Transactions, there are typically a minimal number of investors, a transaction is proposed (generally in a short summary), and once a proposed investor expresses an interest in the transaction in concept, the sponsor/issuer and the investor negotiate the overall terms of the transaction, and the result of such negotiations are that the drafts of the POM and the closing documents are prepared, and ultimately finalized. Generally, when the documentation is finalized, the transaction "closes." Funding of the investors' financial obligation then occurs as negotiated, with actual funding being made to the investment entity structured for the specific transaction. As a result of the transaction flow on a Negotiated Transaction, it is clear that the Proposed Rule does not address the business realities of Negotiated Transactions, both as to filing requirements and the exemptions granted for investors. This is especially true for broker/dealers that have affiliated entities that develop real estate projects, are engaged in investment banking activities and or mergers and acquisition transactions, where all entities involved are Accredited Investors, as defined in Rule 501 of Regulation D, but may not necessarily be Qualified Purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940, and that use the affiliated NASD member to raise funds for these projects.

Clarification for the Definition of "Control Entity"

The proposed definition in the Proposed Rule states in part, "The term 'control' for purposes of this Rule means beneficial ownership of more than 50% of the outstanding voting securities of a corporation, or the right to more than 50% of the distributable profits or losses of a partnership." [2721(a)(2)] We would recommend that the definition be clarified to address the issues related to the questions set out below:

Question 1:

> *Question 1-A.* At what point in the business transaction and offering cycle would the term "control" be applied? By way of a real estate based example, suppose an NASD member has an affiliate ("BD Sponsor Affiliate"), which will team with a landowner to build a shopping mall on the landowner's property. To do so, they form an entity, the Mall Development Corporation ("MDC"), of which the landowner owns 40% while BD Sponsor Affiliate owns 60%. In order to fund the project MDC forms a partnership where it is the general partner. The partnership raises funds by selling limited partnership interests in "The Retail Mall Project LP," The LP is offered via a private placement. After the offering, BD Sponsor Affiliate will be entitled to substantially less than "50% of the distributable profits or losses of a partnership."
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> Using a standard "Pooled Investment" structure, suppose BD Sponsor Affiliate includes the initial organizational limited partner and the General Partner, which collectively own 100% of the investment vehicle. After the offering and successful closing of the transaction, the "Organizational Limited" partner has no interest in the investment vehicle, and the General Partner has a 1% ownership interest in the investment vehicle, and a 20% profits interest after the investors obtain a preferred benchmark return.

Question 1-B: *B*ased solely on who is entitled to the distributable profits and losses of the partnership, would the examples in Question 1-A be a Member Private Offering? (BD Sponsor Affiliate is entitled to 60% of the profits and losses before the offering but less than 50% after the offering, and or BD Sponsor Affiliate and organizational partner own 100% before investors are accepted and 1% after investors are accepted.)

Question 1-C: In the example 1-A, now consider that MDC is the general partner of the partnership. MDC makes all management decisions for the partnership, and the limited partners do not have the ability to remove the General Partner. Since BD Sponsor Affiliate has a 60% say in who manages the partnership, but is entitled to less than 50% of the profits, would this be a Member Private Offering?

Question 2:

Would a flow-through concept apply to the definition of control entity? In the example above, suppose that instead of MDC forming a partnership and selling limited partnership interests, MDC formed a new corporation, Retail Mall Inc. ("RMI"). MDC owns 50% of RMI and outside investors own the other 50%. At some point in the future, Broker Dealer Sponsor Affiliate's NASD firm is engaged in the selling of RMI via a private placement. Since BD Affiliate's diluted interest is less than 50% (60% of 50% = 30%), would the issuer be a control entity?

Clarification for when a PPM will be deemed to be "filed"

In the case of a member private offering, 2721(b) requires PPMs be filed with the NASD's Corporate Finance Department "at or prior to the first time the private placement memorandum is provided to any investor."

Question 3:

When is a private placement memorandum (PPM) considered filed? In a Negotiated Transaction, while the investor may be provided a "summary or request for interest," until a potential investor expresses an interest in the proposed transaction, negotiations are not commenced, and by definition, there can be no "disclosure" document in that the transaction is undefined and the business terms are open.

Additionally, with respect to one client in particular of MGL, many of its customers have obligations outside of their local community and are engaged in frequent travel. It is not unusual for the affiliated sponsor to engage in discussions and negotiations over several days or even a several-week period with a small group of investors, to finalize the business transaction and subsequently, the PPM, and then to e-mail same to the investors. Some of these investors review the final PPM copy the day of receipt, forward the appropriate

funds to the appropriate recipient, and then leave town or even the country, whether for business or pleasure, on the same day the PPM is received. If a hard copy must be sent to the NASD, and such is not considered "filed" by the NASD until the NASD receives its hard copy, this will place an additional burden on the issuer and placement agent. In the example that was just described, a preferred definition of "filed" would be for the NASD to initially accept a PDF version via e-mail. The next best option would be to define "filed" as the date that the document was picked up at the NASD member's office by an overnight courier such as DHL or Fed Ex.

Clarification of offerings by wholesalers

In the Rule 2721 draft, a proposed exemption is allowed for "offerings in which a member acts solely in a wholesaling capacity and sells unregistered securities to other unaffiliated broker-dealers" [Please refer to 2721(e)(3)]. If the intent of this provision is to provide an exemption for wholesalers who serve as the lead or managing placement agent, but do not engage in any actual direct selling to investors, such an exemption would be welcomed. However, the wording of the second clause of the proposed exemption, "and sells unregistered securities to other unaffiliated broker-dealers" appears to be problematic, as it implies that the lead broker/dealers must take a principal position by purchasing the private placements prior to marketing them to their customers, and this rarely if ever happens. We believe that this should be clarified in the final version of the Proposed Rule.

Request to exempt offerings with a small group of investors and to exempt experienced firms without disciplinary history

As the Proposed Rule is currently drafted, it would appear to apply to broker/dealers with affiliates who are involved in real estate, oil and gas, mergers and acquisitions and investment banking firms that are engaged in structuring Negotiated Investments, i.e., firms that negotiate deals with small groups of investors. As discussed earlier, the Negotiated Investment business model is focused on a small group of people, all of whom are accredited investors as defined in Rule 501 of Regulation D, and negotiations and counter proposals transpire over a period of time, and once the parties have agreed to the terms, legal documents are drafted and signed. The Proposed Rule in its current format would require the deal proposals and each revision to be filed with the NASD. As the Proposed Rule's intent is presumably to address Pooled Investments (syndications, hedge fund offerings, and the like), we believe that it would be appropriate for an exemption to be made for deals that have small groups of investors, such as six or less, where all of the investors are accredited.

Furthermore, since market regulation issues related to private placement transactions transgressions appear to be limited to certain broker/dealers and individuals, it appears that it would be sound regulatory rule-making to only require filings for broker/dealers that are new to private placements, and to those firms that have a history of private placement transgressions. Such a precedent already exists in the form of the NASD's advertising rule that requires all firms to file their advertising for the first year that such is utilized, but thereafter only requires future filings for certain products offered to the

public or where the NASD has determined that a problem may exist. Perhaps broker/dealers could be required to file their deals for the first year that they offer private placements, unless NASD exams or reviews of the filed documents indicate material problems. If problems were detected, a longer filing period would be imposed. This approach would provide for the protection of the investing market, while not overly burdening those firms that are currently in compliance with the intent of the Proposed Rule.

Finally, while it appears to be a notice platform, to the extent the NASD does not have clear guidelines with respect to review time, the Proposed Rule may result in having a "chilling effect" on the private placement market. To the extent the NASD requires pre-filing, but is not required to make prompt review and comment, but reserves the right to "subsequently determine" the disclosures are inadequate, it gives the NASD no information that is not currently available to it through its audit program. Further, it has the potential to create additional confusion to those marketing Negotiated Investments and Pooled Investments. State laws and SEC rules and regulations provide ample guidance on this matter; additional rules only exacerbate the ability of a compliant to navigate the regulatory minefield regarding the offering of investments. To this end, we believe to the extent the Proposed Rule is implemented, it should provide clear guidance on the timeline for expectation of comments from the NASD, so that Firms could receive some benefit from the filing and review process.

"The NASD requests comment on whether the proposed rule should apply to these other entities [i.e. private placements which NASD members offer but where the member does not meet the control test]."

We feel that such would impose an unnecessary burden on the industry and would undo or reverse the exemptions that the SEC and related state jurisdictions have seen fit to implement (i.e. Regulation D, Section 4(2), etc.). If the SEC feels that the exemptions are inadequate, they may avail themselves of the legal and regulatory process to change such.

Furthermore, in reviewing the nine cases cited by the NASD in Endnote 3 on page 6 of Notice to Members 07-27 as examples of why proposed Rule 2721 is necessary, in several of the cases, the major problems in the offerings were not inadequate disclosures or material inaccuracies (although, such was present in some instances). Moreover, the problems in the cases cited appear to have been adequately addressed by rules and regulations that are currently in force and subject to the NASD's current exam program. To the extent that broker/dealer firms and or individuals have incurred material rule violations with respect to their private placement offerings, perhaps they, and not the general NASD membership should be subject to a filing requirement, and possibly, they should be subject to a pre-filing requirement (please refer to the analysis below as it appears that in many of the cases, a filing requirement would not have prevented some of the more egregious violations. However, in some cases one might argue that the NASD would have at least been alerted to a potential problem within a few days of the offering).

Concerning the above, a review of the NTM Disciplinary Actions, Press Releases, and Hearing Panel Decisions, that were referenced in Endnote 3, and in some instances the Public Disclosure Documents for the referenced firms, indicated the following:

(1) *Franklin Ross, Inc.* - The primary finding stated that the firm "failed to disclose material facts in a private placement memorandum";

(2) *Capital Growth Financial LLC* - While the NASD cited the firm for utilizing marketing materials that the proposed rule is designed to detect, the greater problem would appear to be that the firm "*used general solicitation sales techniques and sold the securities to non-accredited investors, thereby eliminating the offering from any registration exemption*";

(3) *Craig & Associates* - The Notice to Members actually only listed an action against Gary Lynn Craig, not Craig & Associates. The notice stated "he [Craig] participated in the preparation and distribution of sales literature that contained unwarranted and misleading information." However, it should be noted that Mr. Craig and his firm would presumably have been profiled for increased scrutiny as one disclosure item cites them for failure to properly supervise an individual that offered unregistered securities, and a second disclosure item cites Craig and his firm for failing to promptly transmit funds to a properly set-up escrow account;

(4) *Online Brokerage Services, Inc.* - The firm was cited for engaging in a public offering of its securities without filing the required documents with the SEC and the NASD, and it was cited for changing the terms of the offering without offering a rescission letter to the investors who had committed to the offering. The only allusion to inaccuracies in the offering materials was that during the offering it was represented that the securities being offered were exempt from SEC registration when in fact they were not;

(5) *IAR Securities/Legend Merchant Group* - The NASD stated that the firm or a named principal "made a misrepresentation in a Private Placement Memorandum (PPM), failed to disclose material facts in the PPM, or failed to disseminate supplements to the PPM disclosing materials facts." However, the findings also noted that at the time of the offering the firm's NASD Membership Agreement did not permit the firm to engage in private placements;

(6) *Shelman Securities Corp.* - In a press release, the NASD stated that it had filed a complaint against the firm and a principal for "securities fraud in connection with an unregistered hedge fund offering." Other allegations claimed that approximately 30% of the funds raised "was paid to Shelman, the exclusive underwriter of the offerings, and Prism Independent Consulting, Inc., an entity owned by Parman, for purported expenses, fees, and commissions." The NASD also alleged that the private placement memorandum was "inaccurate and incomplete";

(7) *Neil Brooks* - While the press release focused on Brooks being cited for "conducting a fraudulent hedge fund offering," it should be noted that the press release also stated that

he had engaged in a private securities transaction and that he was not properly licensed to offer and sell securities. Thus, even if the proposed rule were in effect at the time of the offering, it would never have been filed with the NASD;

(8) *Dep't of Enforcement v. L. H. Ross & Co., Inc.* - The Hearing Panel concluded that the firm was guilty of "participating in public offerings and sales of unregistered securities" and of "making material misrepresentations and omissions of fact in connection with the offer, sale or purchase of securities issued by L.H. Ross & Company, Inc.";

(9) *Dep't of Enforcement v. Win Capital Corp*. - The Hearing Panel dismissed the NASD's case against the respondents, thus no rule violations were found to have occurred.

Thank you for your thoughtful consideration of the comments contained herein.

Sincerely,

Curtis N. Sorrells

Curtis N. Sorrells
Vice-President, Regulatory Affairs
MGL Consulting Corporation