SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53598; File No. SR-NASD-2005-080)

April 4, 2006

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2 and 3 thereto to Establish New NASD Rule 2290 Regarding Fairness Opinions

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on June 24, 2005, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. On November 30, 2005, NASD filed Amendment No. 1 to the proposed rule change.[3] On January 25, 2006, NASD filed Amendment No. 2 to the proposed rule change.[4] On March 1, 2006, NASD filed Amendment No. 3 to the proposed rule change.[5] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 In Amendment No. 1, which supplemented the original filing, NASD modified the scope of the proposed rule change and made certain clarifications to the rule text following discussions with Commission staff.

4 In Amendment No. 2, NASD added clarifying language to the rule text following discussions with Commission staff.

5 Amendment No. 3 was a technical amendment and replaced and superseded the original filing, as amended, in its entirety.

NASD is proposing to establish new NASD Rule 2290 to address disclosures and procedures concerning the issuance of fairness opinions. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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2200. COMMUNICATIONS WITH CUSTOMERS AND THE PUBLIC

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2290. Fairness Opinions

(a) Disclosures

Any member issuing a fairness opinion that may be provided, or described, or otherwise referenced to public shareholders must disclose, to the extent not otherwise required, in such fairness opinion:

(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;

(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 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 fairness opinion;

(4) the categories of information that formed a substantial basis for the fairness opinion that was supplied to the member by the company requesting the opinion concerning the companies involved in the transaction and whether any such information in each such category has been independently verified by the member; and

(5) whether the fairness opinion was approved or issued by a fairness committee.

(b) Procedures

Any member issuing a fairness opinion must have procedures that address the process by which a fairness opinion is approved by a firm, including:

(1) the types of transactions and the circumstances in which the member will use a fairness committee to approve or issue a fairness opinion, and in such transactions where it uses a fairness committee:

(A) the process for selecting personnel to be on the fairness committee;

(B) the necessary qualifications of persons serving on the fairness committee; and

(C) the process to promote a balanced review by the fairness committee, including review and approval by persons who do not serve on or advise the "deal team" to the transaction;

(2) the process to determine whether the valuation analyses used in the fairness opinion are appropriate, and the procedures should state the extent to which the

appropriateness of the use of such valuation analyses is determined by the type of company or transaction that is the subject of the fairness opinion; and

(3) the process to evaluate whether the amount and nature of the compensation from the transaction underlying the fairness opinion benefiting any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company, is a factor in reaching a fairness determination.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

NASD notes that a fairness opinion addresses, from a financial point of view, the fairness of the consideration in a transaction. Fairness opinions are routinely used by directors of a company in corporate control transactions to satisfy their fiduciary duties to act with due care and in an informed manner. Although not required by statute or regulation, fairness opinions have become commonplace in corporate control transactions following the 1985 Delaware

Supreme Court case of Smith v. Van Gorkom,[6] in which a corporate board was held to have breached its fiduciary duty of care by approving a merger without adequate information on the transaction, including information on the value of the company and the fairness of the offering price.

NASD notes that, while a fairness opinion addresses the fairness, from a financial point of view, of the consideration involved in a transaction, it does not indicate whether the price of a particular transaction is the best price that could be attained. Rather, it opines on whether the price is "fair" or within an acceptable range of values. A fairness opinion is prepared for a company's board of directors; however, it is often provided to shareholders as part of proxy materials. Inasmuch as a fairness opinion is not required by regulation or statute, the board of directors determines whether to obtain a fairness opinion, the scope of such opinion, and the party preparing such opinion.

NASD has been concerned that the disclosures provided in fairness opinions may not sufficiently inform public shareholders about the potential conflicts of interest that exist between the firm rendering the fairness opinion and the issuer. Among these conflicts are fees that the firm rendering the fairness opinion will receive upon the successful completion of the transaction (either from advisory fees or fees for the fairness opinion itself), as well as other material relationships between the firm and the issuer (including, but not limited to, serving as an underwriter, lender, market maker, asset manager, or providing research coverage).

NASD notes that, under the SEC's proxy rules, which apply to issuers, certain disclosures about potential conflicts of interest are provided to public shareholders. NASD believes that

[6] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

complementary rules for disclosure aimed at broker-dealers rendering fairness opinions would be beneficial. In addition, NASD believes that broker-dealers should develop greater specificity in their written supervisory procedures to guard against conflicts of interest in rendering fairness opinions. To that end, NASD is proposing to identify specific procedures that must be addressed by each firm that renders a fairness opinion.

Paragraph (a)(1) of the proposed rule change sets forth the requirement for a member to disclose in any fairness opinion that may be provided, or described, or otherwise referenced to public shareholders, whether it 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, or (B) serving as an advisor that is contingent upon the successful completion of the transaction. Paragraph (a)(2) would require disclosure of whether such member will receive any other payment or compensation contingent upon the successful completion of the transaction. Paragraph (a)(3) would require disclosure of 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 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 fairness opinion.

NASD intends that the disclosures contemplated by paragraphs (a)(1)-(3) of the proposal be descriptive rather than quantitative. In particular, paragraphs (a)(1) and (2) do not require firms to specify the amount of compensation for rendering the fairness opinion, serving as an advisor or otherwise, that is contingent upon the successful completion of the transaction. For

purposes of the proposed rule change, NASD believes that it would be sufficient for investors to be informed that such contingent compensation relationships exist. Similarly, NASD intends that the disclosures in paragraph (a)(3) pertaining to "material relationships" also be descriptive rather than quantitative.

Paragraph (a)(4) would require disclosure of the categories of information that formed a substantial basis for the fairness opinion that was supplied to the member by the company requesting the opinion concerning the companies involved in the transaction and whether any such information has been independently verified by the member. According to NASD, such disclosure must inform investors about the categories of information (such as projected earnings and revenues, expected cost-savings and synergies, industry trends and growth rate) that formed a substantial basis for the fairness opinion, and with respect to each category, whether the member has independently verified the information supplied by the company.

Finally, paragraph (a)(5) would require disclosure of whether the fairness opinion was approved or issued by a fairness committee and informs investors of whether the fairness opinion was the product of a fairness committee.

Paragraph (b)(1) of the proposed rule change contains the procedures members must follow in issuing a fairness opinion, including the types of transactions and the circumstances in which the member will use a fairness committee to approve or issue a fairness opinion, and, in such transactions where it uses a fairness committee: (A) the process for selecting personnel to be on the fairness committee; (B) the necessary qualifications of persons serving on the fairness committee; and (C) the process to promote a balanced review by the fairness committee,

including review and approval by persons who do not serve on or advise the "deal team" to the transaction.

The procedures in paragraph (b)(2) would require members to have a process to determine whether the valuation analyses used in the fairness opinion are appropriate. In addition, the member's procedures should state the extent to which the appropriateness of the use of such valuation analyses is determined by the type of company or transaction that is the subject of the fairness opinion. Finally, paragraph (b)(3) would require members to have a process to evaluate whether the amount and nature of the compensation from the transaction underlying the fairness opinion benefits any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company, is a factor in reaching a fairness determination.

NASD intends to announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that investors and the public interest will benefit from additional disclosure of potential conflicts of interest in connection with fairness opinions rendered by broker-dealers. NASD also believes

that members should develop and adhere to more detailed procedures to mitigate potential conflicts in rendering fairness opinions.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in NASD Notice to Members 04-83 (November 2004). Twenty comment letters were received in response to the Notice.[7] Of the twenty comment letters received, twelve were in favor of the proposed rule change, seven were opposed, and one expressed no opinion.

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[7] Letter from Lerner College of Business and Economics, University of Delaware dated Nov. 24, 2004; Letter from Ohio Public Employees Retirement System dated Nov. 30, 2004; Letter from Ohio Retirement Systems dated Dec. 9, 2004; Letter from Charles M. Elson, Arthur H. Rosenbloom, and Drew G.L. Chapman dated Dec. 21, 2004; Letter from The Canadian Institute of Chartered Business Valuators dated Jan. 6, 2005; Letter from American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO") dated Jan. 10, 2005; Letter from Kane & Company, Inc. ("Kane") dated Jan. 10, 2005; Letter from Standard & Poor's Corporate Value Consulting ("S&P") dated Jan. 10, 2005; Letter from Council of Institutional Investors dated Jan. 12, 2005; Letter from The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association dated Jan. 26, 2005; Letter from Cravath, Swaine & Moore LLP dated Jan. 31, 2005; Letter from HFBE Capital, L.P. dated Jan. 31, 2005; Letter from Signal Hill Capital Group LLC dated Jan. 31, 2005; Letter from Sutter Securities Incorporated dated Jan. 31, 2005; Letter from California Public Employees' Retirement System ("CalPERS") dated Feb. 1, 2005; Letter from Davis Polk & Wardwell ("David Polk") dated Feb. 1, 2005; Letter from Dewey Ballantine LLP dated Feb. 1, 2005; Letter from Houlihan Lokey Howard & Zukin ("Houlihan Lokey") dated Feb. 1, 2005; Letter from Securities Industry Association dated Feb. 1, 2005; and Letter from The Special Committee on Mergers, Acquisitions and Corporate Control Contests of the Association of the Bar of the City of New York dated Feb. 1, 2005.

In Notice to Members 04-83, NASD solicited comment on whether to propose a new rule that would require disclosures and procedures in connection with conflicts of interest when members provide fairness opinions in corporate control transactions. Although Notice to Members 04-83 did not contain specific rule text, it proposed the following:

1. Any fairness opinion rendered by a member and contained in a proxy statement shall describe a clear and complete description of the material conflicts of interests in issuing the opinion, including the nature of any contingent compensation that the member would receive upon successful completion of the transaction.
2. The member would be required to disclose in the fairness opinion the extent upon which it either relied on the information supplied by the company or independently verified such information.
3. The member would need to maintain written policies and procedures that, with respect to the issuance of fairness opinions, address:
    - the approval process by the member; if the member uses a fairness committee, then the level of experience for committee members, how balanced approval is undertaken and whether steps have been taken to require review by persons whose compensation is not directly related to the transaction;
    - the manner by which it will be determined that the appropriate valuation process will be used in light of the nature of the transaction and the types of companies that are involved; and
    - whether, in a particular transaction, the relative compensation to company insiders versus shareholders is a factor in reaching a fairness determination.

One of the central elements of Notice to Members 04-83 was that any fairness opinion rendered by a member and contained in a proxy statement describe a clear and complete description of the significant potential conflicts of interests in issuing the opinion, including the nature of any contingent compensation that the member would receive upon successful completion of the transaction.

A. What Constitutes a Conflict of Interest?

Many commenters recognized the need for disclosure of potential conflicts of interest, although several commenters took issue with the term "conflict of interest" and instead preferred the term "material relationships" as used in SEC's Regulation M-A. Notice to Members 04-83 focused on potential conflicts arising from serving as advisor to the transaction, such as receiving a contingency fee for a completed transaction. Many commenters believed that a success fee, either for the fairness opinion or the transaction in question, should be disclosed. One commenter noted that potential conflicts of interest may arise under many other circumstances, including serving as an underwriter, lender, market maker, asset manager, or providing research coverage.

Several commenters noted that existing rules of the SEC and common law currently require extensive disclosure in connection with fairness opinions and urged NASD to make sure its rules were consistent with these existing requirements. There was some support for a rule that "complements" existing disclosure requirements. NASD believes that the proposed rule change is consistent with existing SEC requirements. In the proposed rule change, NASD would require disclosure of "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 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 fairness opinion." This disclosure is based on the requirements in Item 1015(b)(4) of SEC's Regulation M-A.[8] NASD has not sought to require firms to identify "any significant conflicts of interest" as originally proposed in Notice to Members 04-83.

While the rule text of paragraph (a)(3) of the proposed rule change was modeled after Item 1015(b)(4), NASD does not intend to construe this section to require quantitative disclosures of the compensation from each material relationship. For purposes of the proposed rule change, NASD believes it will be sufficient for investors to be informed about the material relationships that exist.

NASD also notes that the proposed rule change differs slightly from Item 1015(b)(4) in that the proposed rule change applies to a material relationship between "the member and the companies" involved in the transaction, whereas Item 1015(b)(4) applies only to the member (and its affiliates) and the company (and its affiliates) for which the member is rendering the fairness opinion. NASD believes that investors should be informed of material relationships between the firm authoring the fairness opinion and the companies involved on both sides of the transaction. Moreover, given the narrative (i.e., non-quantitative) focus of this paragraph, NASD believes the additional disclosures are not likely to be burdensome on firms or confusing to investors. NASD notes, however, that unlike Item 1015, Rule 2290 does not reach to affiliates of such companies. NASD intends to review the comment letters received by the SEC before determining whether to amend paragraph (a)(3) to include affiliates.

[8] 17 CFR 229.1015(b)(4).

Several commenters asked NASD to "take stronger measures" to address conflicts in connection with fairness opinions, including requiring "independent" fairness opinions rendered by outside experts that are not connected to the transaction. One commenter recommended prohibiting investment banks from receiving success fees for transactions in which they issue fairness opinions. And another commenter urged an outright ban on arrangements in which part of an investment bank's fee for rendering a fairness opinion is contingent on the transaction closing.

NASD has considered carefully those comments urging stronger measures such as an independent fairness opinion or a prohibition on success fees. As a starting point to its analysis, NASD notes that fairness opinions are not required by regulation or statute; a board of directors determines whether to obtain a fairness opinion, and if so, what the scope of a fairness opinion shall be and who shall prepare such opinion. In addition, NASD believes that, to the extent that a board of directors wants a fairness opinion from a firm not serving as an advisor to the transaction, or to structure payments without a contingency fee, it can do so.

NASD notes that arguments that independent fairness opinions or those without a success fee component offer advantages may be well-founded. However, it is NASD's view that such matters are more appropriately situated within the purview of the board of directors and state corporation law. NASD believes that disclosure and procedures constitute the appropriate course in mitigating potential conflicts of interest in the rendering of fairness opinions, not otherwise limited under applicable law, by NASD members.

Moreover, NASD believes that the lack of consensus among those commenters urging NASD to take stronger measures supports the more uniform course of disclosure and procedures.

Whereas CalPERS asked NASD to prohibit "investment banks from receiving 'success' fees for transactions in which they issue fairness opinions,"[9] the AFL-CIO sought only to prohibit "arrangements in which part of an investment bank's fee for rendering its opinion is contingent on the transaction closing."[10] Some commenters, such as Kane, want to forbid firms with a certain threshold amount of securities business with a company from rendering a fairness opinion, whereas AFL-CIO "do[es] not believe the mere existence of a business relationship with a company should disqualify an investment bank from providing a fairness opinion."[11]

As NASD noted above, fairness opinions are obtained by boards of directors to satisfy their fiduciary duties to act with due care and in an informed manner. NASD further notes that a fairness opinion is not an automatic defense to a claim that a board breached its fiduciary duties. Courts regularly examine the circumstances surrounding a fairness opinion to determine whether it can be relied upon by the board in satisfaction of its fiduciary duties. Thus, NASD notes that boards of directors must today take into account whether an issuer's relationship with an investment bank compromises the purposes for which the fairness opinion is sought. NASD believes that the disclosure standards in these proposed rules would be an important aid to an issuer's board in making that determination.

B. To Whom Should Disclosure be Made?

Some commenters believe that the proposed rule change should only require disclosure of potential conflicts by the member to the board of directors, citing concerns about breach of confidentiality if relationships between the member firm authoring the fairness opinion and its

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9 CalPERS, at 2.

10 AFL-CIO, at 3.

11 Id., at 1.

issuer client were publicly disclosed. Others believe that disclosure should be made more broadly, including in the fairness opinion itself, so that any reader of the fairness opinion can assess the conflicts associated with such opinion. NASD believes that, in general, a board of directors already is in a position to become informed about the potential conflicts with an investment bank that it chooses to render a fairness opinion. NASD notes, however, that investor-shareholders typically do not occupy the same such position. As stated in Notice to Members 04-83, NASD's concern is that investors may not be sufficiently informed "about the subjective nature of some opinions and their potential biases." Accordingly, the proposed rule change requires disclosures by any member issuing a fairness opinion that may be provided, or described, or otherwise referenced to public shareholders. The requirements attach to any such fairness opinion issued by a member, regardless of whether it is included in proxy materials.

C. Verification

As NASD noted above, the proposal in Notice to Members 04-83 would require a firm to disclose in a fairness opinion the extent upon which it either relied on the information supplied by the company or independently verified such information. Nearly every party commenting on this provision stated that firms as a matter of course already disclose in the fairness opinion that they do not independently verify information provided by the issuer. While most commenters did not believe that there was any need for an NASD rule given current practices, the commenters did not oppose NASD rulemaking so long as it did not create a requirement for firms to verify information before rendering a fairness opinion. Many commenters stated that the terms of engagement for rendering a fairness opinion do not call for independent verification of information provided by management, and that other entities, such as forensic accountants,

would be better skilled to verify data. S&P suggested that fairness opinions include disclosure of the information provided by management upon which the opinion is based, and could take the form of a "List of Documents Relied Upon," similar to that which accompanies an expert's report in commercial litigation.[12]

The proposed rule change would not require a member to independently verify data provided by the issuer. NASD agrees with commenters that the scope of a firm's obligations in rendering a fairness opinion is set forth in the terms of engagement with the client, and it is not required that such terms call for independent verification. NASD believes, however, that, to the extent categories of information (such as projected earnings and revenues, expected cost-savings and synergies, industry trends and growth rate) that were supplied by the company requesting the opinion formed a substantial basis for the fairness opinion, and information in each such category was not independently verified, readers of the fairness opinion should be apprised of this fact. Accordingly, the proposed rule change requires members to identify categories of information that formed a substantial basis for the fairness opinion and with respect to such information, whether any such information in each such category has been independently verified by the member. NASD notes that the proposed rule change goes beyond current practices in which firms state, for example, "[w]e have not independently verified the accuracy and completeness of the information supplied to us with respect to the [client] and do not assume any responsibility with respect to it."[13] According to NASD, blanket statements that members have not verified information will not by themselves comply with the proposed rule change;

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12 S&P, at 2-3.

13 Houlihan Lokey, at 4.

members must identify information that formed a substantial basis for the fairness opinions and disclose whether such information was independently verified.

D. Written Policies and Procedures

1. Fairness Opinion Committee

NASD solicited comment on whether to require written procedures governing the approval process by the member, including whether it uses a fairness committee, the level of experience for fairness committee members, how balanced approval is undertaken and whether steps have been taken to require review by persons whose compensation is not directly related to the transaction. Most commenters believed that firms already had procedures in place governing fairness opinions. Notwithstanding this fact, several commenters supported a well-tailored rule in this area. Commenters believed that NASD rulemaking should, however, provide the flexibility to allow each firm to determine the best manner of implementing effective and efficient procedures for reviewing and approving fairness opinions. Several commenters opposed any rule in which NASD would mandate specific procedures that must be followed. These commenters believed that the firms themselves – and not NASD – should determine what policies and procedures should be followed in rendering a fairness opinion.

NASD believes that the proposed rule change is both well-tailored and flexible enough to allow firms to determine how to best implement effective and efficient procedures for reviewing and approving fairness opinions. The specific requirements were discussed in Item II.A.1 above.

2. Valuation

NASD also solicited comment on whether to require written policies and procedures on the manner by which it will be determined that the appropriate valuation process will be used in

light of the nature of the transaction and the types of companies that are involved. The commenters generally were concerned about any NASD rule that would interfere with the selection of the best methodology for a transaction.

NASD does not believe the requirement in the proposed rule change to have written polices and procedures concerning the process to determine whether the valuation analyses used in the fairness opinion are appropriate, nor the requirement that procedures should state the extent to which the appropriateness of the use of such valuation analyses is determined by the type of company or transaction that is the subject of the fairness opinion, will interfere with a firm's ability to select the most appropriate methodology for a transaction. NASD believes that the procedures developed by the firm should be designed to allow the firm to identify and use the correct valuation methodology. In addition, NASD believes that the procedures should prevent the use of a particular valuation methodology at the behest of an interested party when such methodology is inappropriate.

3. Relative Compensation

Finally, NASD solicited comment on a requirement for broker-dealers to have a process to evaluate whether the relative compensation to corporate insiders versus other shareholders in a contemplated transaction is a factor in reaching a fairness opinion.

On the one hand, certain commenters felt the proposal did not go far enough. There was a view that change of control provisions that are a part of any transaction should be disclosed to shareholders as a material factor to be considered as part of the proxy process because often times such payments may be ambiguous or may not be expressly set out in the deal terms of a transaction.

With respect to these commenters, NASD believes the purpose of the proposed requirement in this area is misunderstood. According to NASD, the proposed rulemaking, as it pertains to dealing with the factor of relative compensation in the fairness opinion process, is driven by the regulatory goal of ameliorating this potential conflict through procedures reasonably designed to consider whether in fact such conflict exists and to what extent it may bear on the determination that a transaction is fair. NASD states that it is not intended to fashion additional substantive legal requirements more appropriately addressed, in NASD's view, by state corporation law and the federal law and rules concerning proxies. It is NASD's view that subjecting this potential conflict to the rigor of appropriately and reasonably designed procedures is an appropriate prophylactic with respect to a factor that may or may not weigh on the determination that a transaction is fair.

On the other hand, other commenters felt that management's interests in change of control transactions were not an applicable part of the fairness opinion process because the appropriateness of management compensation was beyond the scope of the fairness opinions, was difficult or impossible to quantify, in many cases rested upon arrangements that preceded the transaction, and required an expertise in executive compensation that is beyond the competency of those issuing fairness opinions.

Again, NASD believes that these comments evidence a misunderstanding of the proposed requirement. NASD does not believe that broker-dealers issuing fairness opinions should review the propriety of preexisting compensation arrangements as such matters would be like any other preexisting fixed or contingent liability of the corporation that cannot be altered by the terms of any change of control transaction. According to the NASD, the intent of the proposed

requirement is that firms consider the extent to which the differential in remuneration between management and other shareholders accruing from the deal proceeds, for which there was no prior contractual commitment, is a factor in determining the fairness of the transaction to shareholders. NASD notes that the proposed requirement does not reach the implicit conclusion that such differential payments are a factor as to whether a transaction is fair but, in NASD's view, it would be equally wrong to conclude that such differential payments are inappropriately placed among the factors and indicia that one should consider in rendering a fairness opinion. NASD believes it is true that a fairness opinion merely states that the transaction is fair and does not necessarily represent the best price. However, NASD also believes it is true that the considerations surrounding the issuance of a fairness opinion are artificially truncated when the total amount that a buyer is willing to pay and how such payment is allocated is never an appropriate factor in a change of control transaction.

E. Other

S&P suggested greater transparency in fairness opinion pricing. Insofar as the price of many fairness opinions is bundled with other advisory services, S&P believed that corporate boards of directors are often less willing to procure an independent fairness opinion. S&P believed that full disclosure of the fairness opinion fee, and in some instances, an actual indication of the financial advisor's effort, could be meaningful disclosure.[14] NASD does not believe it should mandate disclosure of the price or effort expended in preparing the fairness opinion. With respect to price, it is NASD's view that if a board of directors believes it would benefit from more detailed information about prices, it is in a position to obtain that information

[14] S&P, at 2.

from the firm as a condition of engaging the firm to perform advisory and fairness opinion services. With respect to effort, this seems to NASD a potentially misleading metric upon which any reliance would be placed. NASD believes that efforts, great or small, expended upon poorly conceived procedures are of dubious value. Consequently, NASD believes that the appropriate regulatory response is to require members to employ processes framed by appropriately and reasonably designed procedures.

Davis Polk was concerned that NASD rules concerning fairness opinions would discriminate against member firms, since fairness opinions can be provided by non-broker-dealers.[15] NASD recognizes that firms not subject to NASD's jurisdiction are able to render fairness opinions; however, NASD believes that this is not a justification for failing to address actual or perceived conflicts of interest in the brokerage industry or inadequacies in disclosure by such firms.

Finally, several commenters suggested that existing judicial precedent and oversight are more effective controls over the fairness opinion process than would be a new NASD rule, and one commenter suggested that NASD rulemaking may interfere with standards for fairness opinions under corporate law. NASD recognizes and appreciates the role of corporate law on the fairness opinion process. As NASD has noted above, a fairness opinion must comply with corporate law to serve its intended purpose – to satisfy their fiduciary duties to act with due care and in an informed manner. While NASD understands its rules operate in conjunction with judicial precedent, it does not believe that judicial review should exclude NASD rulemaking. NASD notes that many aspects of the securities laws are subject to extensive judicial review, but

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[15] Davis Polk, at 3-4.

that would be an illogical and novel barrier to SEC and SRO rulemaking.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

The Commission notes that the NASD's proposal would not require firms to quantify in the fairness opinion the amount of compensation received that is contingent upon the successful completion of the transaction or to be received as a result of any material relationship between the member firm and any party to the transaction. The Commission requests comment regarding whether the disclosures that would be required by proposed Rule 2290(a)(1), (2), and (3) should be quantified. Further, we request comment as to 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 Commission further notes that the proposed disclosure of material relationships does not extend to relationships with affiliates of the member firm. The Commission requests comment regarding 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.

In addition, the Commission requests comment as to 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. Further, the Commission requests comment on whether members should be required to obtain independent verification of such information.

We also note that the proposed rule does not require disclosure of the procedures utilized by the member firm. We request comment as to whether member firms should disclose these procedures in the fairness opinion or elsewhere.

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD- 2005-080 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2005-080. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the File Number SR-NASD-2005-080 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[16]

Nancy M. Morris
Secretary

[16] 17 CFR 200.30-3(a)(12).