NASD Regulation, Inc.
Corporate Financing Department
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January 20, 2000

Katherine A. England, Esq.
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-00-04**
Amendments to the Corporate Financing Rule

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed herewith is the above-numbered rule filing. Also enclosed is a 3-l/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Suzanne E. Rothwell, Chief Counsel, Corporate Financing, NASD Regulation, Inc., at (202) 974-2747; e-mail rothwels@nasd.com. The fax number of the Corporate Financing Department is (202) 974-2732.

Very truly yours,

Joan C. Conley
Secretary

Attachment

File No. SR-NASD-00-04
Consists of 133 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

TABLE OF CONTENTS

1. Text of Proposed Rule Change

Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 ("Act"), the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly-owned subsidiary NASD Regulation, Inc. ("NASD Regulation"), is filing with the Securities and Exchange Commission (“SEC”) a proposed rule change to Conduct Rule 2710. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

2710. Corporate Financing Rule - Underwriting Terms and Arrangements

(a) Definitions No change.

(b) Filing Requirements

(1) - (5) No change.

(6) Information Required to be Filed

(A) Any person filing documents pursuant to subparagraph (4) above shall provide the following information with respect to the offering:

(i) - (iii) No change.

(iv) [a statement addressing the factors in subparagraphs (c)(4)(C) and (D), where applicable;]

[(v)] a detailed explanation of any other arrangement entered into during the [12-month] 180-day period immediately preceding the filing date of the public offering, which arrangement provides for the receipt of any item of value [and/]or the transfer of any warrants, options, or other securities from the issuer to the underwriter and related persons; and

[(vi)] (v) a detailed explanation and any documents related to:

a. the modification of any information or representation previously provided to the Association or of any item of underwriting compensation[,] ; or

b. any new arrangement that provides for the receipt of any additional item of value by the underwriter and related persons subsequent to the [review and approval of such compensation] issuance of an opinion of no objections to the underwriting terms and arrangements by the Association and within 90 days immediately following the effective date of the public offering.

(B) No change.

(7) - (12) No change.

(c) Underwriting Compensation and Arrangements

(1) - (2) No change.

(3) Items of Compensation

(A) For purposes of determining the amount of underwriting compensation received or to be received by the underwriter and related persons pursuant to subparagraph (2) above, the following items and all other items of value received or to be received by the underwriter and related persons in connection with or related to the distribution of the public offering, as determined pursuant to subparagraph (4) below shall be included:

(i) - (v) No change.

(vi) financial consulting and advisory fees, whether in the form of cash, securities, or any other item of value;

(vii) common or preferred stock, options, warrants, and other equity securities, including debt securities convertible to or exchangeable for equity securities, [including securities] received [as underwriting compensation, for example]:

a. [in connection with] for arranging a private placement of securities for the issuer;

b. for providing or arranging a loan, credit facility, or bridge financing for the issuer;

c. as a finder's fee;

d. for providing consulting services to the issuer; [and]

e. [securities purchased] as an investment in a private placement made by the issuer; or

f. at the time of the public offering;

(viii) - (x) No change.

(xi) commissions, expense reimbursements, or other compensation to be received by the underwriter and related persons as a result of the exercise or conversion, within twelve (12) months following the effective date of the offering, of warrants, options, convertible securities, or similar securities distributed as part of the public offering; and

(xii) fees of a qualified independent underwriter[; and].

[(xiii) compensation, including expense reimbursements, paid in the six (6) months prior to the initial or amended filing of the prospectus or similar documents to any member or person associated with a member for a public offering that was not completed.]

(B) Notwithstanding paragraph (c)(3)(A) above, the calculation of underwriting compensation shall not include:

(i) [E] expenses customarily borne by an issuer, such as printing costs; SEC, "blue sky" and other registration fees; Association filing fees; and accountant's fees, [shall be excluded from underwriter's compensation] whether or not paid through an underwriter;

(ii) compensation, including expense reimbursements, previously paid to any member in connection with a proposed public offering that was not completed, if the member does not participate in the revised public offering; and

(iii) financial consulting and advisory fees, on the basis of information that establishes that an ongoing relationship between the issuer and the financial advisor or consultant was established more than twelve months before the filing date of the public offering.

(4) Determination of Whether Compensation Is Received in Connection with the Offering

(A) All items of value received [or to be received] by the underwriter and related persons during the [twelve (12) month] 180-day period immediately preceding the filing date of the registration statement or similar document, and

at the time of [and subsequent to] the public offering, will be [examined to determine whether such items of value are] considered to be underwriting compensation in connection with the public offering [and, if received during the six (6) month period immediately preceding the filing of the registration statement or similar document, will be presumed to be underwriting compensation received in connection with the offering, provided, however, that such presumption may be rebutted on the basis of information satisfactory to the Association to support a finding that the receipt of an item is not in connection with the offering and shall not include cash discounts or commissions received in connection with a prior distribution of the issuer's securities].

[(B) Items of value received by an underwriter and related person more than twelve (12) months immediately preceding the date of filing of the registration statement or similar document will be presumed not to be underwriting compensation. However, items received prior to such twelve (12) month period may be included as underwriting compensation on the basis of information to support a finding that receipt of the item is in connection with the offering.]

[(C) For purposes of determining whether any item of value received or to be received by the underwriter and related persons is in connection with or related to the distribution of the public offering, the following factors, as well as any other relevant factors and circumstances, shall be considered:]

[(i) the length of time between the date of filing of the registration statement or similar document and:]

[a. the date of the receipt of the item of value;]

[b. the date of any contractual agreement for services for which the item of value was or is to be received; and]

[c. the date the performance of the service commenced, with a shorter period of time tending to indicate that the item is received in connection with the offering;]

[(ii) the details of the services provided or to be provided for which the item of value was or is to be received;]

[(iii) the relationship between the services provided or to be provided for which the item of value was or is to be received and:]

[a. the nature of the item of value;]

[b. the compensation value of the item; and]

[c. the proposed public offering;]

[(iv) the presence or absence of arm's length bargaining or the existence of any affiliate relationship between the issuer and the recipient of the item of value, with the absence of arm's length bargaining or the presence of any affiliation tending to indicate that the item of value is received in connection with the offering.]

[(D) For purposes of determining whether securities received or to be received by the underwriter and related persons are in connection with or related to the

distribution of the public offering, the factors in subparagraph (C) above and the following factors shall be considered:]

[(i) any disparity between the price paid and the offering price or the market price, if a bona fide independent market exists at the time of acquisition, with a greater disparity tending to indicate that the securities constitute compensation;]

[(ii) the amount of risk assumed by the recipient of the securities, as determined by:]

[a. the restrictions on exercise and resale;]

[b. the nature of the securities (e.g., warrant, stock, or debt); and]

[c. the amount of securities, with a larger amount of readily marketable securities without restrictions on resale or a warrant for securities tending to indicate that the securities constitute compensation; and]

[(iii) the relationship of the receipt of the securities to purchases by unrelated purchasers on similar terms at approximately the same time, with an absence of similar purchases tending to indicate that the securities constitute compensation.]

[(E) Notwithstanding the provisions of subparagraph (3)(A)(vi) above, financial consulting and advisory fees may be excluded from underwriting compensation upon a finding by the Association, on the basis of information satisfactory to it, that an ongoing relationship between the issuer and the underwriter and related person has been established at least twelve (12) months prior to the filing of the registration statement or similar document or that the relationship, if established

subsequent to that time, was not entered into in connection with the offering, and that actual services have been or will be rendered which were not or will not be in connection with or related to the offering.]

(B) Securities of the issuer acquired by the underwriter and related persons before the filing date of a public offering will be considered to be received for purposes of subparagraph (c)(4)(A) and (E) as of the date of the:

(i) closing of a private placement, if the securities were purchased from or received as compensation for the private placement;

(ii) execution of an agreement for a loan or credit facility, if the securities were received as compensation for the loan or credit facility; or

(iii) transfer of beneficial ownership of the securities to a consultant, if the securities were received as compensation for consulting services.

(C) All items of value received by the underwriter and related persons during the 90-day period immediately following the effective date of a public offering will be examined to determine whether such items of value are considered underwriting compensation in connection with the public offering.

(D) For purposes of subparagraph (c)(4)(E) below, the following terms will have the meanings stated below.

(i) An entity will include a group of legal entities that either:

a. are contractually obligated to make co-investments and have previously made at least one such investment; or

b. have filed a Form 13D or 13G with the SEC that identifies the entities as “members of the same group” in connection with a previous

investment for purposes of Section 13 of the Securities Exchange Act of 1934.

(ii) An institutional investor will mean any individual or entity that has at least $50 million invested in securities in the aggregate in its portfolio or under management; provided that an institutional investor will not include any member participating in the public offering, any of its associated or affiliated persons, or an immediate family member of its associated or affiliated persons.

(E) Notwithstanding subparagraph (c)(4)(A) above, the following acquisitions of securities will not be considered underwriting compensation:

(i) **Purchases and Loans by Certain Entities** - Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility more than 90 days before the filing date of the public offering, by certain entities if:

a. the entity:

1. either:

A. manages capital contributions of $100 million or more, at least $75 million of which has been committed by persons that are not underwriters or related persons; or

B. manages capital contributions of $25 million or more, at least 75% of which has been committed by persons that are not underwriters or related persons;

2. is a separate and distinct legal entity from the member and is not registered as a broker/dealer;

3. makes investments or loans subject to the evaluation and review of designated individuals who have a fiduciary duty to select investments and loans based on the risks and rewards to the entity and not based on opportunities for the member to earn investment banking revenues;

4. does not participate directly in investment banking fees received by the member for underwriting public offerings;

5. is engaged primarily in the business of making investments in or loans to private or start-up companies or companies in the early process of developing products or services, or participating in leveraged buy-out transactions; and

b. the member maintains and enforces written procedures reasonably designed to ensure that the member's participation in the public offering is not contingent on the entity's participation in the private placement or loan.

(ii) **Investments In and Loans to Certain Issuers** - Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility more than 90 days before the filing date of the public offering, by certain entities if:

a. the entity:

1. manages capital contributions or loan commitments of at least $50 million;

2. is a separate and distinct legal entity from the member and is not registered as a broker/dealer;

3. does not participate directly in investment banking fees received by the member for underwriting public offerings;

4. is engaged primarily in the business of making investments in or loans to private or start-up companies or companies in the early process of developing products or services, or participating in leveraged buy-out transactions; and

b. institutional investors beneficially own at least 33% of the total number of the issuer's equity securities outstanding on a fully diluted basis;

c. an institutional investor is a member of the issuer's board of directors;

d. the transaction was approved by a majority of the issuer's board of directors and by the affirmative vote of institutional investors that are board members;

e. the total amount of securities received by all entities related to each member does not exceed 5% of the total number of the issuer's equity securities outstanding on a fully diluted basis; and

f. the member maintains and enforces written procedures reasonably designed to ensure that member's participation in the public offering will not be contingent on the entity's participation in the private placement or loan.

(iii) **Private Placements With Institutional Investors** - Securities of the issuer purchased in or received as placement agent compensation for a

private placement more than 90 days before the filing date of the public offering if:

a. institutional investors purchase at least 51% of the total offering (comprised of the total number of securities, on a fully diluted basis, sold in the private placement and received as placement agent compensation by a member);

b. an institutional investor was the lead negotiator with the issuer to establish the terms of the private placement;

c. the underwriter and related persons (excluding any entities qualified under paragraph (c)(4)(D)(i) above):

1. have not, in the aggregate, purchased or received as placement agent compensation more than 20% of the total offering; and

2. have purchased securities that were at the same price and with the same terms as the securities purchased by other investors; and

d. the member maintains and enforces written procedures reasonably designed to ensure that its participation in the public offering will not be contingent on its participation in the private placement.

(iv) **Purchases Under a Preemptive Right** - Securities of the issuer under a right of preemption if:

a. the right of preemption was granted either:

1. in connection with a purchase from a private placement of the issuer's securities made more than 180 days before the filing date of the public offering; or

2. in connection with a security purchased from a public offering or the public market; and

b. the purchase under the right of preemption:

1. was exercised in connection with a private placement of the issuer's securities that was for cash;

2. was to all similar preemptive right holders;

3. was at the same price and had the same terms as the securities purchased by other investors; and

4. did not increase the purchaser's percentage ownership of the same class of securities of the issuer.

(5) Valuation of Non-Cash Compensation

For purposes of determining the value to be assigned to securities received as underwriting compensation, the following criteria and procedures shall be applied:

(A) [No underwriter and related person may receive a security or a warrant for a security as compensation in connection with the distribution of a public offering that is different than the security to be offered to the public unless the security received as compensation has a bona fide independent market, provided, however, that: (i) in exceptional and unusual circumstances, upon good cause shown, such arrangement may be permitted by the Association; and (ii) in an offering of units, the underwriter and related persons may only receive a warrant for the unit offered to the public where the unit is the same as the public unit and the terms are no more favorable than the terms of the public unit.]

An underwriter and related person may not receive a security (including securities in a unit) or a warrant for a security as underwriting compensation in connection with a public offering unless: (i) the security received or the security underlying the warrant received is identical to the security offered to the public or to a security with a bona fide independent market; or (ii) the arrangement, upon good cause shown, is permitted by the Association.

(B) [s] Securities that are not options, warrants or convertible securities shall be valued on the basis of:

(i) the difference between [the per security cost and]:

a. either the market price per security on the date of acquisition, [where a] or, if no bona fide independent market exists for the security, [or] the [proposed (and actual)] public offering price per security; and

b. the per security cost;

(ii) multiplied by the number of securities received or to be received as underwriting compensation;

(iii) divided by the public offering proceeds; and

(iv) multiplied by one hundred [(100)].

(C) [o] Options, warrants or convertible securities ("warrants") shall be valued on the basis of [the following formula]:

(i) the [proposed (and actual)] public offering price per security multiplied by .65 [(65%)];

(ii) minus the difference between:

a. the exercise or conversion price per [security] warrant; and

b. either the market price per security on the date of acquisition, [where a] or, if no bona fide independent market exists for the security, [or] the [proposed (and actual)] public offering price per security;

(iii) divided by two [(2)];

(iv) multiplied by the number of securities underlying the warrants[, options, and convertible securities received or to be received as underwriting compensation];

(v) less the total price paid for the [securities] warrants;

(vi) divided by the public offering proceeds; and

(vii) multiplied by one hundred [(100)].

(D) [a lower value equal to 80% and 60% of the calculated value shall be assigned if securities, and where relevant, underlying securities, are or will be restricted from sale, transfer, assignment or other disposition for a period of one and two years, respectively, beyond the one-year period of restriction required by subparagraph (7)(A)(i) below.] A lower value equal to 10% of the calculated value shall be assigned for each 180-day period that the securities or underlying securities are restricted from sale or other disposition beyond the 180-day period of restriction required by subparagraph (c)(7)(A)(i) below, regardless of the availability of subparagraphs (c)(7)(A)(i)(c) and (d) for sale of the securities.

(6) Unreasonable Terms and Arrangements

(A) No change.

(B) Without limiting the foregoing, the following terms and arrangements, when proposed in connection with [the distribution of] a public offering of securities, shall be unfair and unreasonable:

(i) - (vii) No change.

(viii) the receipt by the underwriter and related persons of underwriting compensation consisting of any option, warrant or convertible security [which] that:

a. - f. No change.

g. has anti-dilution terms designed to provide the underwriter and related persons with disproportionate rights, privileges and economic benefits which are not provided to the purchasers of the securities offered to the public (or the public shareholders, if in compliance with subparagraph (5)(A) above); or

h. has anti-dilution terms designed to provide for the receipt or accrual of cash dividends prior to the exercise or conversion of the security[; or];

[i. is convertible or exercisable or otherwise is on terms more favorable than the terms of the securities being offered to the public;]

(ix) - (x) No change.

[(xi) stock numerical limitation. The receipt by the underwriter and related persons of securities which constitute underwriting compensation in an

aggregate amount greater than ten (10) percent of the number or dollar amount of securities being offered to the public, which is calculated to exclude:]

[a. any securities deemed to constitute underwriting compensation;

b. any securities issued or to be issued pursuant to an overallotment option;]

[c. in the case of a "best efforts" offering, any securities not actually sold; and]

[d. any securities underlying warrants, options, or convertible securities which are part of the proposed offering, except where acquired as part of a unit;]

(xii) - (xiv) Renumbered (xi) - (xiii).

(C) In the event that the underwriter and related persons receive securities deemed to be underwriting compensation in an amount [constituting] that results in unfair and unreasonable compensation [pursuant to the stock numerical limitation in subparagraph (B)(ix) above], the recipient shall return any excess securities to the issuer or the source from which received at cost and without recourse, except that [in exceptional and unusual circumstances], upon good cause shown, a different arrangement may be permitted.

(7) Restrictions on Securities

(A) [No member or person associated with a member shall participate in a] Any public offering in which [does not] a member or person associated with a member participates must comply with the following requirements:

(i) any common or preferred stock, options, warrants, and other equity securities [deemed to be underwriting compensation], including debt securities convertible to or exchangeable for equity securities, of the issuer beneficially owned by an underwriter and related person at the time of the offering shall not be sold, transferred, assigned, pledged or hypothecated by any person, except as provided in subparagraph (B) below, for a period of [(a) one year] 180 days immediately following the effective date of the public offering [for which the securities were received.];

[However, securities deemed to be underwriting compensation may be transferred to any member participating in the offering and the bona fide officers or partners thereof and securities which are convertible into other types of securities or which may be exercised for the purchase of other securities may be so transferred, converted or exercised if all securities so transferred or received remain subject to the restrictions specified herein for the remainder of the initially applicable time period;]

[(ii) certificates or similar instruments representing securities restricted pursuant to subparagraph (i) above shall bear an appropriate legend describing the restriction and stating the time period for which the restriction is operative;] and

[(iii)] (ii) securities [to be] received by a member as underwriting compensation shall only be issued to a member participating in the offering and the [bona fide] officers or partners thereof.

(B) [The provisions of] Notwithstanding subparagraph (A) [notwithstanding] above, the following shall not be prohibited:

(i) the transfer of any security:

a. by operation of law or by reason of reorganization of the issuer [shall not be prohibited.];

b. to any member participating in the offering and the officers or partners thereof, if all securities so transferred remain subject to the restrictions in subparagraph (A) above for the remainder of the applicable time period;

[(C) Venture capital restrictions. When a member participates in the initial public offering of an issuer's securities, such member or any officer, director, general partner, controlling shareholder or subsidiary of the member or subsidiary of such controlling shareholder or a member of the immediate family of such persons, who beneficially owns any securities of said issuer at the time of filing of the offering, shall not sell such securities during the offering or sell, transfer, assign or hypothecate such securities for ninety (90) days following the effective date of the offering unless:]

[(i) the price at which the issue is to be distributed to the public is established at a price no higher than that recommended by a qualified independent underwriter who does not beneficially own 5% or more of the outstanding voting securities of the issuer, who shall also participate in the preparation of the registration statement and the prospectus, offering circular, or similar document and who shall exercise the usual standards of "due diligence" in respect thereto; or]

[(ii)] c. if the aggregate amount of such securities held by [such a member and its related persons enumerated above would] an underwriter and its related persons do not exceed 1% of the securities being offered; or

d. if the class of security qualifies as an "actively traded security" for purposes of SEC Regulation M; and

(ii) the exercise or conversion of any security, if all securities received remain subject to the restrictions in subparagraph (A) above for the remainder of the applicable time period.

(8) Conflicts of Interest No change.

(d) Exemptions

Pursuant to the Rule 9600 Series, the Association may exempt a member or person associated with a member from the provisions of this Rule for good cause shown.

2. Procedures of the Self-Regulatory Organization

The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on December 8, 1999, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market has been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on December 9, 1999. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the By-Laws permits the NASD Board of Governors to adopt NASD amendments to NASD Rules without recourse to the membership for approval.

Questions regarding this rule filing may be directed to Suzanne E. Rothwell, Chief Counsel, Corporate Financing, NASD Regulation, at (202) 974-2747.

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

Purpose

I. Background

A. Scope Of The Corporate Financing Rule

NASD Conduct Rule 2710 ("Corporate Financing Rule" or "Rule") is intended to ensure that the underwriting terms and arrangements of a public offering[1] in which an NASD member participates[2] are fair and reasonable. The Rule requires a member to file certain information with NASD Regulation about the underwriting arrangements of a public offering in which the member participates. The Corporate Financing Department ("Department") of NASD Regulation reviews this information prior to commencement of the offering in order

[1] Rule 2720(b)(14) defines "public offering" as:

> any primary or secondary distribution of securities made pursuant to a registration statement or offering circular including exchange offers, rights offerings, offerings made pursuant to a merger or acquisition, straight debt offerings, offerings pursuant to SEC Rule 504, and all other securities distributions of any kind whatsoever, except any offering made pursuant to an exemption from registration under Sections 4(1), 4(2), or 4(6) of the Securities Act of 1933, as amended, or pursuant to SEC Rule 504 if the securities are "restricted securities" under SEC Rule 144(a)(3), SEC Rule 505, or SEC Rule 506 adopted under the Securities Act of 1933, as amended. The term public offering shall exclude exempted securities as defined in Section 3(a)(12) of the Act.

This definition of "public offering" also applies to Rule 2710.

[2] Rule 2710(a)(4) defines "participation" or "participating in a public offering" as:

> participation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering, but not the preparation of an appraisal in a savings and loan conversion or a bank offering or the preparation of a fairness opinion pursuant to SEC Rule 13e-3.

to determine whether the underwriting compensation and other terms and arrangements meet the requirements of applicable NASD rules.[3]

The Corporate Financing Rule regulates, among other matters, the total amount of underwriting compensation that the "underwriter and related persons"[4] may receive in connection with a public offering. The term "underwriter and related persons" includes all broker/dealers (and the associated persons[5] and affiliates[6] of the broker/dealers) participating in any capacity in the proposed public offering, as well as other non-broker/dealers who act as counsel, finders, or consultants, or are members of the immediate family, or are related persons[7] to other persons in the definition. In order to facilitate the following discussion,

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[3] SEC Rule 461(b)(6) provides that the SEC will refuse to accelerate the effective date of an offering includes if the ". . . NASD has not issued a statement expressing no objections to the compensation and other arrangements . . ."

[4] Rule 2710(a)(6) defines "underwriter and related persons" as:

> underwriters, underwriter's counsel, financial consultants and advisors, finders, members of the selling or distribution group, any member participating in the public offering, and any and all other persons associated with or related to and members of the immediate family of any of the aforementioned persons.

[5] Article I, paragraph (ee) of the NASD By-Laws defines "associated person of a member" as:

> (1) any natural person registered under the Rules of the Association; or (2) a sole proprietor, partner, officer, director, or branch manager of a member, or a natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the NASD under the By-Laws or the Rules of the Association.

[6] For purposes of Rules 2710 and 2720, Rule 2720(b)(1) provides that an "affiliate" presumptively includes:

> (1) a company that beneficially owns 10 percent or more of the outstanding voting securities of a member; (2) a member that beneficially owns 10 percent or more of the outstanding voting securities of a company; and (3) a company and a member that are under the common control of a person or company who beneficially owns 10 percent or more of the outstanding voting securities of the company and/or member or who has the power to direct the management or policies of the company and/or member.

The Department's long-standing practice is to deem any company or member that comes within these presumptions to be an affiliate.

[7] In SR-NASD-91-19, published in part in SEC Release No. 34-29928 (November 21, 1991), the NASD stated that "The concept of whether one person is 'related to' any of the enumerated persons in the definition is

participating broker/dealers and their associated persons, affiliates, and related persons are together referred to as "members."

B. Calculating Underwriting Compensation

The Corporate Financing Rule provides in paragraph (c)(4) that any item of value as set forth in Rule 2710(c)(3)(A), including certain securities of the issuer, [8] acquired by the underwriter and related persons within the 12-month period before the filing date of a proposed public offering will be examined by the Department to determine whether it was acquired "in connection with the public offering" and, therefore, is deemed to be underwriting compensation. The Rule presumes that any such item of value acquired within the six-month period before filing is underwriting compensation, but this presumption may be rebutted by the member based on information satisfactory to the Department.[9]

The Corporate Financing Rule requires in paragraphs (c)(4)(C) and (D) that the Department weigh as many as ten different factors to determine whether the item of value received by the underwriter and related persons within the 12-month period before the filing date of a public offering is received "in connection with the public offering" and, therefore, included in the calculation of underwriting compensation. In many cases, an underwriter or related person has acquired unregistered equity securities[10] of the issuer. Members typically

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determined by whether there is an investment or business relationship between the parties and is based on objective facts."

[8] The term "issuer" is defined in Rule 2710(a)(2) to include:

> The issuer of the securities offered to the public, any selling security holders offering securities to the public, any affiliate of the issuer or selling security holder, and the officers or general partners, directors, employees and security holders thereof.

[9] Rule 2710(c)(4)(B) provides that items of value received more than 12 months before the filing date of the public offering are presumed not to be underwriting compensation unless the staff has satisfactory information supporting a conclusion that the item is additional underwriting compensation.

[10] Securities purchased in the public market are not considered to be "items of value."

acquire these unregistered securities as an investment in a private placement; as compensation for the member's services as private placement agent; or for providing a loan or credit facility to the issuer.

The Rule requires the staff to consider the following factors – as well as "any other relevant factors and circumstances and circumstances" -- to determine whether securities have been received in connection with the public offering:

- the length of time between the date of the receipt of the security and the filing date;
- details of any services provided;
- the presence or absence of arm's length bargaining;
- the disparity between the price paid for a security and the proposed public offering price;
- the existence of restrictions on exercise and resale;
- the nature of the securities;
- the amount of securities; and
- the relationship of the receipt of securities to purchases by other unrelated purchasers.

The factor-weighing process requires the staff to review each acquisition of the issuer's securities by members on a case-by-case basis. The value of any securities that the Department determines are underwriting compensation, as calculated under Rule 2710(c)(5), is added to the underwriting discount or commission and any other fees or reimbursements received by the underwriting syndicate to determine whether the compensation is unfair or unreasonable.

C. Restrictions On Resale

Securities included in the calculation of underwriting compensation are also restricted by the Rule from sale for one year following the effective date of the offering under Rule 2710(c)(7)(A) (the "compensation lock-up"). In the case of an initial public offering, if the members and certain senior persons and subsidiaries of the member hold securities of the issuer that are not deemed to be underwriting compensation, a 90-day lock-up is nonetheless imposed under Rule 2710(c)(7)(B) (the "venture capital lock-up").[11]

D. Limitation On Amount Of Securities

The Rule also limits the amount of securities that can be received by the underwriter and related persons as underwriting compensation to 10% of the number of securities to be sold in the public offering (the "stock numerical limitation") under Rule 2710(c)(6)(B)(xi).

II. Changes In The Capital Markets

In recent years, many NASD members have expanded the variety of services that they provide to their corporate financing clients. These services may include venture capital investment, consulting, commercial lending, and investment banking. Moreover, the pace of corporate financing activities has accelerated, and the time period between private fundraising and the issuer's initial public offering has often been shortened. These developments necessitate a review of the Corporate Financing Rule to ensure that it accommodates the modern, legitimate capital financing activities of NASD members, while continuing to protect investors and issuers from unreasonable underwriting activities.

[11] The venture capital lock-up only applies to securities of the issuer held by the member, or any officer, director, general partner, controlling shareholder or subsidiary of the member, or by a subsidiary of a controlling shareholder of the member, or by a member of the immediate family of such persons. In comparison, the compensation lock-up applies to all securities considered to be underwriting compensation that are held by the underwriter and related persons. *See,* definition of "underwriter and related persons" in note 4 above.

The current subjective, factor-weighing process for determining whether securities were acquired in connection with a public offering is an inefficient method to achieve these objectives. The subjectivity hampers the Department's ability to provide clear and predictable guidance to members. The consequences under the Rule of a particular venture capital or other private placement financing are sometimes uncertain until a public offering is filed and the Department's review is completed. This uncertainty unnecessarily complicates the capital-raising process, to the detriment of issuers and investors.

III. Description Of Proposed Rule Change

A. Summary Of Proposed Rule Change

NASD Regulation proposes to amend the Corporate Financing Rule to allow members to provide legitimate capital-raising services to issuers, while adopting restrictions that are designed to minimize the opportunity for abusive practices by members. NASD Regulation also proposes to eliminate or revise other burdensome and obsolete provisions, including rules regulating the exercise price of warrants received as underwriting compensation and the treatment of fees paid to a previous underwriter for an uncompleted offering. In addition, the proposed rule change would clarify a member's obligation to update previously filed information.

B. Treatment of Securities As Underwriting Compensation

1. Six-Month Pre-Offering Objective Test The proximity of an acquisition of equity securities of an issuer (or any other item of value) to the filing date of its public offering has proven to be the most significant factor in determining whether those securities constitute underwriting compensation. The Department has found that the application of the six-month presumption contained in the Rule generally minimizes the opportunity for

abusive practices by members. Application of a longer time period has typically been unnecessary to achieve this goal, however.

NASD Regulation proposes to amend the Corporate Financing Rule to provide greater clarity and predictability regarding whether equity securities[12] of the issuer and other items of value acquired by the underwriter and related persons constitute underwriting compensation. The proposed rule change would replace the twelve-month review period, the six-month presumption, and the subjective review factors with an objective standard in Rule 2710(c)(4)(A) under which all other items of value acquired during the 180-day period immediately preceding the filing date of the registration statement or similar document and at the time of the public offering will constitute underwriting compensation. The proposed rule change would also provide four safe harbors from this general standard.[13] These safe harbors are described below.

Replacement of the existing subjective analysis with an objective, bright-line test would provide greater clarity and predictability concerning application of the Rule to specific transactions. Consequently, members and their venture capital and lending affiliates should find it easier to determine at the time of a private placement or other financing whether its investment will be treated as underwriting compensation when the subsequent public offering is filed with the Department for review.

2. Safe Harbor Provisions NASD Regulation proposes four safe harbors from the determination that certain acquisitions of securities during the 180-day review

[12] The proposed rule change would clarify that the securities that will be considered to be underwriting compensation include common or preferred stock, options, warrants, and debt securities convertible to or exchangeable for equity securities.

[13] Regardless of when an underwriter or related person acquires securities of the issuer, or the availability of any safe harbor, all securities held by the underwriter and related persons are proposed to be subject to a lock-up on their sale, as described below.

period are deemed to be underwriting compensation.[14] The four safe harbors are intended to identify acquisitions that occur in *bona fide* capital-raising transactions, and would impose restrictions designed to minimize the opportunity for abusive practices.

The first three safe harbors in proposed Rules 2710(c)(4)(E)(i) - (iii), would be available for acquisitions by certain entities that regularly make venture capital investments; for acquisitions in issuers with significant institutional investor involvement in their corporate governance; and for acquisitions in private placements that have significant institutional investor participation. The fourth safe harbor in paragraph (c)(4)(E)(iv) would exempt acquisitions that occur from the exercise of a preemptive right to purchase.

The first three safe harbors would be available only for acquisitions that occur more than 90 days before the filing date of the public offering. These safe harbors would also require that the member maintain and enforce written procedures reasonably designed to ensure that the member's participation in the public offering is not contingent on the acquiring party's participation in the private placement or loan.

(a) Safe Harbor No. 1 - Purchases And Loans By Certain Entities The first safe harbor, proposed in Rule 2710(c)(4)(E)(i), is intended for acquisitions of the issuer's securities by certain entities that routinely make venture capital investments or provide loans or credit facilities. The safe harbor would be available: (1) to any qualifying entities related to any member participating in an offering; (2) for purchases in a private placement and for the receipt of securities as compensation for a loan or credit facility; and (3) without any limitation on the amount of securities purchased or received.

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[14] The Department will maintain its authority under the Rule 9600 Series to grant exemptions on a case-by-case basis from the determination that certain securities are deemed to be underwriting compensation. The Department expects to exercise this authority sparingly and only in exceptional and unusual circumstances.

(i) Legal Entity/Registration The related entity would have to be a legal entity that is separate and distinct from the member and not registered as a broker/dealer. The term "entity" would be defined in new Rule 2710(c)(4)(D)(i) to include a group of legal entities that either are contractually obligated to make co-investments and have previously made at least one such investment or have filed a Form 13D or 13G with the SEC that identifies the entities as "members of the same group" in connection with a previous investment.

(ii) Venture Capital/Fiduciary Duty The related entity must also be "primarily engaged in the business of making investments in or loans to private or start-up companies or companies in the early process of developing products or services, or participating in leveraged buy-out transactions." The related entity can make investments or loans that are under the safe harbor only if they are subject to the evaluation and review of designated individuals who have a fiduciary duty to select investments and loans based on the risks and rewards to the related entity and not based on opportunities for the member to earn investment banking revenues.

(iii) Sharing In Investment Banking Fees The related entity could not participate directly in investment banking fees received by the member for underwriting public offerings.

(iv) Capital Under Management The related entity would have to either: (1) manage capital contributions of $100 million or more, at least $75 million of which has been committed by persons that are not an underwriter or related person; or (2) manage capital contributions of $25 million or more, at least 75% of which has been committed by

persons that are not an underwriter or related person.[15] The requirement for significant third-party capital would protect against potentially abusive situations, as the related entity must make its investment or lending decision in the interest of investors who are not underwriters or related persons.

(b) Safe Harbor No. 2 - Investments In And Loans To Certain Issuers The second safe harbor, proposed in Rule 2710(c)(4)(E)(ii), is intended for acquisitions of securities of issuers that have significant institutional investor involvement in their corporate governance. The proposed safe harbor would be available for acquisitions by qualifying related entities: (1) in a private placement; and (2) as compensation for a loan or credit facility, with a limitation on the amount acquired.

(i) 5% Limitation On Acquisition The total amount of securities acquired by all entities that are related to a single member could not exceed 5% of the issuer's outstanding equity securities, on a fully diluted basis. The 5% limitation would apply on a member-by-member basis when more than one member proposes to rely on this safe harbor.

(ii) Related Entity Qualifications The related entity would have to manage capital contributions and loan commitments of at least $50 million. Unlike the first safe harbor, there would not be a requirement that the entity manage third-party capital contributions. The related entity would also have to be a separate legal entity and not registered as a broker/dealer; could not participate directly in the member's investment banking fees; and would have to be primarily engaged in the business of making venture capital investments.

[15] Such third-party capital commitments could come from members and their associated and affiliated persons, so long as those members do not participate in the public offering.

(iii) 33% Institutional Investor Ownership The proposed safe harbor would require that institutional investors beneficially own at least 33% of the total number of the issuer's equity securities outstanding on a fully diluted basis. The term "institutional investor" would be defined in Rule 2710(c)(4)(D)(ii) to include any individual or entity (including a group of legal entities as proposed to be defined in Rule 2710(c)(4)(D)(i)) that has at least $50 million invested in securities in the aggregate in its portfolio or under management and is not: (1) a member participating in the public offering; (2) any of the member's associated or affiliated persons; or (3) an immediate family member of any of the member's associated or affiliated persons.[16]

(iv) Participation On And Vote Of Board of Directors At least one of those institutional investors would have to serve as a member of the issuer's board of directors and the transaction would have to be approved by a majority of the issuer's board of directors and by an affirmative vote of the institutional investors that are board members.

(c) Safe Harbor No. 3 - Private Placements With Institutional Investors

The third safe harbor, proposed in Rule 2710(c)(4)(E)(iii), is intended for acquisitions in private placements with significant institutional investor participation. The safe harbor would be available for purchases of securities in a private placement and for the receipt of securities as placement agent compensation.

(i) 20% Of Total Offering Limitation The underwriter and related persons could not, in the aggregate, acquire more than 20% of the "total offering." The "total offering" would be defined to consist of the total number of securities, on a fully diluted basis, sold in the private placement and received as placement agent compensation by a

[16] An institutional investor could be a member, or a person associated or affiliated with a member, that is not participating in the public offering.

member. The 20% calculation would exclude purchases by those affiliates and other related persons of a member that would be qualified to acquire securities of the issuer under the first safe harbor. [17]

(ii) Same Terms And Price All securities purchased by the underwriter and related persons from the private placement must have the same terms[18] and be purchased at the same price[19] as securities purchased by the other investors.

(iii) 51% Institutional Investor Participation Institutional investors would have to purchase at least 51% of the total offering.[20] In addition, an institutional investor would have to be the lead negotiator with the issuer to establish the terms of the private placement. This requirement would not prevent an underwriter or related person from participating in the negotiation of the terms of the private placement.

(d) Safe Harbor No. 4 - Purchases Under A Preemptive Right The fourth safe harbor, proposed in Rule 2710(c)(4)(E)(iv), is intended for any acquisition of the issuer's securities by any underwriter or related person that is made pursuant to a right of preemption, whether that preemptive right was granted by contract, by the terms of the security, or under

[17] For example, if the private placement consists of 100,000 shares of common stock and the issuer pays placement agent compensation to a member that includes a warrant for 10,000 shares of common stock, the total offering is 110,000 shares of common stock. The acquisition by the underwriter and related persons that are not qualified to purchase under the first safe harbor could not exceed 22,000 shares of common stock. Of these 22,000 shares, 10,000 shares would be accounted for by the warrant and up to 12,000 shares could be purchased as an investment.

[18] A security would be considered to have the same terms if it is a security of the same class with the same rights as the security sold to other investors. Thus, in a unit offering, the unit purchased by a member must be composed of the same number and type of securities and any exerciseable security within a unit must have the same exercise price as the exerciseable security within the unit purchased by other investors.

[19] If the purchasing member is also acting as placement agent, purchases by the member at a price that is net of the commission it receives for sales to the other investors will be considered to be "at the same price" for purposes of this provision.

[20] In the example provided in note 17 above, institutional investors must purchase at least 56,100 shares of the total offering of 110,000.

applicable law. Purchases pursuant to a right of preemption generally do not raise the sorts of concerns that the Rule was designed to address because they are based on a purchase right granted to the purchaser in a prior investment. The right of preemption merely protects the purchaser from dilution when the company issues additional securities.

(i) Requirements Applicable To Acquisition Of Preemptive Right If the security with a preemptive right was acquired from a private placement, the private placement would have to occur more than 180 days before the filing date of the public offering. If the security with a preemptive right was acquired from the public market or from a public offering, there would be no limitation on when the security must have been purchased, *i.e.*, the security could have been purchased within 180 days before the subsequent public offering is filed.

(ii) Requirements Applicable To Purchase Under The Preemptive Right Under the safe harbor: (1) the right of preemption must be exercised in connection with a private placement of the issuer's securities for cash; (2) the private placement must be to all similar preemptive right holders; (3) the price and terms of the securities purchased must be the same as that for all other investors in the private placement; and (4) the purchaser may not, through the exercise of its preemptive rights, increase its ownership of the same class of securities of the issuer.

3. Calculation Of The 180-Day Review Period The 180-day review period and the 90-day period in the safe harbors are proposed to be calculated from the filing date of a public offering with the appropriate regulatory authority in order to provide a readily identifiable standard. Consistent with existing Department practice, the "filing date" for purposes of this calculation would be the earlier of the date of filing with the SEC, state

securities commission, or other regulatory authority or the date of filing with the Association. Thus, if an offering is filed with the SEC before it is filed with the NASD, the "filing date" will be the SEC filing date. In addition, offerings submitted to the SEC for review on a confidential basis will be considered filed with the SEC as of the date of the confidential submission for purposes of Rule 2710.

4. Determination Of When Securities Are Considered "Received" The proposed rule change would adopt Rule 2710(c)(4)(B) to clarify when securities will be considered to be "received" under the Rule for purposes of the the 180-day review period under Rule 2710(c)(4)(A) and the 90-day safe harbor period under Rule 2710(c)(4)(E) . Securities purchased from or received as compensation for a private placement will be deemed to have been received on the date of the closing of the private placement.[21] Securities received as compensation for a loan or credit facility will be deemed to have been received on the date the loan or credit facility agreement is executed. Securities received for consulting services to the issuer will be deemed to have been received on the date that beneficial ownership of the securities is transferred to the consultant. These proposals are consistent with existing Departmental practice.

5. 90-Day Post-Offering Objective Test Rule 2710(c)(4)(A) permits the staff to examine items of value received "subsequent to the public offering" to determine whether the items of value are considered to be underwriting compensation in connection with the public offering. The ability of the staff to include items of value received after the public offering in the calculation of underwriting compensation is necessary to avoid circumvention of the Rule.

[21] The Department relies on the closing date rather than the date of a commitment letter because a commitment letter does not transfer beneficial ownership of the securities.

In order to provide greater clarity concerning the extent of the "subsequent" time period, the proposed rule change would replace this language with new Rule 2710(c)(4)(C), under which items of value received within the 90-day period immediately following the effective date of a public offering would be examined to determine whether they constitute underwriting compensation.

6. Valuation of Warrants Rule 2710(c)(6)(B)(viii)(i) provides that any option, warrant or convertible securities received by the underwriter and related persons as underwriting compensation may not be convertible or exercisable on terms more favorable than the terms of the securities being offered to the public. The provision, therefore, prohibits members from receiving compensation in the form of warrants that have an exercise price below the proposed public offering price.

The Rule requires that the warrants be valued, that they be included in the calculation of the underwriting compensation, and that they be subject to the Rule's compensation provisions. Therefore, the requirement that members revise the exercise price of their warrants seems unnecessary and Rule 2710(c)(6)(B)(viii)(i) is proposed to be deleted.

The proposed rule change would amend Rule 2710(c)(5)(A), which prohibits the payment of underwriting compensation in the form of securities that are not identical to those offered to the public or to a security that has a bona fide independent market, in order to clarify the application of this prohibition.

C. Restrictions On Resale of Securities

As discussed above, the Corporate Financing Rule imposes a one-year compensation lock-up on securities that constitute underwriting compensation or, in the case of an initial public offering, a 90-day venture capital lock-up on all securities held by members and certain senior persons and subsidiaries.

1. Background - Compensation Lock-Up The compensation lock-up was adopted primarily to protect the aftermarket in a new security from the potential for fraud and manipulation that exists when a member is an underwriter, actively trades the securities, and is a selling securityholder. These multiple roles for a broker/dealer were a basic concern discussed at length in the Report of the Special Study of the Securities Markets of the Securities and Exchange Commission issued in 1963.[22] In the testimony underlying that study, industry members also stated that sales of an underwriter's private placement investments in an issuer shortly after the completion of an offering creates a negative appearance as the member has previously recommended the purchase of the security to its customers.

2. Background - Venture Capital Lock-Up The venture capital lock-up was intended to address similar potentials for abuse in the context of an initial public offering, by imposing a lock-up restriction that prohibits the sale of any of the issuer's securities (not just those considered to be underwriting compensation) held by a member and certain senior persons and subsidiaries at the time of the offering and for 90 days thereafter. The venture

[22] Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, 88th Cong., 1st Session, House Document No. 95, Part 1, Chapter IV.

capital lock-up does provide exceptions for *de minimis* transactions and transactions in which a qualified independent underwriter[23] provides due diligence and a pricing opinion.

3. Proposed 180-Day Lock-Up NASD Regulation understands that it is common industry practice to impose a 180-day lock-up on securities of the issuer held by certain officers and directors of the issuer. Consistent with this industry practice, NASD Regulation proposes to amend Rule 2710(c)(7)(A) and delete Rule 2710(c)(7)(C) to impose a 180-day lock-up on all equity securities of the issuer held by the underwriter and related persons at the time of the offering. Securities purchased from the public market would not be subject to any lock-up. The new 180-day lock-up would replace the one-year compensation lock-up and the 90-day venture capital lock-up. It would apply to both initial public offerings and to secondary offerings, subject to the following exceptions in amended Rule 2710(c)(7)(B) for:

- transfers of otherwise restricted securities that occur by operation of law or by reason of reorganization of the issuer;
- transfers to participating members and their officers and partners, so long as the transferred securities remain subject to any remaining lock-up period;
- transfers if a member and its related persons do not, in the aggregate, own more than 1% of the securities being offered;
- the exercise of securities, so long as the exercised securities remain subject to any remaining lock-up period; and

[23] The term "qualified independent underwriter" is defined in Rule 2720(b)(15).

- transfers of securities that qualify as an "actively traded security" for purposes of SEC Regulation M.[24]

The proposal would eliminate the existing exception in Rule 2710(c)(7)(C)(i) from the venture capital lock-up for transactions in which a qualified independent underwriter provides a pricing opinion and performs due diligence.

4. Lower Compensation Value For Longer Lock-Up In valuing any securities considered to be underwriting compensation, Rule 2710(c)(5)(E) permits a lower valuation when the securities are subject to a lock-up beyond the current one-year compensation lock-up period. This paragraph would be amended to discount the compensation value of securities by 10% for each 180-day period that the securities (or underlying securities) are restricted from sale beyond the proposed 180-day lock-up period.

When a person agrees to such a longer lock-up in order to obtain a lower compensation value for the securities, the person would not be able to later rely on the exceptions from the 180-day lock-up for *de minimis* sales and sales of an "actively traded security." However, the other exceptions would be available.

5. Restrictive Legend The proposed rule change would delete Rule 2710(c)(7)(A)(ii), which requires that certificates representing any security subject to a lock-up bear a restrictive legend describing the lock-up. NASD Regulation understands that members are required to obtain a CUSIP number for the securities subject to the lock-up imposed by the rule that is different from the number assigned to other securities of the same issue. NASD Regulation proposes to delete this requirement, as it places an unintended burden on members that is unnecessary. Members would still be required to establish

[24] Under SEC Regulation M, a security is considered to be an "actively traded security" if it has at least $1 million average daily trading volume and $150 million public float value.

appropriate written procedures pursuant to NASD Rule 3010(b)(1) for ensuring compliance with the proposed 180-day lock-up.

D. Stock Numerical Limitation

1. Elimination Of Requirement The proposed rule change would eliminate the 10% stock numerical limitation in Rule 2710(c)(6)(B)(xi) on the amount of securities that participating underwriters and related persons may receive as underwriting compensation. The Rule already restricts the total value of all items that a member may receive as compensation, and Rule 2720 addresses the conflicts-of-interest that may arise when a member is an affiliate of the issuer. Therefore, the stock numerical limitation is unnecessary to achieve the purposes of the Rule.

2. Sales Of Securities Considered To Be Underwriting Compensation Rule 2710(c)(6)(C) requires that when the stock numerical limitation has been exceeded, the recipient of the securities must return any excess securities to the issuer or the source from which received at cost and without recourse. A different arrangement may be permitted by the Association. In light of the proposed elimination of the stock numerical limitation, this provision would be amended to apply to an acquisition of securities that results in unfair and unreasonable compensation.

E. Other Amendments[25]

1. Types Of Securities Considered To Be Items Of Value NASD Regulation proposes to amend Rule 2710(c)(3)(vii) to make non-substantive amendments to the description of the types of equity securities that are considered items of value to be included in the calculation of underwriting compensation.

[25] The proposed rule change includes non-substantive amendments to Rule 2710 that are intended to provide clarity and consistency.

2. Exclusions From The Calculation Of Underwriting Compensation The proposed rule change would amend Rule 2710(c)(3)(B) to put into one place all items of value that will be excluded from the calculation of underwriting compensation.

(a) Payments To A Previous Underwriter Rule 2710(c)(3)(xiii) requires the Department to include any fees paid to a previous underwriter that failed to complete a public offering in the calculation of underwriting compensation for a subsequent underwriter. This provision is intended to restrict the total amount of compensation paid to all underwriters, but it has imposed an unfair restriction on the compensation of replacement underwriters. Consequently, the proposed rule change would delete this provision.

The proposed rule change would further codify this determination in new Rule 2710(c)(3)(B)(ii) by excluding from the calculation of underwriting compensation any payment to a member in connection with a proposed public offering that was not completed, if the member does not participate in the revised offering.[26]

(b) Consulting Agreements The requirements of Rule 2710(c)(4)(E) would be moved to new Rule 2710(c)(3)(B)(iii), which would continue to exclude from the calculation of underwriting compensation any payments received under a consulting agreement entered into more than one year before the filing date of the public offering.

3. Members' Obligation To File Information

Rule 2710(b) requires that members file certain documents and other information with the Department in connection with a public offering. The Department must rely on the adequacy and accuracy of the information filed by members in order to carry out its regulatory obligations under the rules that apply to public offerings of securities. To the

[26] Rule 2710(c)(6)(B)(iv) would continue to prohibit payment of any compensation by an issuer to a member in connection with an offering of securities that is not completed according to the terms of agreement between the

extent, therefore, that a member or its counsel or other agent fails to provide all of the facts necessary for the Department's review of a public offering, files inaccurate information, fails to update or correct previously filed information, or fails to comply with representations made to the Department, the member would violate the Rule and NASD Conduct Rule 2110 (the Association's basic ethical conduct rule).

The proposed rule change would clarify this obligation of the member in several respects. First, Rule 2710(b)(6)(A)(v) would be amended to require members to provide the Department with a detailed explanation and documents related to a modification of any information or representation previously provided to the Association or of any item of underwriting compensation. Thus, in the event that the member (or member's counsel or other agent) determines that subsequent events have made inaccurate any information or representations previously provided to the Department, the member must inform the Department regarding the change. This obligation applies regardless of whether the change occurs before or after the issuance of the Department's opinion of a "no objections" to the underwriting terms and arrangements.

Second, the proposed rule change would provide that if an underwriter or related person receives any additional item of value subsequent to the Department's issuance of a "no objections" opinion and within 90 days following the offering's effective date, the member must provide a detailed explanation and any documents related to the new arrangement to the Department.

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issuer and underwriter, except for reimbursement of out-of-pocket accountable expenses actually incurred by the member.

The proposed rule change would also delete Rule 2710(b)(6)(iv), as it requires the submission of information addressing the subjective review factors in Rules 2710(c)(4)(C) and (D). As set forth above, paragraphs (C) and (D) are proposed to be deleted.

IV. Implementation Of Proposed Rule Change

NASD Regulation proposes to implement the proposed rule change upon approval by the SEC. Any public offering filed subsequent to the adoption of the amendments and any public offering that had been filed with the Department but for which a "no objections" letter has yet to be issued, would be subject to the new requirements. In addition, with respect to public offerings for which a "no objections" letter has been issued at the time the amendments are adopted, the one-year compensation lock-up on securities would be shortened to 180 days and members could rely on the exceptions from the 180 day lock-up. Upon adoption of the amendments, any securities that are subject to the 90-day venture capital lock-up would remain subject to that lock-up until it expires, but any person holding such securities could rely on the exceptions from the 180-day lock-up.

Statutory Basis

NASD Regulation 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 the Association's rules 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. The NASD believes that the proposed rule change will eliminate burdensome rules that no longer distinguish between *bona fide* capital-raising and lending practices and abusive arrangements and minimize the opportunity for abusive practices by members in connection with underwriting public offerings of securities.

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

NASD Regulation 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.

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

Written comments were not solicited on the proposed rule change. However, NASD Notice to Members 98-81 (October, 1998) requested comment on whether any NASD rules are obsolete. A copy of the Notice to Members is attached as Exhibit 2. A comment letter was received from The Bond Market Association that included two recommended amendments to Rule 2710 that are pertinent to the proposed rule change. A copy of the comment letter received from the BMA is attached as Exhibit 3. The recommendations of the BMA to amend other provisions of Rule 2710 are under consideration by the Association and are not pertinent to the proposed rule change.

On page 18 of its letter, the BMA recommends that the subjective review factors om Rule 2710(c)(4)(D) be amended to consider whether there is a bona fide business purpose for an acquisition of securities. Rule 2710(c)(4)(D) is proposed to be deleted and Rule 2710(c)(4)(A) would be amended to adopt an objective, bright-line test to include in the calculation of underwriting compensation all items of value received by the underwriter and related persons during the 180-day period immediately preceding the filing of the public offering and during the public offering. Thus, the subjective factor proposed by the BMA is no longer necessary to the Association’s review of underwriting compensation.

In addition, the BMA recommends on page 18 of its letter that Rule 2710(c)(5)(A) be amended to permit the underwriter and related person to receive as compensation a security

different than the security offered to the public if there is a reasonable method to value the security received. The proposed rule change would amend Rule 2710(c)(5)(A) to clarify the current language of the provision, which allows the Department to permit the underwriter and related person to receive a security that is different than the security offered to the public and that does not have a bona fide independent market, if good cause can be shown for the arrangement. One of the considerations in permitting such an arrangement would be whether the Department can value the security for compensation purposes. In the absence of a bona fide independent market for a security, the decision on whether security that is different than the security to be offered to the public can be reliably valued is subjective and, therefore, not amenable to codification.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.
2. Notice to Members 98-81 (October, 1998).
3. Comment Letter of The Bond Market Association.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY:_____
Joan C. Conley, Secretary

Date: January 19, 2000

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-00-04)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Corporate Financing Rule.

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 , the National Association of Securities Dealers, Inc. (“NASD”), through its wholly-owned subsidiary NASD Regulation, Inc. ("NASD Regulation"), 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 Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation proposes to amend NASD Conduct Rule 2710. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

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

2 17 CFR 240.19b-4.

2710. Corporate Financing Rule - Underwriting Terms and Arrangements

(a) Definitions No change.

(b) Filing Requirements

(1) - (5) No change.

(6) Information Required to be Filed

(A) Any person filing documents pursuant to subparagraph (4) above shall provide the following information with respect to the offering:

(i) - (iii) No change.

(iv) [a statement addressing the factors in subparagraphs (c)(4)(C) and (D), where applicable;]

[(v)] a detailed explanation of any other arrangement entered into during the [12-month] 180-day period immediately preceding the filing date of the public offering, which arrangement provides for the receipt of any item of value [and/]or the transfer of any warrants, options, or other securities from the issuer to the underwriter and related persons; and

[(vi)] (v) a detailed explanation and any documents related to:

a. the modification of any information or representation previously provided to the Association or of any item of underwriting compensation[,] ; or

b. any new arrangement that provides for the receipt of any additional item of value by the underwriter and related persons subsequent to the [review and approval of such compensation] issuance of an opinion of no objections to the underwriting terms and arrangements by the

Association and within 90 days immediately following the effective date of the public offering.

(B) No change.

(7) - (12) No change.

(c) Underwriting Compensation and Arrangements

(1) - (2) No change.

(3) Items of Compensation

(A) For purposes of determining the amount of underwriting compensation received or to be received by the underwriter and related persons pursuant to subparagraph (2) above, the following items and all other items of value received or to be received by the underwriter and related persons in connection with or related to the distribution of the public offering, as determined pursuant to subparagraph (4) below shall be included:

(i) - (v) No change.

(vi) financial consulting and advisory fees, whether in the form of cash, securities, or any other item of value;

(vii) common or preferred stock, options, warrants, and other equity securities, including debt securities convertible to or exchangeable for equity securities, [including securities] received [as underwriting compensation, for example]:

a. [in connection with] for arranging a private placement of securities for the issuer;

b. for providing or arranging a loan, credit facility, or bridge financing for the issuer;

c. as a finder's fee;

d. for providing consulting services to the issuer; [and]

e. [securities purchased] as an investment in a private placement made by the issuer; or

f. at the time of the public offering;

(viii) - (x) No change.

(xi) commissions, expense reimbursements, or other compensation to be received by the underwriter and related persons as a result of the exercise or conversion, within twelve (12) months following the effective date of the offering, of warrants, options, convertible securities, or similar securities distributed as part of the public offering; and

(xii) fees of a qualified independent underwriter[; and].

[(xiii) compensation, including expense reimbursements, paid in the six (6) months prior to the initial or amended filing of the prospectus or similar documents to any member or person associated with a member for a public offering that was not completed.]

(B) Notwithstanding paragraph (c)(3)(A) above, the calculation of underwriting compensation shall not include:

(i) [E] expenses customarily borne by an issuer, such as printing costs; SEC, "blue sky" and other registration fees; Association filing fees; and

accountant's fees, [shall be excluded from underwriter's compensation] whether or not paid through an underwriter;

(ii) compensation, including expense reimbursements, previously paid to any member in connection with a proposed public offering that was not completed, if the member does not participate in the revised public offering; and

(iii) financial consulting and advisory fees, on the basis of information that establishes that an ongoing relationship between the issuer and the financial advisor or consultant was established more than twelve months before the filing date of the public offering.

(4) Determination of Whether Compensation Is Received in Connection with the Offering

(A) All items of value received [or to be received] by the underwriter and related persons during the [twelve (12) month] 180-day period immediately preceding the filing date of the registration statement or similar document, and at the time of [and subsequent to] the public offering, will be [examined to determine whether such items of value are] considered to be underwriting compensation in connection with the public offering [and, if received during the six (6) month period immediately preceding the filing of the registration statement or similar document, will be presumed to be underwriting compensation received in connection with the offering, provided, however, that such presumption may be rebutted on the basis of information satisfactory to the Association to support a finding that the receipt of an item is not in connection

with the offering and shall not include cash discounts or commissions received in connection with a prior distribution of the issuer's securities].

[(B) Items of value received by an underwriter and related person more than twelve (12) months immediately preceding the date of filing of the registration statement or similar document will be presumed not to be underwriting compensation. However, items received prior to such twelve (12) month period may be included as underwriting compensation on the basis of information to support a finding that receipt of the item is in connection with the offering.]

[(C) For purposes of determining whether any item of value received or to be received by the underwriter and related persons is in connection with or related to the distribution of the public offering, the following factors, as well as any other relevant factors and circumstances, shall be considered:]

[(i) the length of time between the date of filing of the registration statement or similar document and:]

[a. the date of the receipt of the item of value;]

[b. the date of any contractual agreement for services for which the item of value was or is to be received; and]

[c. the date the performance of the service commenced, with a shorter period of time tending to indicate that the item is received in connection with the offering;]

[(ii) the details of the services provided or to be provided for which the item of value was or is to be received;]

[(iii) the relationship between the services provided or to be provided for which the item of value was or is to be received and:]

[a. the nature of the item of value;]

[b. the compensation value of the item; and]

[c. the proposed public offering;]

[(iv) the presence or absence of arm's length bargaining or the existence of any affiliate relationship between the issuer and the recipient of the item of value, with the absence of arm's length bargaining or the presence of any affiliation tending to indicate that the item of value is received in connection with the offering.]

[(D) For purposes of determining whether securities received or to be received by the underwriter and related persons are in connection with or related to the distribution of the public offering, the factors in subparagraph (C) above and the following factors shall be considered:]

[(i) any disparity between the price paid and the offering price or the market price, if a bona fide independent market exists at the time of acquisition, with a greater disparity tending to indicate that the securities constitute compensation;]

[(ii) the amount of risk assumed by the recipient of the securities, as determined by:]

[a. the restrictions on exercise and resale;]

[b. the nature of the securities (e.g., warrant, stock, or debt); and]

[c. the amount of securities, with a larger amount of readily marketable securities without restrictions on resale or a warrant for securities tending to indicate that the securities constitute compensation; and]

[(iii) the relationship of the receipt of the securities to purchases by unrelated purchasers on similar terms at approximately the same time, with an absence of similar purchases tending to indicate that the securities constitute compensation.]

[(E) Notwithstanding the provisions of subparagraph (3)(A)(vi) above, financial consulting and advisory fees may be excluded from underwriting compensation upon a finding by the Association, on the basis of information satisfactory to it, that an ongoing relationship between the issuer and the underwriter and related person has been established at least twelve (12) months prior to the filing of the registration statement or similar document or that the relationship, if established subsequent to that time, was not entered into in connection with the offering, and that actual services have been or will be rendered which were not or will not be in connection with or related to the offering.]

(B) Securities of the issuer acquired by the underwriter and related persons before the filing date of a public offering will be considered to be received for purposes of subparagraph (c)(4)(A) and (E) as of the date of the:

(i) closing of a private placement, if the securities were purchased from or received as compensation for the private placement;

(ii) execution of an agreement for a loan or credit facility, if the securities were received as compensation for the loan or credit facility; or

(iii) transfer of beneficial ownership of the securities to a consultant, if the securities were received as compensation for consulting services.

(C) All items of value received by the underwriter and related persons during the 90-day period immediately following the effective date of a public offering will be examined to determine whether such items of value are considered underwriting compensation in connection with the public offering.

(D) For purposes of subparagraph (c)(4)(E) below, the following terms will have the meanings stated below.

(i) An entity will include a group of legal entities that either:

a. are contractually obligated to make co-investments and have previously made at least one such investment; or

b. have filed a Form 13D or 13G with the SEC that identifies the entities as "members of the same group" in connection with a previous investment for purposes of Section 13 of the Securities Exchange Act of 1934.

(ii) An institutional investor will mean any individual or entity that has at least $50 million invested in securities in the aggregate in its portfolio or under management; provided that an institutional investor will not include any member participating in the public offering, any of its associated or affiliated persons, or an immediate family member of its associated or affiliated persons.

(E) Notwithstanding subparagraph (c)(4)(A) above, the following acquisitions of securities will not be considered underwriting compensation:

(i) **Purchases and Loans by Certain Entities** - Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility more than 90 days before the filing date of the public offering, by certain entities if:

a. the entity:

1. either:

A. manages capital contributions of $100 million or more, at least $75 million of which has been committed by persons that are not underwriters or related persons; or

B. manages capital contributions of $25 million or more, at least 75% of which has been committed by persons that are not underwriters or related persons;

2. is a separate and distinct legal entity from the member and is not registered as a broker/dealer;

3. makes investments or loans subject to the evaluation and review of designated individuals who have a fiduciary duty to select investments and loans based on the risks and rewards to the entity and not based on opportunities for the member to earn investment banking revenues;

4. does not participate directly in investment banking fees received by the member for underwriting public offerings;

5. is engaged primarily in the business of making investments in or loans to private or start-up companies or companies in the early

process of developing products or services, or participating in leveraged buy-out transactions; and

b. the member maintains and enforces written procedures reasonably designed to ensure that the member's participation in the public offering is not contingent on the entity's participation in the private placement or loan.

(ii) **Investments In and Loans to Certain Issuers** - Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility more than 90 days before the filing date of the public offering, by certain entities if:

a. the entity:

1. manages capital contributions or loan commitments of at least $50 million;

2. is a separate and distinct legal entity from the member and is not registered as a broker/dealer;

3. does not participate directly in investment banking fees received by the member for underwriting public offerings;

4. is engaged primarily in the business of making investments in or loans to private or start-up companies or companies in the early process of developing products or services, or participating in leveraged buy-out transactions; and

b. institutional investors beneficially own at least 33% of the total number of the issuer's equity securities outstanding on a fully diluted basis;

c. an institutional investor is a member of the issuer's board of directors;

d. the transaction was approved by a majority of the issuer's board of directors and by the affirmative vote of institutional investors that are board members;

e. the total amount of securities received by all entities related to each member does not exceed 5% of the total number of the issuer's equity securities outstanding on a fully diluted basis; and

f. the member maintains and enforces written procedures reasonably designed to ensure that the member's participation in the public offering is not contingent on the entity's participation in the private placement or loan.

(iii) **Private Placements With Institutional Investors** - Securities of the issuer purchased in or received as placement agent compensation for a private placement more than 90 days before the filing date of the public offering if:

a. institutional investors purchase at least 51% of the total offering (comprised of the total number of securities, on a fully diluted basis, sold in the private placement and received as placement agent compensation by a member);

b. an institutional investor was the lead negotiator with the issuer to establish the terms of the private placement;

c. the underwriter and related persons (excluding any entities qualified under paragraph (c)(4)(D)(i) above):

1. have not, in the aggregate, purchased or received as placement agent compensation more than 20% of the total offering; and

2. have purchased securities that were at the same price and with the same terms as the securities purchased by other investors; and

d. the member maintains and enforces written procedures reasonably designed to ensure that its participation in the public offering will not be contingent on its participation in the private placement.

(iv) **Purchases Under a Preemptive Right** - Securities of the issuer under a right of preemption if:

a. the right of preemption was granted either:

1. in connection with a purchase from a private placement of the issuer's securities made more than 180 days before the filing date of the public offering; or

2. in connection with a security purchased from a public offering or the public market; and

b. the purchase under the right of preemption:

1. was exercised in connection with a private placement of the issuer's securities that was for cash;

2. was to all similar preemptive right holders;

3. was at the same price and had the same terms as the securities purchased by other investors; and

4. did not increase the purchaser's percentage ownership of the same class of securities of the issuer.

(5) Valuation of Non-Cash Compensation

For purposes of determining the value to be assigned to securities received as underwriting compensation, the following criteria and procedures shall be applied:

(A) [No underwriter and related person may receive a security or a warrant for a security as compensation in connection with the distribution of a public offering that is different than the security to be offered to the public unless the security received as compensation has a bona fide independent market, provided, however, that: (i) in exceptional and unusual circumstances, upon good cause shown, such arrangement may be permitted by the Association; and (ii) in an offering of units, the underwriter and related persons may only receive a warrant for the unit offered to the public where the unit is the same as the public unit and the terms are no more favorable than the terms of the public unit.]

An underwriter and related person may not receive a security (including securities in a unit) or a warrant for a security as underwriting compensation in connection with a public offering unless: (i) the security received or the security underlying the warrant received is identical to the security offered to the public or to a security with a bona fide independent market; or (ii) the arrangement, upon good cause shown, is permitted by the Association.

(B) [s] Securities that are not options, warrants or convertible securities shall be valued on the basis of:

(i) the difference between [the per security cost and]:

a. either the market price per security on the date of acquisition, [where a] or, if no bona fide independent market exists for the security, [or] the [proposed (and actual)] public offering price per security; and

b. the per security cost;

(ii) multiplied by the number of securities received or to be received as underwriting compensation;

(iii) divided by the public offering proceeds; and

(iv) multiplied by one hundred [(100)].

(C) [o] Options, warrants or convertible securities ("warrants") shall be valued on the basis of [the following formula]:

(i) the [proposed (and actual)] public offering price per security multiplied by .65 [(65%)];

(ii) minus the difference between:

a. the exercise or conversion price per [security] warrant; and

b. either the market price per security on the date of acquisition, [where a] or, if no bona fide independent market exists for the security, [or] the [proposed (and actual)] public offering price per security;

(iii) divided by two [(2)];

(iv) multiplied by the number of securities underlying the warrants[, options, and convertible securities received or to be received as underwriting compensation];

(v) less the total price paid for the [securities] warrants;

(vi) divided by the public offering proceeds; and

(vii) multiplied by one hundred [(100)].

(D) [a lower value equal to 80% and 60% of the calculated value shall be assigned if securities, and where relevant, underlying securities, are or will be restricted from sale, transfer, assignment or other disposition for a period of one and two years, respectively, beyond the one-year period of restriction required by subparagraph (7)(A)(i) below.] A lower value equal to 10% of the calculated value shall be assigned for each 180-day period that the securities or underlying securities are restricted from sale or other disposition beyond the 180-day period of restriction required by subparagraph (c)(7)(A)(i) below, regardless of the availability of subparagraphs (c)(7)(A)(i)(c) and (d) for sale of the securities.

(6) Unreasonable Terms and Arrangements

(A) No change.

(B) Without limiting the foregoing, the following terms and arrangements, when proposed in connection with [the distribution of] a public offering of securities, shall be unfair and unreasonable:

(i) - (vii) No change.

(viii) the receipt by the underwriter and related persons of underwriting compensation consisting of any option, warrant or convertible security [which] that:

a. - f. No change.

g. has anti-dilution terms designed to provide the underwriter and related persons with disproportionate rights, privileges and economic benefits which are not provided to the purchasers of the securities offered to the public (or the public shareholders, if in compliance with subparagraph (5)(A) above); or

h. has anti-dilution terms designed to provide for the receipt or accrual of cash dividends prior to the exercise or conversion of the security[; or];

[i. is convertible or exercisable or otherwise is on terms more favorable than the terms of the securities being offered to the public;]

(ix) - (x) No change.

[(xi) stock numerical limitation. The receipt by the underwriter and related persons of securities which constitute underwriting compensation in an aggregate amount greater than ten (10) percent of the number or dollar amount of securities being offered to the public, which is calculated to exclude:]

[a. any securities deemed to constitute underwriting compensation;

b. any securities issued or to be issued pursuant to an overallotment option;]

[c. in the case of a “best efforts” offering, any securities not actually sold; and]

[d. any securities underlying warrants, options, or convertible securities which are part of the proposed offering, except where acquired as part of a unit;]

(xii) - (xiv) Renumbered (xi) - (xiii).

(C) In the event that the underwriter and related persons receive securities deemed to be underwriting compensation in an amount [constituting] that results in unfair and unreasonable compensation [pursuant to the stock numerical limitation in subparagraph (B)(ix) above], the recipient shall return any excess securities to the issuer or the source from which received at cost and without recourse, except that [in exceptional and unusual circumstances], upon good cause shown, a different arrangement may be permitted.

(7) Restrictions on Securities

(A) [No member or person associated with a member shall participate in a] Any public offering in which [does not] a member or person associated with a member participates must comply with the following requirements:

(i) any common or preferred stock, options, warrants, and other equity securities [deemed to be underwriting compensation], including debt securities convertible to or exchangeable for equity securities, of the issuer beneficially owned by an underwriter and related person at the time of the offering shall not be sold, transferred, assigned, pledged or hypothecated by any person, except as provided in subparagraph (B) below, for a period of [(a) one year] 180 days immediately following the effective date of the public offering [for which the securities were received.];

[However, securities deemed to be underwriting compensation may be transferred to any member participating in the offering and the bona fide officers or partners thereof and securities which are convertible into other types of securities or which may be exercised for the purchase of other securities may be so transferred, converted or exercised if all securities so transferred or received remain subject to the restrictions specified herein for the remainder of the initially applicable time period;]

[(ii) certificates or similar instruments representing securities restricted pursuant to subparagraph (i) above shall bear an appropriate legend describing the restriction and stating the time period for which the restriction is operative;] and

[(iii)] (ii) securities [to be] received by a member as underwriting compensation shall only be issued to a member participating in the offering and the [bona fide] officers or partners thereof.

(B) [The provisions of] Notwithstanding subparagraph (A) [notwithstanding] above, the following shall not be prohibited:

(i) the transfer of any security:

a. by operation of law or by reason of reorganization of the issuer [shall not be prohibited.];

b. to any member participating in the offering and the officers or partners thereof, if all securities so transferred remain subject to the restrictions in subparagraph (A) above for the remainder of the applicable time period;

[(C) Venture capital restrictions. When a member participates in the initial public offering of an issuer's securities, such member or any officer, director, general partner, controlling shareholder or subsidiary of the member or subsidiary of such controlling shareholder or a member of the immediate family of such persons, who beneficially owns any securities of said issuer at the time of filing of the offering, shall not sell such securities during the offering or sell, transfer, assign or hypothecate such securities for ninety (90) days following the effective date of the offering unless:]

[(i) the price at which the issue is to be distributed to the public is established at a price no higher than that recommended by a qualified independent underwriter who does not beneficially own 5% or more of the outstanding voting securities of the issuer, who shall also participate in the preparation of the registration statement and the prospectus, offering circular, or similar document and who shall exercise the usual standards of "due diligence" in respect thereto; or]

[(ii)] c. if the aggregate amount of such securities held by [such a member and its related persons enumerated above would] an underwriter and its related persons do not exceed 1% of the securities being offered; or

d. if the class of security qualifies as an "actively traded security" for purposes of SEC Regulation M; and

(ii) the exercise or conversion of any security, if all securities received remain subject to the restrictions in subparagraph (A) above for the remainder of the applicable time period.

(8) Conflicts of Interest No change.

(d) Exemptions

Pursuant to the Rule 9600 Series, the Association may exempt a member or person associated with a member from the provisions of this Rule for good cause shown.

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 Regulation 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 Regulation 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

Purpose

I. Background

A. Scope Of The Corporate Financing Rule

NASD Conduct Rule 2710 ("Corporate Financing Rule" or "Rule") is intended to ensure that the underwriting terms and arrangements of a public offering[3] in which an NASD

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[3] Rule 2720(b)(14) defines "public offering" as:

any primary or secondary distribution of securities made pursuant to a registration statement or offering circular including exchange offers, rights offerings, offerings made pursuant to a merger or acquisition, straight debt offerings, offerings pursuant to SEC Rule 504, and all other securities distributions of any kind whatsoever, except any offering made pursuant to an exemption from registration under Sections 4(1), 4(2), or 4(6) of the Securities Act of 1933, as amended, or pursuant to SEC Rule 504 if the securities are "restricted securities" under SEC Rule 144(a)(3), SEC Rule 505, or SEC Rule 506 adopted under the Securities Act of 1933, as amended. The term

member participates[4] are fair and reasonable. The Rule requires a member to file certain information with NASD Regulation about the underwriting arrangements of a public offering in which the member participates. The Corporate Financing Department ("Department") of NASD Regulation reviews this information prior to commencement of the offering in order to determine whether the underwriting compensation and other terms and arrangements meet the requirements of applicable NASD rules.[5]

The Corporate Financing Rule regulates, among other matters, the total amount of underwriting compensation that the "underwriter and related persons"[6] may receive in connection with a public offering. The term "underwriter and related persons" includes all

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public offering shall exclude exempted securities as defined in Section 3(a)(12) of the Act.

This definition of "public offering" also applies to Rule 2710.

4 Rule 2710(a)(4) defines "participation" or "participating in a public offering" as:

participation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering, but not the preparation of an appraisal in a savings and loan conversion or a bank offering or the preparation of a fairness opinion pursuant to SEC Rule 13e-3.

5 SEC Rule 461(b)(6) provides that the SEC will refuse to accelerate the effective date of an offering includes if the ". . . NASD has not issued a statement expressing no objections to the compensation and other arrangements . . ."

6 Rule 2710(a)(6) defines "underwriter and related persons" as:

underwriters, underwriter's counsel, financial consultants and advisors, finders, members of the selling or distribution group, any member participating in the public offering, and any and all other persons associated with or related to and members of the immediate family of any of the aforementioned persons.

broker/dealers (and the associated persons[7] and affiliates[8] of the broker/dealers) participating in any capacity in the proposed public offering, as well as other non-broker/dealers who act as counsel, finders, or consultants, or are members of the immediate family, or are related persons[9] to other persons in the definition. In order to facilitate the following discussion, participating broker/dealers and their associated persons, affiliates, and related persons are together referred to as "members."

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7 Article I, paragraph (ee) of the NASD By-Laws defines "associated person of a member" as:

(1) any natural person registered under the Rules of the Association; or (2) a sole proprietor, partner, officer, director, or branch manager of a member, or a natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the NASD under the By-Laws or the Rules of the Association.

8 For purposes of Rules 2710 and 2720, Rule 2720(b)(1) provides that an "affiliate" presumptively includes:

(1) a company that beneficially owns 10 percent or more of the outstanding voting securities of a member; (2) a member that beneficially owns 10 percent or more of the outstanding voting securities of a company; and (3) a company and a member that are under the common control of a person or company who beneficially owns 10 percent or more of the outstanding voting securities of the company and/or member or who has the power to direct the management or policies of the company and/or member.

The Department's long-standing practice is to deem any company or member that comes within these presumptions to be an affiliate.

9 In SR-NASD-91-19, published in part in SEC Release No. 34-29928 (November 21, 1991), the NASD stated that "The concept of whether one person is 'related to' any of the enumerated persons in the definition is determined by whether there is an investment or business relationship between the parties and is based on objective facts."

B. Calculating Underwriting Compensation

The Corporate Financing Rule provides in paragraph (c)(4) that any item of value as set forth in Rule 2710(c)(3)(A), including certain securities of the issuer, [10] acquired by the underwriter and related persons within the 12-month period before the filing date of a proposed public offering will be examined by the Department to determine whether it was acquired "in connection with the public offering" and, therefore, is deemed to be underwriting compensation. The Rule presumes that any such item of value acquired within the six-month period before filing is underwriting compensation, but this presumption may be rebutted by the member based on information satisfactory to the Department.[11]

The Corporate Financing Rule requires in paragraphs (c)(4)(C) and (D) that the Department weigh as many as ten different factors to determine whether the item of value received by the underwriter and related persons within the 12-month period before the filing date of a public offering is received "in connection with the public offering" and, therefore, included in the calculation of underwriting compensation. In many cases, an underwriter or related person has acquired unregistered equity securities[12] of the issuer. Members typically acquire these unregistered securities as an investment in a private placement; as

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[10] The term "issuer" is defined in Rule 2710(a)(2) to include:

> The issuer of the securities offered to the public, any selling security holders offering securities to the public, any affiliate of the issuer or selling security holder, and the officers or general partners, directors, employees and security holders thereof.

[11] Rule 2710(c)(4)(B) provides that items of value received more than 12 months before the filing date of the public offering are presumed not to be underwriting compensation unless the staff has satisfactory information supporting a conclusion that the item is additional underwriting compensation.

compensation for the member's services as private placement agent; or for providing a loan or credit facility to the issuer.

The Rule requires the staff to consider the following factors – as well as "any other relevant factors and circumstances and circumstances" -- to determine whether securities have been received in connection with the public offering:

- the length of time between the date of the receipt of the security and the filing date;
- details of any services provided;
- the presence or absence of arm's length bargaining;
- the disparity between the price paid for a security and the proposed public offering price;
- the existence of restrictions on exercise and resale;
- the nature of the securities;
- the amount of securities; and
- the relationship of the receipt of securities to purchases by other unrelated purchasers.

The factor-weighing process requires the staff to review each acquisition of the issuer's securities by members on a case-by-case basis. The value of any securities that the Department determines are underwriting compensation, as calculated under Rule 2710(c)(5), is added to the underwriting discount or commission and any other fees or reimbursements received by the underwriting syndicate to determine whether the compensation is unfair or unreasonable.

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[12] Securities purchased in the public market are not considered to be "items of value."

C. Restrictions On Resale

Securities included in the calculation of underwriting compensation are also restricted by the Rule from sale for one year following the effective date of the offering under Rule 2710(c)(7)(A) (the "compensation lock-up"). In the case of an initial public offering, if the members and certain senior persons and subsidiaries of the member hold securities of the issuer that are not deemed to be underwriting compensation, a 90-day lock-up is nonetheless imposed under Rule 2710(c)(7)(B) (the "venture capital lock-up").[13]

D. Limitation On Amount Of Securities

The Rule also limits the amount of securities that can be received by the underwriter and related persons as underwriting compensation to 10% of the number of securities to be sold in the public offering (the "stock numerical limitation") under Rule 2710(c)(6)(B)(xi).

II. Changes In The Capital Markets

In recent years, many NASD members have expanded the variety of services that they provide to their corporate financing clients. These services may include venture capital investment, consulting, commercial lending, and investment banking. Moreover, the pace of corporate financing activities has accelerated, and the time period between private fundraising and the issuer's initial public offering has often been shortened. These developments necessitate a review of the Corporate Financing Rule to ensure that it

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[13] The venture capital lock-up only applies to securities of the issuer held by the member, or any officer, director, general partner, controlling shareholder or subsidiary of the member, or by a subsidiary of a controlling shareholder of the member, or by a member of the immediate family of such persons. In comparison, the compensation lock-up applies to all securities considered to be underwriting compensation that are held by the underwriter and related persons. *See*, definition of "underwriter and related persons" in above.

accommodates the modern, legitimate capital financing activities of NASD members, while continuing to protect investors and issuers from unreasonable underwriting activities.

The current subjective, factor-weighing process for determining whether securities were acquired in connection with a public offering is an inefficient method to achieve these objectives. The subjectivity hampers the Department's ability to provide clear and predictable guidance to members. The consequences under the Rule of a particular venture capital or other private placement financing are sometimes uncertain until a public offering is filed and the Department's review is completed. This uncertainty unnecessarily complicates the capital-raising process, to the detriment of issuers and investors.

III. Description Of Proposed Rule Change

A. Summary Of Proposed Rule Change

NASD Regulation proposes to amend the Corporate Financing Rule to allow members to provide legitimate capital-raising services to issuers, while adopting restrictions that are designed to minimize the opportunity for abusive practices by members. NASD Regulation also proposes to eliminate or revise other burdensome and obsolete provisions, including rules regulating the exercise price of warrants received as underwriting compensation and the treatment of fees paid to a previous underwriter for an uncompleted offering. In addition, the proposed rule change would clarify a member's obligation to update previously filed information.

B. Treatment of Securities As Underwriting Compensation

1. Six-Month Pre-Offering Objective Test The proximity of an acquisition of equity securities of an issuer (or any other item of value) to the filing date of its public offering has proven to be the most significant factor in determining whether those securities

constitute underwriting compensation. The Department has found that the application of the six-month presumption contained in the Rule generally minimizes the opportunity for abusive practices by members. Application of a longer time period has typically been unnecessary to achieve this goal, however.

NASD Regulation proposes to amend the Corporate Financing Rule to provide greater clarity and predictability regarding whether equity securities[14] of the issuer and other items of value acquired by the underwriter and related persons constitute underwriting compensation. The proposed rule change would replace the twelve-month review period, the six-month presumption, and the subjective review factors with an objective standard in Rule 2710(c)(4)(A) under which all other items of value acquired during the 180-day period immediately preceding the filing date of the registration statement or similar document and at the time of the public offering will constitute underwriting compensation. The proposed rule change would also provide four safe harbors from this general standard.[15] These safe harbors are described below.

Replacement of the existing subjective analysis with an objective, bright-line test would provide greater clarity and predictability concerning application of the Rule to specific transactions. Consequently, members and their venture capital and lending affiliates should find it easier to determine at the time of a private placement or other financing whether its

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[14] The proposed rule change would clarify that the securities that will be considered to be underwriting compensation include common or preferred stock, options, warrants, and debt securities convertible to or exchangeable for equity securities.

[15] Regardless of when an underwriter or related person acquires securities of the issuer, or the availability of any safe harbor, all securities held by the underwriter and related persons are proposed to be subject to a lock-up on their sale, as described below.

investment will be treated as underwriting compensation when the subsequent public offering is filed with the Department for review.

2. Safe Harbor Provisions NASD Regulation proposes four safe harbors from the determination that certain acquisitions of securities during the 180-day review period are deemed to be underwriting compensation.[16] The four safe harbors are intended to identify acquisitions that occur in *bona fide* capital-raising transactions, and would impose restrictions designed to minimize the opportunity for abusive practices.

The first three safe harbors in proposed Rules 2710(c)(4)(E)(i) - (iii), would be available for acquisitions by certain entities that regularly make venture capital investments; for acquisitions in issuers with significant institutional investor involvement in their corporate governance; and for acquisitions in private placements that have significant institutional investor participation. The fourth safe harbor in paragraph (c)(4)(E)(iv) would exempt acquisitions that occur from the exercise of a preemptive right to purchase.

The first three safe harbors would be available only for acquisitions that occur more than 90 days before the filing date of the public offering. These safe harbors would also require that the member maintain and enforce written procedures reasonably designed to ensure that the member's participation in the public offering is not contingent on the acquiring party's participation in the private placement or loan.

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16 The Department will maintain its authority under the Rule 9600 Series to grant exemptions on a case-by-case basis from the determination that certain securities are deemed to be underwriting compensation. The Department expects to exercise this authority sparingly and only in exceptional and unusual circumstances.

(a) Safe Harbor No. 1 - Purchases And Loans By Certain Entities

The first safe harbor, proposed in Rule 2710(c)(4)(E)(i), is intended for acquisitions of the issuer's securities by certain entities that routinely make venture capital investments or provide loans or credit facilities. The safe harbor would be available: (1) to any qualifying entities related to any member participating in an offering; (2) for purchases in a private placement and for the receipt of securities as compensation for a loan or credit facility; and (3) without any limitation on the amount of securities purchased or received.

(i) Legal Entity/Registration The related entity would have to be a legal entity that is separate and distinct from the member and not registered as a broker/dealer. The term "entity" would be defined in new Rule 2710(c)(4)(D)(i) to include a group of legal entities that either are contractually obligated to make co-investments and have previously made at least one such investment or have filed a Form 13D or 13G with the SEC that identifies the entities as "members of the same group" in connection with a previous investment.

(ii) Venture Capital/Fiduciary Duty The related entity must also be "primarily engaged in the business of making investments in or loans to private or start-up companies or companies in the early process of developing products or services, or participating in leveraged buy-out transactions." The related entity can make investments or loans that are under the safe harbor only if they are subject to the evaluation and review of designated individuals who have a fiduciary duty to select investments and loans based on the risks and rewards to the related entity and not based on opportunities for the member to earn investment banking revenues.

(iii) Sharing In Investment Banking Fees The related entity could not participate directly in investment banking fees received by the member for underwriting public offerings.

(iv) Capital Under Management The related entity would have to either: (1) manage capital contributions of $100 million or more, at least $75 million of which has been committed by persons that are not underwriters or related persons; or (2) manage capital contributions of $25 million or more, at least 75% of which has been committed by persons that are not underwriters or related persons.[17] The requirement for significant third-party capital would protect against potentially abusive situations, as the related entity must make its investment or lending decision in the interest of investors who are not underwriters or related persons.

(b) Safe Harbor No. 2 - Investments In And Loans To Certain Issuers The second safe harbor, proposed in Rule 2710(c)(4)(E)(ii), is intended for acquisitions of securities of issuers that have significant institutional investor involvement in their corporate governance. The proposed safe harbor would be available for acquisitions by qualifying related entities: (1) in a private placement; and (2) as compensation for a loan or credit facility, with a limitation on the amount acquired.

(i) 5% Limitation On Acquisition The total amount of securities acquired by all entities that are related to a single member could not exceed 5% of the issuer's

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[17] Such third-party capital commitments could come from members and their associated and affiliated persons, so long as those members do not participate in the public offering.

outstanding equity securities, on a fully diluted basis. The 5% limitation would apply on a member-by-member basis when more than one member proposes to rely on this safe harbor.

(ii) Related Entity Qualifications The related entity would have to manage capital contributions and loan commitments of at least $50 million. Unlike the first safe harbor, there would not be a requirement that the entity manage third-party capital contributions. The related entity would also have to be a separate legal entity and not registered as a broker/dealer; could not participate directly in the member's investment banking fees; and would have to be primarily engaged in the business of making venture capital investments.

(iii) 33% Institutional Investor Ownership The proposed safe harbor would require that institutional investors beneficially own at least 33% of the total number of the issuer's equity securities outstanding on a fully diluted basis. The term "institutional investor" would be defined in Rule 2710(c)(4)(D)(ii) to include any individual or entity (including a group of legal entities as proposed to be defined in Rule 2710(c)(4)(D)(i)) that has at least $50 million invested in securities in the aggregate in its portfolio or under management and is not: (1) a member participating in the public offering; (2) any of the member's associated or affiliated persons; or (3) an immediate family member of any associated or affiliated person of the member.[18]

(iv) Participation On And Vote Of Board of Directors At least one of those institutional investors would have to serve as a member of the issuer's board of

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[18] An institutional investor could be a member, or a person associated or affiliated with a member, that is not participating in the public offering.

directors and the transaction would have to be approved by a majority of the issuer's board of directors and by an affirmative vote of the institutional investors that are board members.

(c) Safe Harbor No. 3 - Private Placements With Institutional Investors

The third safe harbor, proposed in Rule 2710(c)(4)(E)(iii), is intended for acquisitions in private placements with significant institutional investor participation. The safe harbor would be available for purchases of securities in a private placement and for the receipt of securities as placement agent compensation.

(i) 20% Of Total Offering Limitation The underwriter and related persons could not, in the aggregate, acquire more than 20% of the "total offering." The "total offering" would be defined to consist of the total number of securities, on a fully diluted basis, sold in the private placement and received as placement agent compensation by a member. The 20% calculation would exclude purchases by those affiliates and other related persons of a member that would be qualified to acquire securities of the issuer under the first safe harbor. [19]

(ii) Same Terms And Price All securities purchased by the underwriter and related persons from the private placement must have the same terms[20] and be purchased at the same price[21] as securities purchased by the other investors.

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[19] For example, if the private placement consists of 100,000 shares of common stock and the issuer pays placement agent compensation to a member that includes a warrant for 10,000 shares of common stock, the total offering is 110,000 shares of common stock. The acquisition by the underwriter and related persons that are not qualified to purchase under the first safe harbor could not exceed 22,000 shares of common stock. Of these 22,000 shares, 10,000 shares would be accounted for by the warrant and up to 12,000 shares could be purchased as an investment.

[20] A security would be considered to have the same terms if it is a security of the same class with the same rights as the security sold to other investors. Thus, in a unit

(iii) 51% Institutional Investor Participation Institutional investors would have to purchase at least 51% of the total offering.[22] In addition, an institutional investor would have to be the lead negotiator with the issuer to establish the terms of the private placement. This requirement would not prevent an underwriter or related person from participating in the negotiation of the terms of the private placement.

(d) Safe Harbor No. 4 - Purchases Under A Preemptive Right The fourth safe harbor, proposed in Rule 2710(c)(4)(E)(iv), is intended for any acquisition of the issuer's securities by any underwriter or related person that is made pursuant to a right of preemption, whether that preemptive right was granted by contract, by the terms of the securities, or by applicable law. Purchases pursuant to a right of preemption generally do not raise the sorts of concerns that the Rule was designed to address because they are based on a purchase right granted to the purchaser in a prior investment. The right of preemption merely protects the purchaser from dilution when the company issues additional securities.

(i) Requirements Applicable To Acquisition Of Preemptive Right If the security with a preemptive right was acquired from a private placement, the private placement would have to occur more than 180 days before the filing date of the public

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offering, the unit purchased by a member must be composed of the same number and type of securities and any exerciseable security within a unit must have the same exercise price as the exerciseable security within the unit purchased by other investors.

21 If the purchasing member is also acting as placement agent, purchases by the member at a price that is net of the commission it receives for sales to the other investors will be considered to be "at the same price" for purposes of this provision.

22 In the example provided above, institutional investors must purchase at least 56,100 shares of the total offering of 110,000.

offering. If the security with a preemptive right was acquired from the public market or from a public offering, there would be no limitation on when the security must have been purchased, *i.e.*, the security could have been purchased within 180 days before the subsequent public offering is filed.

(ii) Requirements Applicable To Purchase Under The Preemptive Right

Under the safe harbor: (1) the right of preemption must be exercised in connection with a private placement of the issuer's securities for cash; (2) the private placement must be to all similar preemptive right holders; (3) the price and terms of the securities purchased must be the same as that for all other investors in the private placement; and (4) the purchaser may not, through the exercise of its preemptive rights, increase its ownership of the same class of securities of the issuer.

3. Calculation Of The 180-Day Review Period The 180-day review period and the 90-day period in the safe harbors are proposed to be calculated from the filing date of a public offering with the appropriate regulatory authority in order to provide a readily identifiable standard. Consistent with existing Department practice, the "filing date" for purposes of this calculation would be the earlier of the date of filing with the SEC, state securities commission, or other regulatory authority or the date of filing with the Association. Thus, if an offering is filed with the SEC before it is filed with the NASD, the "filing date" will be the SEC filing date. In addition, offerings submitted to the SEC for review on a confidential basis will be considered filed with the SEC as of the date of the confidential submission for purposes of Rule 2710.

4. Determination Of When Securities Are Considered "Received" The proposed rule change would adopt Rule 2710(c)(4)(B) to clarify when securities will be

considered to be "received" under the Rule for purposes of the the 180-day review period under Rule 2710(c)(4)(A) and the 90-day safe harbor period under Rule 2710(c)(4)(E) . Securities purchased from or received as compensation for a private placement will be deemed to have been received on the date of the closing of the private placement.[23] Securities received as compensation for a loan or credit facility will be deemed to have been received on the date the loan or credit facility agreement is executed. Securities received for consulting services to the issuer will be deemed to have been received on the date that beneficial ownership of the securities is transferred to the consultant. These proposals are consistent with existing Departmental practice.

5. 90-Day Post-Offering Objective Test Rule 2710(c)(4)(A) permits the staff to examine items of value received "subsequent to the public offering" to determine whether the items of value are considered to be underwriting compensation in connection with the public offering. The ability of the staff to include items of value received after the public offering in the calculation of underwriting compensation is necessary to avoid circumvention of the Rule.

In order to provide greater clarity concerning the extent of the "subsequent" time period, the proposed rule change would replace this language with new Rule 2710(c)(4)(C), under which items of value received within the 90-day period immediately following the effective date of a public offering would be examined to determine whether they constitute underwriting compensation.

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[23] The Department relies on the closing date rather than the date of a commitment letter because a commitment letter does not transfer beneficial ownership of the securities.

6. Valuation of Warrants Rule 2710(c)(6)(B)(viii)(i) provides that any option, warrant or convertible securities received by the underwriter and related persons as underwriting compensation may not be convertible or exercisable on terms more favorable than the terms of the securities being offered to the public. The provision, therefore, prohibits members from receiving compensation in the form of warrants that have an exercise price below the proposed public offering price.

The Rule requires that the warrants be valued, that they be included in the calculation of the underwriting compensation, and that they be subject to the Rule's compensation provisions. Therefore, the requirement that members revise the exercise price of their warrants seems unnecessary and Rule 2710(c)(6)(B)(viii)(i) is proposed to be deleted.

The proposed rule change would amend Rule 2710(c)(5)(A), which prohibits the payment of underwriting compensation in the form of securities that are not identical to those offered to the public or to a security that has a bona fide independent market, in order to clarify the application of this prohibition.

C. Restrictions On Resale of Securities

As discussed above, the Corporate Financing Rule imposes a one-year compensation lock-up on securities that constitute underwriting compensation or, in the case of an initial public offering, a 90-day venture capital lock-up on all securities held by members and certain senior persons and subsidiaries.

1. Background - Compensation Lock-Up The compensation lock-up was adopted primarily to protect the aftermarket in a new security from the potential for fraud and manipulation that exists when a member is an underwriter, actively trades the securities, and is a selling securityholder. These multiple roles for a broker/dealer were a basic concern

discussed at length in the Report of the Special Study of the Securities Markets of the Securities and Exchange Commission issued in 1963.[24] In the testimony underlying that study, industry members also stated that sales of an underwriter's private placement investments in an issuer shortly after the completion of an offering creates a negative appearance as the member has previously recommended the purchase of the security to its customers.

2. Background - Venture Capital Lock-Up The venture capital lock-up was intended to address similar potentials for abuse in the context of an initial public offering, by imposing a lock-up restriction that prohibits the sale of any of the issuer's securities (not just those considered to be underwriting compensation) held by a member and certain senior persons and subsidiaries at the time of the offering and for 90 days thereafter. The venture capital lock-up does provide exceptions for *de minimis* transactions and transactions in which a qualified independent underwriter[25] provides due diligence and a pricing opinion.

3. Proposed 180-Day Lock-Up NASD Regulation understands that it is common industry practice to impose a 180-day lock-up on the securities of the issuer held by certain officers and directors of the issuer. Consistent with this industry practice, NASD Regulation proposes to amend Rule 2710(c)(7)(A) and delete Rule 2710(c)(7)(C) to impose a 180-day lock-up on all equity securities of the issuer held by the underwriter and related persons at the time of the offering. Securities purchased from the public market would not be subject to any lock-up. The new 180-day lock-up would replace the one-year compensation lock-up and the 90-day venture capital lock-up. It would apply to both initial public offerings

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[24] Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, 88th Cong., 1st Session, House Document No. 95, Part 1, Chapter IV.

and to secondary offerings, subject to the following exceptions in amended Rule 2710(c)(7)(B) for:

- transfers of otherwise restricted securities that occur by operation of law or by reason of reorganization of the issuer;
- transfers to participating members and their officers and partners, so long as the transferred securities remain subject to any remaining lock-up period;
- transfers if a member and its related persons do not, in the aggregate, own more than 1% of the securities being offered;
- the exercise of securities, so long as the exercised securities remain subject to any remaining lock-up period; and
- transfers of securities that qualify as an "actively traded security" for purposes of SEC Regulation M.[26]

The proposal would eliminate the existing exception in Rule 2710(c)(7)(C)(i) from the venture capital lock-up for transactions in which a qualified independent underwriter provides a pricing opinion and performs due diligence.

4. Lower Compensation Value For Longer Lock-Up In valuing any securities considered to be underwriting compensation, Rule 2710(c)(5)(E) permits a lower valuation when the securities are subject to a lock-up beyond the current one-year compensation lock-up period. This paragraph would be amended to discount the compensation value of

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25 The term "qualified independent underwriter" is defined in Rule 2720(b)(15).

26 Under SEC Regulation M, a security is considered to be an "actively traded security" if it has at least $1 million average daily trading volume and $150 million public float value.

securities by 10% for each 180-day period that the securities (or underlying securities) are restricted from sale beyond the proposed 180-day lock-up period.

When a person agrees to such a longer lock-up in order to obtain a lower compensation value for the securities, the person would not be able to later rely on the exceptions from the 180-day lock-up for *de minimis* sales and sales of an "actively traded security." However, the other exceptions would be available.

5. Restrictive Legend The proposed rule change would delete Rule 2710(c)(7)(A)(ii), which requires that certificates representing any security subject to a lock-up bear a restrictive legend describing the lock-up. NASD Regulation understands that members are required to obtain a CUSIP number for the securities subject to the lock-up imposed by the rule that is different from the number assigned to other securities of the same issue. NASD Regulation proposes to delete this requirement, as it places an unintended burden on members that is unnecessary. Members would still be required to establish appropriate written procedures pursuant to NASD Rule 3010(b)(1) for ensuring compliance with the proposed 180-day lock-up.

D. Stock Numerical Limitation

1. Elimination Of Requirement The proposed rule change would eliminate the 10% stock numerical limitation in Rule 2710(c)(6)(B)(xi) on the amount of securities that participating underwriters and related persons may receive as underwriting compensation. The Rule already restricts the total value of all items that a member may receive as compensation, and Rule 2720 addresses the conflicts-of-interest that may arise when a member is an affiliate of the issuer. Therefore, the stock numerical limitation is unnecessary to achieve the purposes of the Rule.

2. Sales Of Securities Considered To Be Underwriting Compensation Rule 2710(c)(6)(C) requires that when the stock numerical limitation has been exceeded, the recipient of the securities must return any excess securities to the issuer or the source from which received at cost and without recourse. A different arrangement may be permitted by the Association. In light of the proposed elimination of the stock numerical limitation, this provision would be amended to apply to an acquisition of securities that results in unfair and unreasonable compensation.

E. Other Amendments[27]

1. Types Of Securities Considered To Be Items Of Value NASD Regulation proposes to amend Rule 2710(c)(3)(vii) to make non-substantive amendments to the description of the types of equity securities that are considered items of value to be included in the calculation of underwriting compensation.

2. Exclusions From The Calculation Of Underwriting Compensation The proposed rule change would amend Rule 2710(c)(3)(B) to put into one place all items of value that will be excluded from the calculation of underwriting compensation.

(a) Payments To A Previous Underwriter Rule 2710(c)(3)(xiii) requires the Department to include any fees paid to a previous underwriter that failed to complete a public offering in the calculation of underwriting compensation for a subsequent underwriter. This provision is intended to restrict the total amount of compensation paid to all underwriters, but it has imposed an unfair restriction on the compensation of replacement underwriters. Consequently, the proposed rule change would delete this provision.

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[27] The proposed rule change includes non-substantive amendments to Rule 2710 that are intended to provide clarity and consistency.

The proposed rule change would further codify this determination in new Rule 2710(c)(3)(B)(ii) by excluding from the calculation of underwriting compensation any payment to a member in connection with a proposed public offering that was not completed, if the member does not participate in the revised offering.[28]

(b) Consulting Agreements The requirements of Rule 2710(c)(4)(E) would be moved to new Rule 2710(c)(3)(B)(iii), which would continue to exclude from the calculation of underwriting compensation any payments received under a consulting agreement entered into more than one year before the filing date of the public offering.

3. Members' Obligation To File Information

Rule 2710(b) requires that members file certain documents and other information with the Department in connection with a public offering. The Department must rely on the adequacy and accuracy of the information filed by members in order to carry out its regulatory obligations under the rules that apply to public offerings of securities. To the extent, therefore, that a member or its counsel or other agent fails to provide all of the facts necessary for the Department's review of a public offering, files inaccurate information, fails to update or correct previously filed information, or fails to comply with representations made to the Department, the member would violate the Rule and NASD Conduct Rule 2110 (the Association's basic ethical conduct rule).

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[28] Rule 2710(c)(6)(B)(iv) would continue to prohibit payment of any compensation by an issuer to a member in connection with an offering of securities that is not completed according to the terms of agreement between the issuer and underwriter, except for reimbursement of out-of-pocket accountable expenses actually incurred by the member.

The proposed rule change would clarify this obligation of the member in several respects. First, Rule 2710(b)(6)(A)(v) would be amended to require members to provide the Department with a detailed explanation and documents related to a modification of any information or representation previously provided to the Association or of any item of underwriting compensation. Thus, in the event that the member (or member's counsel or other agent) determines that subsequent events have made inaccurate any information or representations previously provided to the Department, the member must inform the Department regarding the change. This obligation applies regardless of whether the change occurs before or after the issuance of the Department's opinion of a "no objections" to the underwriting terms and arrangements.

Second, the proposed rule change would provide that if an underwriter or related person receives any additional item of value subsequent to the Department's issuance of a "no objections" opinion and within 90 days following the offering's effective date, then the member must provide a detailed explanation and any documents related to the new arrangement to the Department.

The proposed rule change would also delete Rule 2710(b)(6)(iv), as it requires the submission of information addressing the subjective review factors in Rules 2710(c)(4)(C) and (D). As set forth above, paragraphs (C) and (D) are proposed to be deleted.

IV. Implementation Of Proposed Rule Change

NASD Regulation proposes to implement the proposed rule change upon approval by the SEC. Any public offering filed subsequent to the adoption of the amendments and any public offering that had been filed with the Department but for which a "no objections" letter has yet to be issued, would be subject to the new requirements. In addition, with respect to

public offerings for which a "no objections" letter has been issued at the time the amendments are adopted, the one-year compensation lock-up on securities would be shortened to 180 days and members could rely on the exceptions from the 180 day lock-up. Upon adoption of the amendments, any securities that are subject to the 90-day venture capital lock-up would remain subject to that lock-up until it expires, but any person holding such securities could rely on the exceptions from the 180-day lock-up.

Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6)[29] of the Act, which requires, among other things, that the Association's rules 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. The NASD believes that the proposed rule change will eliminate burdensome rules that no longer distinguish between *bona fide* capital-raising and lending practices and abusive arrangements and minimize the opportunity for abusive practices by members in connection with underwriting public offerings of securities.

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

NASD Regulation 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.

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[29] 15 U.S.C. § 78o-3.

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

Written comments were not solicited on the proposed rule change. However, NASD Notice to Members 98-81 (October, 1998) requested comment on whether any NASD rules are obsolete. A copy of the Notice to Members is attached as Exhibit 2 to the proposed rule change. A comment letter was received from The Bond Market Association that included two recommended amendments to Rule 2710 that are pertinent to the proposed rule change. A copy of the comment letter received from the BMA is attached as Exhibit 3 to the proposed rule change. The recommendations of the BMA to amend other provisions of Rule 2710 are under consideration by the Association and are not pertinent to the proposed rule change.

On page 18 of its letter, the BMA recommends that the subjective review factors om Rule 2710(c)(4)(D) be amended to consider whether there is a bona fide business purpose for an acquisition of securities. Rule 2710(c)(4)(D) is proposed to be deleted and Rule 2710(c)(4)(A) would be amended to adopt an objective, bright-line test to include in the calculation of underwriting compensation all items of value received by the underwriter and related persons during the 180-day period immediately preceding the filing of the public offering and during the public offering. Thus, the subjective factor proposed by the BMA is no longer necessary to the Association’s review of underwriting compensation.

In addition, the BMA recommends on page 18 of its letter that Rule 2710(c)(5)(A) be amended to permit the underwriter and related person to receive as compensation a security different than the security offered to the public if there is a reasonable method to value the security received. The proposed rule change would amend Rule 2710(c)(5)(A) to clarify the current language of the provision, which allows the Department to permit the underwriter and

related person to receive a security that is different than the security offered to the public and that does not have a bona fide independent market, if good cause can be shown for the arrangement. One of the considerations in permitting such an arrangement would be whether the Department can value the security for compensation purposes. In the absence of a bona fide independent market for a security, the decision on whether security that is different than the security to be offered to the public can be reliably valued is subjective and, therefore, not amenable to codification.

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 by order approve such proposed rule change, or institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing including whether the proposal is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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. Copies of such filing will also be available for inspection and copying at the principal office of the

NASD. All submissions should refer to file No. SR-NASD-00-04 and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[30]

Jonathan G. Katz
Secretary

[30] 17 CFR 200.30-3(a)(12).

Exhibit No. 2

Notice to Members 98-81 (October, 1998)

Exhibit No. 3

Comment Letter of The Bond Market Association