# KANE & COMPANY, INC.

**INVESTMENT BANKERS**

*The Independent Underwriter™*

**Michael W. Kane Ph.D., J.D.**
***President & CEO***

***Member:* NASD/SIPC**


May 1, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number: **SR-NASD-2005-080**

Ladies and Gentlemen:

Having observed closely, and submitted comments to, the NASD's rule-making procedure for NASD Rule 2290 Regarding Fairness Opinions, we respectfully submit the following comments keyed to our paraphrasing of the issues raised in Section IV (Solicitation of Comments) of SEC Release No. 34-53598:

*1. Whether the disclosures that would be required by proposed Rule 2290(a)(1), (2), and (3) should be quantified; and further, whether it would be more informative to investors for firms to specifically state that a conflict may exist and describe the impact of such conflict rather than to merely state that compensation is contingent:*

The benefit to the investor of quantifying a disclosure about compensation is that it provides a scale to gauge the amount(s) at stake for the member firm, and the rules of engagement defining the triggering events that will yield that stake. If the stakes are high, and the rules of engagement call for a significant portion of compensation to be paid contingently upon successful completion of the transaction, then the investor will likely weight the probability higher that the amount and structure of the compensation might bias the outcome of the fairness opinion. If the stakes are relatively low, the payment schedule is not contingent on transaction completion, or to the extent it is, it is small in proportion or absolutely, the investor will likely assign a lower probability to the compensation structure influencing opinion outcome. For its ability to improve investors' ability to distinguish which compensation arrangements, irrespective of structure, are likely, or not likely, to be problematic sources of bias, this firm supports quantification of compensation arrangements where disclosure of such arrangements are required by proposed NASD Rule 2290.


*Invenium Viam Aut Faciam*

*10877 Wilshire Boulevard, 14th Floor, Los Angeles, CA. 90024-0098*

*(310) 208-1166 (Voice), (310) 443-9920 (Facsimile), Website: www.kaneco.com*

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Similarly, this firm supports the idea of member firms stating that a conflict may exist, and describing the impact of such conflict on the fairness opinion. However, to avoid the development of boilerplate disclosure that does not convey a sense of scale, i.e., "our compensation arrangements with the company may create a potential conflict of interest that might bias our opinion, ......" etc., we believe that this approach should also require in all cases (whether contingent or not) description of compensation structure and quantification of amounts at stake.

Further, this firm believes that as currently drafted, proposed NASD Rule 2290 carries the potential for inadequate disclosure to accomplish its central purpose insofar as it appears to exclude the requirement for opining member firms to disclose the structure of compensation and to quantify the amounts at stake for compensation arrangements that are NOT explicitly contingent on successful transaction closure. As drafted member firms rendering financial opinions must disclose:

"…..(1) "whether such member has acted as a financial advisor to any transaction that is the subject of the fairness opinion, ***and if applicable***, that it will receive compensation for: (A) rendering the fairness opinion that is contingent upon the successful completion of the transaction; (B) serving as an advisor that is contingent upon the successful completion of the transaction; (2) whether such member will receive any other payment or compensation contingent upon the successful completion of the transaction;…." [Emphasis added]

What the investing public loses here is the ability to assess whether ostensibly "non-contingent" compensation arrangements are functionally equivalent, in some significant part, to contingent compensation. As currently drafted, we believe the Rule invites as many permutations as fertile minds can conjure to expand the interpretation of what can go into the residual category of "non-contingent" compensation arrangements. Indeed, subsection (3) of the Rule appears to contemplate the possibility of "quid pro quo" compensation, i.e., compensation paid, or to be paid, by the company to the member firm in connection with their relationship generally, yet not explicitly tied, contractually or otherwise, to the subject transaction specifically – creating potentially "cross-conditional" delivery of two or more services and related compensation. Section (3) requires disclosure of:

"…. (3) whether there is any material relationship that existed during the past two years or is mutually understood to be contemplated in which any compensation was received


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or is intended to be received as a result of the relationship between the member and the companies that are involved in the transaction that is the subject of the opinion;…"

If we think that there is a possibility that some admixture of services provided, related or unrelated to the closed transaction, before, during or after the term of the fairness opinion engagement, could be tantamount to "cross-conditional" compensation, then why should we exclude a priori the possibility that some admixture of compensation arrangements, arrayed within or across service lines, the structure and timing of which are ostensibly "non-contingent," could, by operating as a quid pro quo, ALSO be functionally equivalent in effect to a contingent payment?

We believe that the investing public is better served if member firms rendering fairness opinions have a simple standard to follow for disclosure bearing on the potential for conflict of interest, or other sources of systematic bias: 1) disclose all business with the company and its counterparty within the last two years, currently and anticipated within the next twelve months; 2) describe the structure of compensation, including the definition of events that trigger payments; 3) quantify (exactly where known, reasonably estimate where yet to be paid) each increment of compensation; and, 4) notwithstanding the foregoing, state whether you believe that given the totality of the facts and circumstances of which you are now reasonably aware, you believe a conflict may exist and describe its probable impact on your conclusions and compensation.

*2. Whether the proposed disclosure obligation should cover material relationships between the parties to the transaction and affiliates of the member firm providing the fairness opinion:*

This firm supports the extension of the disclosure obligation to cover relationships among the parties to the transaction and affiliates of the member firm.

In the commercial world, mutual financial gain is the raison d' être for affiliation. As a practical matter, financial ties are assumed among affiliates, the burden of proof being on those affiliates seeking to deny the financial relationship.

Within the last decade, large commercial banks absorbed a significant proportion of the then existing independent, mid-size investment banks.[1] A stated purpose

[1] A representative sample: Deutsche Bank: Alex Brown & Sons; NationsBank: Montgomery Securities; Chase Bank: Hambrecht & Quist LLC; U.S. Bancorp: Piper Jaffray Companies; ING Group: Furman Selz;


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shared among the acquirers was to mine the bank's corporate lending roster for equity underwriting fees, M&A advisory work, including fairness opinions, brokerage commissions, etc. There are myriad corporate structures by which the banks' investment banking arms are "affiliated" with the corporate lending groups, but suffice it to say that with public corporations' need for both equity and debt, the now-related arms of these full-service financial institutions are directed to work together. Generally, the loosest mechanism of control and ownership of investment and commercial banking affiliates is the public holding company; other interlocks are tighter.

Now is there a potential for the impairment of independence of a member firm providing a fairness opinion on the exchange of equity, if the member firm received the assignment because it's commercial banking affiliate, in exchange for funding the credit line, captured the company's financial advisory work either on a contractually tied, or on a de facto quid pro quo basis? One need go no further to acknowledge the possibility than asking: what is the purpose of the financial institution deploying client "relationship managers" if not to assure that ALL of the client's needs are met? Is there a potential for conflict if the fairness opinion concerns a prospective equity transaction that could be detrimental to the company's creditors, or those of the company's counterparty, among which the commercial banking affiliate is numbered? It is up to the investor to decide whether, how and with what probability. The investor cannot do this unless member firms disclose all of the relationships among the member firm's affiliates, the company and its counterparty.

*3. Whether member firms should be required to describe what type of verification they undertook with respect to information that was supplied by the company requesting the opinion that formed a substantial basis for the opinion; and further, whether members should be required to obtain independent verification of such information:*

Under current and past industry practice, it is usually stated in the body of the fairness opinion that the member firm did not undertake to independently verify the information provided by the client company, and that under its agreement with the company, that the member firm was entitled to rely on the accuracy and

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Société Générale: Cowen & Company; Bank of America: Robertson, Stephens & Co.; Canadian Imperial Bank Corp. (CIBC): Oppenheimer & Co., Inc. ; Credit Suisse: First Boston ("CSFB"); CSFB: Donaldson Lufkin & Jenrette; Citigroup: Salomon Brothers Smith Barney; First Union Corporation: Wheat First Butcher Singer ; UBS AG: Warburg Dillon Read; Key Bank: McDonald & Co.

completeness of the information with which it was provided, at the risk of altering or invalidating the opinion's conclusion. Accordingly, members do now describe the type of verification they undertook with respect to supplied information: explicitly cautioning readers that there was no verification. This firm believes that current practice should continue, i.e., that members should not be required to obtain independent verification.

The basic rationale is that the member firms do not house the forensic and investigative skill sets and experience to perform this function to the same level as do the independent accounting firms and the executives of the company providing the information. The task of the member firm in rendering a fairness opinion is to start with a question about the exchange of relative value, and work backward far enough to be able to answer the question within the structure of the proposed transaction. Member firms' expertise resides in valuing the transaction elements configured as they are in relation to one another (e.g., the strength of the wall based on its geometry); not necessarily the constituent elemental assets and liabilities (e.g., the bricks). The counterparties to the transaction start on the other end, engaging in the activities that produce the information provided to the member firm. With the restructuring of the independent public auditing industry and the passage of Sarbanes-Oxley legislation, special regulatory emphasis has been placed on the accurate creation, reporting and certification of the information public companies provide about their financial affairs. Effectively denying member firms the ability to rely on this information (e.g., the integrity of the bricks) by placing on them the burden of independent verification adds to the regulatory overhead of the capital markets without much, if any, incremental benefit to the investor because of the relative competencies (and "incompetencies") distributed among the players in public company transactions.

*4. Whether members firms should disclose in the fairness opinion or elsewhere the procedures utilized by the member firm to arrive at the conclusion expressed:*

We believe that the extent to which member firms delivering fairness opinions support their conclusions, particularly as described in public proxy statements pertaining to the transactions for which proxies are issued, form an adequate basis for informing the investor about the likely validity of the analysis underpinning the opinion. Therefore, any additional disclosure requirement beyond that already found in proxy statements fully responsive to the comments of SEC staff, should not be required.


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Empirical measurement and analysis of all of the types and amounts of consideration exchanged by counterparties in a transaction is as informative and valid as permitted by the existence and accessibility of relevant comparative data from the external capital markets. Additionally, because the comparative data are drawn from pools that are statistically independent and frequently each contain some (and different) forms of systematic bias, there is no formula for weighting alternative modes of analysis. Where empiricism ends, art (professional judgment) begins. The best we can hope for is accurate use and summarization of the empirical bases for opinion conclusions, as is currently found in public proxy statements. This firm believes that it will be futile to expect that ALL "procedures" used in developing a fairness opinion can be described accurately, if at all, or that, given it's relative intangibility, what is essentially the same creative thought process will be described the same way by different firms. To try to go further would be like trying to standardize art criticism.

Thank you for your time and consideration.

Respectfully submitted,

*Michael W. Kane*

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