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April 11, 2003

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-2000-04, Amendment No. 8  
Amendments to the Corporate Financing Rule**

Dear Ms. England:

Pursuant to Rule 19b-4, NASD is filing Amendment No. 8 to the above-numbered rule filing to amend the text of the Corporate Financing Rule ("Rule") in response to a comment letter, as discussed below. NASD originally proposed amendments to the Rule on January 20, 2000. The Securities and Exchange Commission ("SEC" or "Commission") most recently published Amendment No. 5 for comment on March 14, 2001 and received 8 comment letters. NASD filed Amendment No. 6 on November 19, 2001. Amendment No. 6 responded to the comments and requested approval of the proposed amendments. On April 3, 2003, NASD submitted Amendment No. 7, which made three technical, non-substantive changes to the proposed rule change.

On October 15, 2002, NASD received a new comment letter from Cleary, Gottlieb, Steen and Hamilton ("Cleary") writing on behalf of the Derivative Products and Capital Markets Committees of the Securities Industry Association and the Corporate Bond Legal Advisory Committee of the Bond Market Association. This letter suggested that the proposed rule change be amended so that it does not have the unintentional effect of capturing within "underwriting compensation" certain derivative and other instruments that are entered into by members or related persons in the ordinary course of business. NASD staff agrees that as proposed, the definition of "items of value" would include derivative instruments and certain other transactions that were not intended to be included in the compensation provisions. Accordingly, we amended the proposal to add subsections (c)(3)(B)(vi) and (vii) to Rule 2710, which provide that nonconvertible or non-exchangeable debt securities and derivative instruments acquired or entered into:

- for a fair price;
- in the ordinary course of business;
- in transactions unrelated to the public offering;

are not “items of value” under the Rule. Because they are not items of value, they also are excluded from the lock-up requirements in the Rule.

The term “fair price” is defined in Rule 2710(a)(9) to require that the underwriters and related persons have priced the nonconvertible or non-exchangeable debt security or derivative instrument in good faith, on an arms’ length basis, in a commercially reasonable manner, and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions. This “fair price” definition distinguishes covered debt and derivative transactions from a transaction in which the benefit to the underwriter or related person is related to underwriting or similar services provided to the issuer. For example, if the return associated with options or warrants received as placement agent compensation or securities and derivatives received in connection with a bridge loan, venture capital investment, or merger and acquisition advice is a function of the value to the issuer of the services, loans or investments provided by the underwriter, then the securities acquired in those transactions would not be acquired for a “fair price,” as that term is defined in the Rule.

Moreover, if any debt or derivative transaction between an underwriter or related person and an issuer is structured so that the risk to the underwriter or related person and the benefit to the customer is expected to be minimal, in comparison to the benefit received by the underwriter or related person, the debt security or derivative instrument would not have been acquired or entered into “in good faith, on an arms’ length basis, in a commercially reasonable manner, and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions” as required to come within the “fair price” definition in Rule 2710(a)(9). NASD recognizes, however, that the fact that a debt security or derivative instrument turns out to be more or less favorable to a party as the result of market movements or events subsequent to entry into the transaction would not effect whether the transactions was entered into at a “fair price” under the definition. Accordingly, whether a transaction is at a fair price will be determined at the time the transaction is entered into.

Rule 2710(c)(3)(B)(vi) and (vii) require that the nonconvertible or non-exchangeable debt securities and derivative instruments are acquired or entered into “in transactions unrelated to the public offering.” Generally, if a transaction occurring within the review period is negotiated by personnel in a member’s investment banking department, it would not be considered to be “unrelated to the public offering.” An exception to this general principle would be a put option or other derivative instrument that is entered into by an issuer with an underwriter or related person, in connection with a publicly disclosed share repurchase program. The public disclosure and transparent nature of the repurchase program distinguish the derivative transaction in support of the program from other privately negotiated transactions between the investment bankers and the issuer during the review period.

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NASD staff has not defined the term “in the ordinary course of business” for purposes of Rule 2710(c)(3)(B)(vi) and (vii). Whether a debt or derivative transaction between an issuer and an underwriter or related person is part of regular business services provided by the member to its clients or whether it is a customized transaction that is being offered in connection with a public offering depends on the particular facts and circumstances.

Information regarding debt and derivative transactions that do not meet the “in the ordinary course of business in transactions unrelated to the public offering” requirement of Rule 2710(c)(3)(B)(vi) and (vii) must be filed under the Rule if the related public offering is subject to the filing requirements of the Rule. We have modified the filing requirement in Rule 2710(b)(6)(A)(iv), however, such that information initially filed in connection with debt securities and derivative instruments acquired or entered into for “fair price” as defined in Rule 2710(a)(9) may be limited to a brief description of the transaction and a representation that the transaction was (or if the pricing terms have not been set) will be entered into at a fair price as defined in Rule 2710(a)(9). The required information would have to be submitted only with respect to the particular public offering to which a particular nonconvertible or non-exchangeable debt security or derivative instrument relates. The Department will evaluate the information submitted in the same case-by-case manner that it will review financial consulting and advisory arrangements under the Rule.

NASD staff has also amended the exceptions from the lock-up requirements in Rule 2710(g)(2) to provide that debt securities and derivative instruments (1) that are not items of value, or (2) that are eligible for the limited filing requirement in Rule 2710(b)(6)(A)(iv) and have not been deemed to be underwriting compensation by the Department under the Rule will not be locked up. NASD staff understands that interest rate swaps entered into in connection with a bond offering may be designed to reduce the issuer’s net cost of funding for the offering or to exchange a fixed rate obligation for a floating rate obligation. If the transaction were entered into at a “fair price” as defined in Rule 2710(a)(9), the Department would not determine that the interest rate swap constituted underwriting compensation and the lock-up provision would not apply. If the interest rate swap were entered into in connection with a bond offering subject to the filing requirements of the Rule, however, information regarding the swap arrangement would be required to be filed and reviewed so that the Department could reach this conclusion.

Finally, NASD is adopting a new corporate structure and is seeking the merger of NASD Regulation and NASD Dispute Resolution into NASD, with the merger becoming effective upon the Commission’s authorization of the operation of Nasdaq other than as a facility of NASD. To underscore this new corporate structure and renewed regulatory focus, NASD generally does not refer to itself using its full corporate name, “the Association” or “the NASD.” Instead NASD uses “NASD” unless otherwise appropriate

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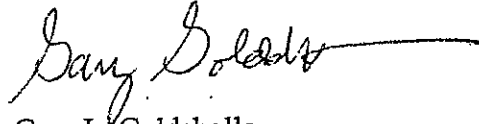
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for corporate or regulatory reasons. Accordingly, NASD has replaced several references to "the Association" and "the NASD" in the text of the proposed rule change with "NASD."

We have enclosed a 3-1/2" disk containing the rule filing in Microsoft Word to facilitate production of the Federal Register release. In addition, we have attached as Exhibit A the proposed amendment marked to show changes from the rule language proposed in Amendment No. 7. Attached as Exhibit B is the complete text of the proposed rule change.

If you have any questions or comments regarding these changes, please contact Joseph E. Price, Vice President, Corporate Financing Department, NASD at (240) 386-4642; or at [joseph.price@nasd.com](mailto:joseph.price@nasd.com). The fax number for the Corporate Financing Department is (240) 386-4654.

Very truly yours,

A handwritten signature in cursive script, reading "Gary L. Goldsholle", followed by a horizontal line extending to the right.

Gary L. Goldsholle  
Associate General Counsel

**2710. Corporate Financing Rule - Underwriting Terms and Arrangements****(a) Definitions**

For purposes of this Rule, the following terms shall have the meanings stated below. The definitions in Rule 2720 are incorporated herein by reference.

**(1) Issuer**

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.

**(2) Net Offering Proceeds**

Offering proceeds less all expenses of issuance and distribution.

**(3) Offering Proceeds**

Public offering price of all securities offered to the public, not including securities subject to any overallotment option, securities to be received by the underwriter and related persons, or securities underlying other securities.

**(4) Participating Member(s)**

Any NASD member that is participating in a public offering, any associated person of the member, any members of their immediate family, and any affiliate of the member.

**(5) Participation or Participating in a Public Offering**

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.

**(6) Underwriter and Related Persons**

Consists of underwriter's counsel, financial consultants and advisors, finders, any participating member, and any other persons related to any participating member.

**(7) Listed Securities**

Securities meeting the listing standards to trade on the national securities exchanges identified in SEC Rule 146, markets registered with the SEC under Section 6 [or 11A] of the Exchange Act, and any offshore market that is a "designated offshore securities market" under Rule 902(b) of SEC Regulation S.

**(8) Derivative Instruments**

A derivative instrument is any "eligible OTC derivative instrument" as defined in SEC Rule 3b-13(a)(1), (2) and (3).

**(9) Fair Price**

A derivative instrument or non-convertible or non-exchangeable debt security has been acquired or entered into at a fair price for purposes of subparagraphs (b)(6)(iv) and (c)(3)(B)(vi) and (vii) if the underwriters and related persons have priced the debt security or derivative instrument in good faith; on arm's length, commercially reasonable basis; and in accordance with pricing

methods and models and procedures used in the ordinary course of their business for pricing similar transactions.

**(b) Filing Requirements**

(1) through (3) No change.

**(4) Requirement for Filing**

(A) Unless filed by the issuer, the managing underwriter, or another member, a member that anticipates participating in a public offering of securities subject to this Rule shall file with [the Association] NASD the documents and information with respect to the offering specified in subparagraphs (5) and (6) below:

(i) no later than one business day after any such documents are filed with or submitted to:

a. the Commission; or

b. any state securities commission or other regulatory authority; or

(ii) if not filed with or submitted to any regulatory authority, at least fifteen business days prior to the anticipated date on which offers will commence.

(B) No sales of securities subject to this Rule shall commence unless:

(i) the documents and information specified in subparagraphs (5) and (6) below have been filed with and reviewed by [the Association] NASD; and

(ii) No change.

(C) No change.

(5) No change.

**(6) Information Required to be Filed**

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

(i) through (ii) No change.

(iii) a statement of the association or affiliation with any member of any officer or director of the issuer, of any beneficial owner of 5% or more of any class of the issuer's securities, and of any beneficial owner of the issuer's unregistered equity securities that were acquired during the 180-day period immediately preceding the required filing date of the public offering, except for purchases described in subparagraph (c)(3)(B)(iv) below. This statement must identify:

a. the person;

b. the member and whether such member is participating in any capacity in the public offering; and

c. the number of equity securities or the face value of debt securities owned by such person, the date such securities were acquired, and the price paid for such securities.



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

a. information regarding debt securities and derivative instruments not considered an item of value under subsection (c)(3)(vi) and (vii) is not required to be filed; and

b. information initially filed in connection with debt securities and derivative instruments acquired or entered into for “fair price” as defined in subsection (a)(9) maybe limited to a brief description of the transaction and a representation by the member that a registered principal or senior manager on behalf of the member has determined that the transaction was (or if the pricing terms have not been set) will be entered into a fair price as defined in subsection (a)(9);

(v) a statement demonstrating compliance with all of the criteria of an exception from underwriting compensation in subparagraph (d)(5) below, when applicable; and

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

a. the modification of any information or representation previously provided to [the Association] NASD or of any item of underwriting compensation, including the information required in subparagraph (b)(6)(A)(iii) above with respect to any securities of the issuer acquired subsequent to the required filing date and prior to the effectiveness or commencement of the offering;

or

b. any new arrangement that provides for the receipt of any additional item of value by any participating member subsequent to the issuance of an opinion of no objections to the underwriting terms and arrangements by [the Association] NASD and within 90 days immediately following the date of effectiveness or commencement of sales of the public offering.

(B) No change.

(7) through (11) No change.

**(c) Underwriting Compensation and Arrangements**

**(1) General**

No member or person associated with a member shall participate in any manner in any public offering of securities in which the underwriting or other terms or arrangements in connection with or relating to the distribution of the securities, or the terms and conditions related thereto, are unfair or unreasonable.

**(2) Amount of Underwriting Compensation**

(A) No member or person associated with a member shall receive an amount of underwriting compensation in connection with a public offering that is unfair or unreasonable and no member or person associated with a member shall underwrite or participate in a public offering of securities if the underwriting compensation in connection with the public offering is unfair or unreasonable.

(B) through (D) No change.

(E) The maximum amount of compensation (stated as a percentage of the dollar amount of the offering proceeds) that is considered fair and reasonable generally will vary directly with the amount of risk to be assumed by participating members and inversely with the dollar amount of the offering proceeds.

**(3) Items of Value**

(A) For purposes of determining the amount of underwriting compensation received or to be received by the underwriter and related persons pursuant to subparagraph (c)(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 paragraph (d) below shall be included:

(i) through (iii) No change.

(iv) finder's fees, whether in the form of cash, securities or any other item of value;

(v) wholesaler's fees;

(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, received:

a. for acting as private placement agent for the issuer;

b. for providing or arranging a loan, credit facility, merger or acquisition services, or any other service for the issuer;

c. as an investment in a private placement made by the issuer; or

d. at the time of the public offering;

(viii) special sales incentive items;

(ix) any right of first refusal provided to any participating member to underwrite or participate in future public offerings, private placements or other financings, which will have a compensation value of 1% of the offering proceeds or that dollar amount contractually agreed to by the issuer and underwriter to waive or terminate the right of first refusal;

(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 months following the effective date of the offering, of warrants, options, convertible securities, or similar securities distributed as part of the public offering;

(xii) fees of a qualified independent underwriter; and

(xiii) compensation, including expense reimbursements, previously paid to any member in connection with a proposed public offering that was not completed, unless the member does not participate in the revised public offering.

(B) Notwithstanding subparagraph (c)(3)(A) above, the following shall not be considered an item of value:

(i) Expenses customarily borne by an issuer, such as printing costs; SEC, “blue sky” and other registration fees; [the Association] NASD filing fees; and accountant’s fees, whether or not paid through a participating member;

(ii) cash compensation for acting as placement agent for a private placement or for providing a loan, credit facility, or for services in connection with a merger/acquisition;

(iii) listed securities purchased in public market transactions;

(iv) securities acquired through any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code [and];

(v) securities acquired by an investment company registered under the Investment Company Act of 1940[.];

(vi) nonconvertible or non-exchangeable debt securities acquired for a fair price in the ordinary course of business in a transaction unrelated to the public offering; and

(vii) derivative instruments entered into for a fair price in the ordinary course of business in a transaction unrelated to the public offering.

**(d) Determination of Whether Items of Value Are Included In Underwriting Compensation**

**(1) Pre-Offering Compensation**

All items of value received and all arrangements entered into for the future receipt of an item of value by the underwriter and related persons during the period commencing 180 days immediately preceding the required filing date of the registration statement or similar document pursuant to subparagraph (b)(4) above until the date of effectiveness or commencement of sales of the public offering will be considered to be underwriting compensation in connection with the public offering.

**(2) Undisclosed and Post-Offering Compensation**

All items of value received and all arrangements entered into for the future receipt of an item of value by any participating member that are not disclosed to [the Association] NASD prior to the date of effectiveness or commencement of sales of a public offering, including items of value received subsequent to the public offering, are subject to post-offering review to determine whether such items of value are, in fact, underwriting compensation for the public offering.

**(3) Date of Receipt of Securities**

Securities of the issuer acquired by the underwriter and related persons will be considered to be received for purposes of subparagraphs (d)(1) and (d)(5) as of the date of the:

(A) closing of a private placement, if the securities were purchased in or received for arranging a private placement; or

(B) execution of a written contract with detailed provisions for the receipt of securities as compensation for a loan, credit facility, or put option; or

(C) transfer of beneficial ownership of the securities, if the securities were received as compensation for consulting or advisory services, merger or acquisition services, acting as a finder, or for any other service.

**(4) Definitions**

For purposes of subparagraph (d)(5) below, the following terms will have the meanings stated below.

(A) An entity:

(i) includes a group of legal persons that either:

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

b. have filed a Schedule 13D or 13G with the SEC that identifies the legal persons as members of a group that have agreed to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer in connection with a previous investment; and

(ii) may make its investment or loan through a wholly owned subsidiary (except when the entity is a group of legal persons).

(B) An institutional investor is any individual or legal person that has at least \$50 million invested in securities in the aggregate in its portfolio or under management, including investments held by its wholly owned subsidiaries; provided that no participating members direct or otherwise manage the institutional investor's investments or have an equity interest in the institutional investor, either individually or in the aggregate, that exceeds 5% for a publicly owned entity or 1% for a nonpublic entity.

(C) A bank or insurance company is only the regulated entity, not its subsidiaries or other affiliates.



(D) A right of preemption means the right of a shareholder to acquire additional securities in the same company in order to avoid dilution when additional securities are issued, pursuant to:

- (i) any option, shareholder agreement, or other contractual right entered into at the time of a purchase of securities;
- (ii) the terms of the security purchased;
- (iii) the issuer's charter or by-laws; or
- (iv) the domestic law of a foreign jurisdiction that regulates the issuance of the securities.

(E) "Total equity securities" means the aggregate of the total shares of:

- (i) common stock outstanding of the issuer; and
- (ii) common stock of the issuer underlying all convertible securities outstanding that convert without the payment of any additional consideration.

#### **(5) Exceptions From Underwriting Compensation**

Notwithstanding subparagraph (d)(1) above, the following items of value are excluded from underwriting compensation (but are subject to the lock-up restriction in subparagraph (g)(1) below), provided that the member does not condition its participation in the public offering on an acquisition of securities under an exception and any securities purchased are purchased at the same price and with the same terms as the securities purchased by all other investors.

(A) **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 before the required filing date of the public offering pursuant to subparagraph (b)(4) above by certain entities if:

(i) each entity:

a. either:

1. manages capital contributions or commitments of \$100 million or more, at least \$75 million of which has been contributed or committed by persons that are not participating members;

2. manages capital contributions or commitments of \$25 million or more, at least 75% of which has been contributed or committed by persons that are not participating members;

3. is an insurance company as defined in Section 2(a)(13) of the Securities Act or is a foreign insurance company that has been granted an exemption under this Rule; or

4. is a bank as defined in Section 3(a)(6) of the Act or is a foreign bank that has been granted an exemption under this Rule; and

b. is a separate and distinct legal person from any member and is not registered as a broker/dealer;

c. makes investments or loans subject to the evaluation of individuals who have a contractual or 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;

d. does not participate directly in investment banking fees received by any participating member for underwriting public offerings; and

e. has been primarily engaged in the business of making investments in or loans to other companies; and

(ii) all entities related to each member in acquisitions that qualify for this exception do not acquire more than 25% of the issuer's total equity securities during the review period in subparagraph (d)(1), calculated immediately following the transaction.

**(B) 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 before the required filing date of the public offering pursuant to subparagraph (b)(4) above by certain entities if:**

(i) each entity:

a. manages capital contributions or commitments of at least \$50 million;

b. is a separate and distinct legal person from any member and is not registered as a broker/dealer;

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

d. has been primarily engaged in the business of making investments in or loans to other companies; and

(ii) institutional investors beneficially own at least 33% of the issuer's total equity securities, calculated immediately prior to the transaction;

(iii) the transaction was approved by a majority of the issuer's board of directors and a majority of any institutional investors, or the designees of institutional investors, that are board members; and

(iv) all entities related to each member in acquisitions that qualify for this exception do not acquire more than 25% of the issuer's total equity securities, calculated immediately following the transaction.

**(C) Private Placements With Institutional Investors - Securities** of the issuer purchased in, or received as placement agent compensation for, a private placement before the required filing date of the public offering pursuant to subparagraph (b)(4) above if:

(i) institutional investors purchase at least 51% of the “total offering” (comprised of the total number of securities sold in the private placement and received or to be received as placement agent compensation by any member);

(ii) an institutional investor was the lead negotiator or, if the terms were not negotiated, was the lead investor with the issuer to establish or approve the terms of the private placement; and

(iii) underwriters and related persons did not, in the aggregate, purchase or receive as placement agent compensation more than 20% of the “total offering” (excluding purchases by any entity qualified under subparagraph (d)(5)(A) above).

**(D) Acquisitions and Conversions to Prevent Dilution -**

Securities of the issuer if:

(i) the securities were acquired as the result of:

a. a right of preemption that was granted in connection with securities that were purchased either:

1. in a private placement and the securities are not deemed by [the Association] NASD to be underwriting compensation; or

2. from a public offering or the public market; or

b. a stock-split or a pro-rata rights or similar offering; or

c. the conversion of securities that have not been deemed by [the Association] NASD to be underwriting compensation; and

(ii) the only terms of the purchased securities that are different from the terms of securities purchased by other investors are pre-existing contractual rights that were granted in connection with a prior purchase;

(iii) the opportunity to purchase in a rights offering or pursuant to a right of preemption, or to receive additional securities as the result of a stock-split or conversion was provided to all similarly situated securityholders; and

(iv) the amount of securities purchased or received did not increase the recipient's percentage ownership of the same generic class of securities of the issuer or of the class of securities underlying a convertible security calculated immediately prior to the investment, except in the case of conversions and passive increases that result from another investor's failure to exercise its own rights.

**(E) Purchases Based On A Prior Investment History -**

Purchases of securities of the issuer if:

(i) the amount of securities purchased did not increase the purchaser's percentage ownership of the same generic class of securities of the issuer or of the class of securities underlying a

convertible security calculated immediately prior to the investment; and

(ii) an initial purchase of securities of the issuer was made at least two years and a second purchase was made more than 180 days before the required filing date of the public offering pursuant to subparagraph (b)(4) above.

**(e) 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.

**(1) Limitation on Securities Received Upon Exercise or Conversion of Another Security**

An underwriter and related person may not receive a security (including securities in a unit), a warrant for a security, or a security convertible into another security as underwriting compensation in connection with a public offering unless:

(A) the security received or the security underlying the warrant or convertible security received is identical to the security offered to the public or to a security with a bona fide independent market; or

(B) the security can be accurately valued, as required by subparagraph (f)(2)(I) below.

**(2) Valuation of Securities That Do Not Have an Exercise or Conversion Price**

Securities that do not have an exercise or conversion price shall have a compensation value based on:

(A) the difference between:

(i) either the market price per security on the date of acquisition, or, if no bona fide independent market exists for the security, the public offering price per security; and

(ii) the per security cost;

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

(C) divided by the offering proceeds; and

(D) multiplied by one hundred.

### **(3) Valuation of Securities That Have an Exercise or Conversion**

#### **Price**

Options, warrants or convertible securities that have an exercise or conversion price (“warrants”) shall have a compensation value based on the following formula:

(A) the public offering price per security multiplied by .65;

(B) minus the resultant of the exercise or conversion price per warrant less either:

(i) the market price per security on the date of acquisition, where a bona fide independent market exists for the security, or

(ii) the public offering price per security;

(C) divided by two;



- (D) multiplied by the number of securities underlying the warrants;
- (E) less the total price paid for the warrants;
- (F) divided by the offering proceeds; and
- (G) multiplied by one hundred;
- (H) provided, however, that, notwithstanding subparagraph (e)(4) below, such warrants shall have a compensation value of at least .2% of the offering proceeds for each amount of securities that is up to 1% of the securities being offered to the public (excluding securities subject to an overallotment option).

#### **(4) Valuation Discount For Securities With a Longer Resale**

##### **Restriction**

A lower value equal to 10% of the calculated value shall be deducted for each 180-day period that the securities or underlying securities are restricted from sale or other disposition beyond the 180-day period of the lock-up restriction required by subparagraph (g)(1) below. The transfers permitted during the lock-up restriction by subparagraphs (g)(2)(A)(iii)-(iv) are not available for such securities.

##### **(f) Unreasonable Terms and Arrangements**

###### **(1) General**

No member or person associated with a member shall participate in any manner in a public offering of securities after any arrangement proposed in connection with the public offering, or the terms and conditions relating thereto,

has been determined to be unfair or unreasonable pursuant to this Rule or inconsistent with any By-Law or any Rule or regulation of [the Association] NASD.

**(2) Prohibited Arrangements**

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.

(A) Any accountable expense allowance granted by an issuer to the underwriter and related persons that includes payment for general overhead, salaries, supplies, or similar expenses of the underwriter incurred in the normal conduct of business.

(B) Any non-accountable expense allowance in excess of 3% of offering proceeds.

(C) Any payment of commissions or reimbursement of expenses directly or indirectly to the underwriter and related persons prior to commencement of the public sale of the securities being offered, except a reasonable advance against out-of-pocket accountable expenses actually anticipated to be incurred by the underwriter and related persons, which advance is reimbursed to the issuer to the extent not actually incurred.

(D) The payment of any compensation by an issuer to a member or person associated with 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 those negotiated and paid in

connection with a transaction that occurs in lieu of the proposed offering as a result of the efforts of the underwriter and related persons and provided, however, that the reimbursement of out-of-pocket accountable expenses actually incurred by the member or person associated with a member shall not be presumed to be unfair or unreasonable under normal circumstances.

(E) Any "tail fee" arrangement granted to the underwriter and related persons that has a duration of more than two years from the date the member's services are terminated, in the event that the offering is not completed in accordance with the agreement between the issuer and the underwriter and the issuer subsequently consummates a similar transaction, except that a member may demonstrate on the basis of information satisfactory to [the Association] NASD that an arrangement of more than two years is not unfair or unreasonable under the circumstances.

(F) Any right of first refusal provided to the underwriter or related persons to underwrite or participate in future public offerings, private placements or other financings that:

(i) has a duration of more than three years from the date of effectiveness or commencement of sales of the public offering; or

(ii) has more than one opportunity to waive or terminate the right of first refusal in consideration of any payment or fee.

(G) Any payment or fee to waive or terminate a right of first refusal regarding future public offerings, private placements or other financings provided to the underwriter and related persons that:

(i) has a value in excess of the greater of 1% of the offering proceeds in the public offering where the right of first refusal was granted (or an amount in excess of 1% if additional compensation is available under the compensation guideline of the original offering) or 5% of the underwriting discount or commission paid in connection with the future financing (including any overallotment option that may be exercised), regardless of whether the payment or fee is negotiated at the time of or subsequent to the original public offering; or

(ii) is not paid in cash.

(H) The terms or the exercise of the terms of an agreement for the receipt by the underwriter and related persons of underwriting compensation consisting of any option, warrant or convertible security that:

(i) is exercisable or convertible more than five years from the effective date of the offering;

(ii) is not in compliance with subparagraph (e)(1) above;

(iii) has more than one demand registration right at the issuer's expense;

(iv) has a demand registration right with a duration of more than five years from the date of effectiveness or the commencement of sales of the public offering;

(v) has a piggyback registration right with a duration of more than seven years from the date of effectiveness or the commencement of sales of the public offering;

(vi) has anti-dilution terms that allow the underwriter and related persons to receive more shares or to exercise at a lower price than originally agreed upon at the time of the public offering, when the public shareholders have not been proportionally affected by a stock split, stock dividend, or other similar event; or

(vii) has anti-dilution terms that allow the underwriter and related persons to receive or accrue cash dividends prior to the exercise or conversion of the security.

(I) The receipt by the underwriter and related persons of any item of compensation for which a value cannot be determined at the time of the offering.

(J) When proposed in connection with the distribution of a public offering of securities on a "firm commitment" basis, any over allotment option providing for the over allotment of more than 15% of the amount of securities being offered, computed excluding any securities offered pursuant to the over allotment option.

(K) The receipt by a member or person associated with a member, pursuant to an agreement entered into at any time before or after the effective date of a public offering of warrants, options, convertible securities or units containing such securities, of any compensation or expense reimbursement in connection with the exercise or conversion of any such warrant, option, or convertible security in any of the following circumstances:

(i) the market price of the security into which the warrant, option, or convertible security is exercisable or convertible is lower than the exercise or conversion price;

(ii) the warrant, option, or convertible security is held in a discretionary account at the time of exercise or conversion, except where prior specific written approval for exercise or conversion is received from the customer;

(iii) the arrangements whereby compensation is to be paid are not disclosed:

a. in the prospectus or offering circular by which the warrants, options, or convertible securities are offered to the public, if such arrangements are contemplated or any agreement exists as to such arrangements at that time, and

b. in the prospectus or offering circular provided to security holders at the time of exercise or conversion; or

(iv) the exercise or conversion of the warrants, options or convertible securities is not solicited by the underwriter or related person, provided however, that any request for exercise or conversion will be presumed to be unsolicited unless the customer states in writing that the transaction was solicited and designates in writing the broker/dealer to receive compensation for the exercise or conversion.

(L) For a member or person associated with a member to accept, directly or indirectly, any non-cash sales incentive item including, but not limited to, travel bonuses, prizes and awards, from an issuer or an affiliate thereof in excess of \$100 per person per issuer annually. Notwithstanding the foregoing, a member may provide non-cash sales incentive items to its associated persons provided that no issuer, or an affiliate thereof, including specifically an affiliate of the member, directly or indirectly participates in or contributes to providing such non-cash sales incentive.

(M) For a member to participate with an issuer in the public distribution of a non-underwritten issue of securities if the issuer hires persons primarily for the purpose of distributing or assisting in the distribution of the issue, or for the purpose of assisting in any way in connection with the underwriting, except to the extent in compliance with [17 C.F.R. §240.3a4-1] SEC Rule 3a4-1 and applicable state law.

(N) For a member or person associated with a member to participate in a public offering of real estate investment trust securities, as

defined in Rule 2340(c)(4), unless the trustee will disclose in each annual report distributed to investors pursuant Section 13(a) of the Act a per share estimated value of the trust securities, the method by which it was developed, and the date of the data used to develop the estimated value.

**(g) Lock-Up Restriction on Securities**

**(1) Lock-Up Restriction**

Any common or preferred stock, options, warrants, and other equity securities of the issuer, including debt securities convertible to or exchangeable for equity securities of the issuer, that are unregistered and acquired by an underwriter and related person during 180 days prior to the required filing date, or acquired after the required filing date and deemed to be underwriting compensation by [the Association] NASD, and securities excluded from underwriting compensation pursuant to subparagraph (d)(5) above, shall not be sold during the offering, or sold, transferred, assigned, pledged, or hypothecated, or be the subject of any hedging, short sale, derivative, put, or call transaction that would result in the effective economic disposition of the securities by any person for a period of 180 days immediately following the date of effectiveness or commencement of sales of the public offering, except as provided in subparagraph (g)(2) below.

**(2) Exceptions to Lock-Up Restriction**

Notwithstanding subparagraph (g)(1) above, the following shall not be prohibited:

(A) the transfer of any security:



(i) by operation of law or by reason of reorganization of the issuer;

(ii) to any member participating in the offering and the officers or partners thereof, if all securities so transferred remain subject to the lock-up restriction in subparagraph (g)(1) above for the remainder of the time period;

(iii) if the aggregate amount of securities of the issuer held by the underwriter or related person do not exceed 1% of the securities being offered;

(iv) that is beneficially owned on a pro-rata basis by all equity owners of an investment fund, provided that no participating member manages or otherwise directs investments by the fund, and participating members in the aggregate do not own more than 10% of the equity in the fund;

(v) that is not an item of value under subparagraphs (c)(3)(B)(iii) - (vii) above;

(vi) that is eligible for the limited filing requirement in subparagraph (b)(6)(A)(iv)b. and has not been deemed to be underwriting compensation under the Rule;

[(vi)](vii) that was previously but is no longer subject to the lock-up restriction in subparagraph (g)(1) above in connection with a prior public offering (or a lock-up restriction in the predecessor rule), provided that if the prior restricted period has

not been completed, the security will continue to be subject to such prior restriction until it is completed; or

[(vii) that was acquired before the period commencing 180 days immediately preceding the required filing date pursuant to subparagraph (b)(4) above and:]

[a. the class of security qualifies as an “actively traded security” under SEC Rule 101(c)(1) of Regulation M as of the date of effectiveness or commencement of sales of the public offering; or]

[b. is beneficially owned by a person that is not a participating member; or]

(viii) that was acquired subsequent to the issuer’s initial public offering in a transaction exempt from registration under SEC Rule 144A; or

(B) the exercise or conversion of any security, if all securities received remain subject to the lock-up restriction in subparagraph (g)(1) above for the remainder of the time period.

**(h) Proceeds Directed to a Member**

**(1) Compliance With Rule 2720**

No member shall participate in a public offering of an issuer's securities where more than 10% of the net offering proceeds, not including underwriting compensation, are intended to be paid to participating members, unless the price

at which an equity issue or the yield at which a debt issue is to be distributed to the public is established pursuant to Rule 2720(c)(3).

**(2) Disclosure**

All offerings included within the scope of subparagraph (h)(1) shall disclose in the underwriting or plan of distribution section of the registration statement, offering circular or other similar document that the offering is being made pursuant to the provisions of this subparagraph and, where applicable, the name of the member acting as qualified independent underwriter, and that such member is assuming the responsibilities of acting as a qualified independent underwriter in pricing the offering and conducting due diligence.

**(3) Exception From Compliance**

The provisions of subparagraphs (h)(1) and (2) shall not apply to:

- (A) an offering otherwise subject to the provisions of Rule 2720;
- (B) an offering of securities exempt from registration with the Commission under Section 3(a)(4) of the Securities Act of 1933;
- (C) an offering of a real estate investment trust as defined in Section 856 of the Internal Revenue Code; or
- (D) an offering of securities subject to Rule 2810, unless the net offering proceeds are intended to be paid to the above persons for the purpose of repaying loans, advances or other types of financing utilized to acquire an interest in a pre-existing company.

**(i) Exemptions**

Pursuant to the Rule 9600 Series, the appropriate NASD staff, for good cause shown after taking into consideration all relevant factors, may conditionally or unconditionally grant an exemption from any provision of this Rule to the extent that such exemption is consistent with the purposes of the Rule, the protection of investors, and the public interest.

**2720. Distribution of Securities of Members and Affiliates – Conflicts of Interest**

**(a)** No Change

**(b) Definitions**

(1) through (8) No Change

(9) Immediate family - the parents, mother-in-law, father-in-law, [husband or wife] spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children of an employee or associated person of a member, except any person other than the spouse and children who does not live in the same household as, have a business relationship with, provide material support to, or receive material support from, the employee or associated person of a member. In addition, the immediate family includes any other person who either lives in the same household as, provides material support to, or receives material support from, an employee or associated person of a member.

**2710. Corporate Financing Rule - Underwriting Terms and Arrangements****(a) Definitions**

For purposes of this Rule, the following terms shall have the meanings stated below. The definitions in Rule 2720 are incorporated herein by reference.

**(1) Issuer**

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.

**(2) Net Offering Proceeds**

Offering proceeds less all expenses of issuance and distribution.

**(3) Offering Proceeds**

Public offering price of all securities offered to the public, not including securities subject to any overallotment option, securities to be received by the underwriter and related persons, or securities underlying other securities.

**(4) Participating Member(s)**

Any NASD member that is participating in a public offering, any associated person of the member, any members of their immediate family, and any affiliate of the member.

**(5) Participation or Participating in a Public Offering**

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.

**(6) Underwriter and Related Persons**

Consists of underwriter's counsel, financial consultants and advisors, finders, any participating member, and any other persons related to any participating member.

**(7) Listed Securities**

Securities meeting the listing standards to trade on the national securities exchanges identified in SEC Rule 146, markets registered with the SEC under Section 6 of the Exchange Act, and any offshore market that is a "designated offshore securities market" under Rule 902(b) of SEC Regulation S.

**(8) Derivative Instruments**

A derivative instrument is any "eligible OTC derivative instrument" as defined in SEC Rule 3b-13(a)(1), (2) and (3).

**(9) Fair Price**

A derivative instrument or non-convertible or non-exchangeable debt security has been acquired or entered into at a fair price for purposes of subparagraphs (b)(6)(iv) and (c)(3)(B)(vi) and (vii) if the underwriters and related persons have priced the debt security or derivative instrument in good faith; on arms-length, commercially reasonable basis; and in accordance with pricing

methods and models and procedures used in the ordinary course of their business for pricing similar transactions.

**(b) Filing Requirements**

(1) through (3) No change.

**(4) Requirement for Filing**

(A) Unless filed by the issuer, the managing underwriter, or another member, a member that anticipates participating in a public offering of securities subject to this Rule shall file with NASD the documents and information with respect to the offering specified in subparagraphs (5) and (6) below:

(i) no later than one business day after any such documents are filed with or submitted to:

a. the Commission; or

b. any state securities commission or other regulatory authority; or

(ii) if not filed with or submitted to any regulatory authority, at least fifteen business days prior to the anticipated date on which offers will commence.

(B) No sales of securities subject to this Rule shall commence unless:

(i) the documents and information specified in subparagraphs (5) and (6) below have been filed with and reviewed by NASD; and

(ii) No change.

(C) No change.

(5) No change.

**(6) Information Required to be Filed**

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

(i) through (ii) No change.

(iii) a statement of the association or affiliation with any member of any officer or director of the issuer, of any beneficial owner of 5% or more of any class of the issuer's securities, and of any beneficial owner of the issuer's unregistered equity securities that were acquired during the 180-day period immediately preceding the required filing date of the public offering, except for purchases described in subparagraph (c)(3)(B)(iv) below. This statement must identify:

a. the person;

b. the member and whether such member is participating in any capacity in the public offering; and

c. the number of equity securities or the face value of debt securities owned by such person, the date such securities were acquired, and the price paid for such securities.



(iv) a detailed explanation of any other arrangement entered into during the 180-day period immediately preceding the required filing date of the public offering, which arrangement provides for the receipt of any item of value or the transfer of any warrants, options, or other securities from the issuer to the underwriter and related persons, provided however:

a. information regarding debt securities and derivative instruments not considered an item of value under subsection (c)(3)(vi) and (vii) is not required to be filed; and

b. information initially filed in connection with debt securities and derivative instruments acquired or entered into for “fair price” as defined in subsection (a)(9) maybe limited to a brief description of the transaction and a representation by the member that a registered principal or senior manager on behalf of the member has determined that the transaction was (or if the pricing terms have not been set) will be entered into at a fair price as defined in subsection (a)(9);

(v) a statement demonstrating compliance with all of the criteria of an exception from underwriting compensation in subparagraph (d)(5) below, when applicable; and

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

a. the modification of any information or representation previously provided to NASD or of any item of underwriting compensation, including the information required in subparagraph (b)(6)(A)(iii) above with respect to any securities of the issuer acquired subsequent to the required filing date and prior to the effectiveness or commencement of the offering; or

b. any new arrangement that provides for the receipt of any additional item of value by any participating member subsequent to the issuance of an opinion of no objections to the underwriting terms and arrangements by NASD and within 90 days immediately following the date of effectiveness or commencement of sales of the public offering.

(B) No change.

(7) through (11) No change.

**(c) Underwriting Compensation and Arrangements**

**(1) General**

No member or person associated with a member shall participate in any manner in any public offering of securities in which the underwriting or other terms or arrangements in connection with or relating to the distribution of the securities, or the terms and conditions related thereto, are unfair or unreasonable.

**(2) Amount of Underwriting Compensation**

(A) No member or person associated with a member shall receive an amount of underwriting compensation in connection with a public offering that is unfair or unreasonable and no member or person associated with a member shall underwrite or participate in a public offering of securities if the underwriting compensation in connection with the public offering is unfair or unreasonable.

(B) through (D) No change.

(E) The maximum amount of compensation (stated as a percentage of the dollar amount of the offering proceeds) that is considered fair and reasonable generally will vary directly with the amount of risk to be assumed by participating members and inversely with the dollar amount of the offering proceeds.

### **(3) Items of Value**

(A) For purposes of determining the amount of underwriting compensation received or to be received by the underwriter and related persons pursuant to subparagraph (c)(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 paragraph (d) below shall be included:

(i) through (iii) No change.

(iv) finder's fees, whether in the form of cash, securities or any other item of value;

(v) wholesaler's fees;

(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, received:

a. for acting as private placement agent for the issuer;

b. for providing or arranging a loan, credit facility, merger or acquisition services, or any other service for the issuer;

c. as an investment in a private placement made by the issuer; or

d. at the time of the public offering;

(viii) special sales incentive items;

(ix) any right of first refusal provided to any participating member to underwrite or participate in future public offerings, private placements or other financings, which will have a compensation value of 1% of the offering proceeds or that dollar amount contractually agreed to by the issuer and underwriter to waive or terminate the right of first refusal;

(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 months following the effective date of the offering, of warrants, options, convertible securities, or similar securities distributed as part of the public offering;

(xii) fees of a qualified independent underwriter; and

(xiii) compensation, including expense reimbursements, previously paid to any member in connection with a proposed public offering that was not completed, unless the member does not participate in the revised public offering.

(B) Notwithstanding subparagraph (c)(3)(A) above, the following shall not be considered an item of value:

(i) Expenses customarily borne by an issuer, such as printing costs; SEC, “blue sky” and other registration fees; NASD filing fees; and accountant’s fees, whether or not paid through a participating member;

(ii) cash compensation for acting as placement agent for a private placement or for providing a loan, credit facility, or for services in connection with a merger/acquisition;

(iii) listed securities purchased in public market transactions;

(iv) securities acquired through any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code;

(v) securities acquired by an investment company registered under the Investment Company Act of 1940;

(vi) nonconvertible or non-exchangeable debt securities acquired for a fair price in the ordinary course of business in a transaction unrelated to the public offering; and

(vii) derivative instruments entered into for a fair price in the ordinary course of business in a transaction unrelated to the public offering.

**(d) Determination of Whether Items of Value Are Included In Underwriting Compensation**

**(1) Pre-Offering Compensation**

All items of value received and all arrangements entered into for the future receipt of an item of value by the underwriter and related persons during the period commencing 180 days immediately preceding the required filing date of the registration statement or similar document pursuant to subparagraph (b)(4) above until the date of effectiveness or commencement of sales of the public offering will be considered to be underwriting compensation in connection with the public offering.

**(2) Undisclosed and Post-Offering Compensation**

All items of value received and all arrangements entered into for the future receipt of an item of value by any participating member that are not disclosed to NASD prior to the date of effectiveness or commencement of sales of a public offering, including items of value received subsequent to the public offering, are subject to post-offering review to determine whether such items of value are, in fact, underwriting compensation for the public offering.

**(3) Date of Receipt of Securities**

Securities of the issuer acquired by the underwriter and related persons will be considered to be received for purposes of subparagraphs (d)(1) and (d)(5) as of the date of the:

(A) closing of a private placement, if the securities were purchased in or received for arranging a private placement; or

(B) execution of a written contract with detailed provisions for the receipt of securities as compensation for a loan, credit facility, or put option; or

(C) transfer of beneficial ownership of the securities, if the securities were received as compensation for consulting or advisory services, merger or acquisition services, acting as a finder, or for any other service.

**(4) Definitions**

For purposes of subparagraph (d)(5) below, the following terms will have the meanings stated below.

(A) An entity:

(i) includes a group of legal persons that either:

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

b. have filed a Schedule 13D or 13G with the SEC that identifies the legal persons as members of a group that have agreed to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer in connection with a previous investment; and

(ii) may make its investment or loan through a wholly owned subsidiary (except when the entity is a group of legal persons).

(B) An institutional investor is any individual or legal person that has at least \$50 million invested in securities in the aggregate in its portfolio or under management, including investments held by its wholly owned subsidiaries; provided that no participating members direct or otherwise manage the institutional investor's investments or have an equity interest in the institutional investor, either individually or in the aggregate, that exceeds 5% for a publicly owned entity or 1% for a nonpublic entity.

(C) A bank or insurance company is only the regulated entity, not its subsidiaries or other affiliates.



(D) A right of preemption means the right of a shareholder to acquire additional securities in the same company in order to avoid dilution when additional securities are issued, pursuant to:

- (i) any option, shareholder agreement, or other contractual right entered into at the time of a purchase of securities;
- (ii) the terms of the security purchased;
- (iii) the issuer's charter or by-laws; or
- (iv) the domestic law of a foreign jurisdiction that regulates the issuance of the securities.

(E) "Total equity securities" means the aggregate of the total shares of:

- (i) common stock outstanding of the issuer; and
- (ii) common stock of the issuer underlying all convertible securities outstanding that convert without the payment of any additional consideration.

**(5) Exceptions From Underwriting Compensation**

Notwithstanding subparagraph (d)(1) above, the following items of value are excluded from underwriting compensation (but are subject to the lock-up restriction in subparagraph (g)(1) below), provided that the member does not condition its participation in the public offering on an acquisition of securities under an exception and any securities purchased are purchased at the same price and with the same terms as the securities purchased by all other investors.

(A) **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 before the required filing date of the public offering pursuant to subparagraph (b)(4) above by certain entities if:

(i) each entity:

a. either:

1. manages capital contributions or commitments of \$100 million or more, at least \$75 million of which has been contributed or committed by persons that are not participating members;

2. manages capital contributions or commitments of \$25 million or more, at least 75% of which has been contributed or committed by persons that are not participating members;

3. is an insurance company as defined in Section 2(a)(13) of the Securities Act or is a foreign insurance company that has been granted an exemption under this Rule; or

4. is a bank as defined in Section 3(a)(6) of the Act or is a foreign bank that has been granted an exemption under this Rule; and

b. is a separate and distinct legal person from any member and is not registered as a broker/dealer;

c. makes investments or loans subject to the evaluation of individuals who have a contractual or 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;

d. does not participate directly in investment banking fees received by any participating member for underwriting public offerings; and

e. has been primarily engaged in the business of making investments in or loans to other companies; and

(ii) all entities related to each member in acquisitions that qualify for this exception do not acquire more than 25% of the issuer's total equity securities during the review period in subparagraph (d)(1), calculated immediately following the transaction.

**(B) 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 before the required filing date of the public offering pursuant to subparagraph (b)(4) above by certain entities if:**

(i) each entity:

a. manages capital contributions or commitments of at least \$50 million;

b. is a separate and distinct legal person from any member and is not registered as a broker/dealer;

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

d. has been primarily engaged in the business of making investments in or loans to other companies; and

(ii) institutional investors beneficially own at least 33% of the issuer's total equity securities, calculated immediately prior to the transaction;

(iii) the transaction was approved by a majority of the issuer's board of directors and a majority of any institutional investors, or the designees of institutional investors, that are board members; and

(iv) all entities related to each member in acquisitions that qualify for this exception do not acquire more than 25% of the issuer's total equity securities, calculated immediately following the transaction.

**(C) Private Placements With Institutional Investors - Securities** of the issuer purchased in, or received as placement agent compensation for, a private placement before the required filing date of the public offering pursuant to subparagraph (b)(4) above if:

(i) institutional investors purchase at least 51% of the “total offering” (comprised of the total number of securities sold in the private placement and received or to be received as placement agent compensation by any member);

(ii) an institutional investor was the lead negotiator or, if the terms were not negotiated, was the lead investor with the issuer to establish or approve the terms of the private placement; and

(iii) underwriters and related persons did not, in the aggregate, purchase or receive as placement agent compensation more than 20% of the “total offering” (excluding purchases by any entity qualified under subparagraph (d)(5)(A) above).

**(D) Acquisitions and Conversions to Prevent Dilution -**

Securities of the issuer if:

(i) the securities were acquired as the result of:

a. a right of preemption that was granted in

connection with securities that were purchased either:

1. in a private placement and the securities

are not deemed by NASD to be underwriting

compensation; or

2. from a public offering or the public

market; or

b. a stock-split or a pro-rata rights or similar

offering; or

c. the conversion of securities that have not been deemed by NASD to be underwriting compensation; and

(ii) the only terms of the purchased securities that are different from the terms of securities purchased by other investors are pre-existing contractual rights that were granted in connection with a prior purchase;

(iii) the opportunity to purchase in a rights offering or pursuant to a right of preemption, or to receive additional securities as the result of a stock-split or conversion was provided to all similarly situated securityholders; and

(iv) the amount of securities purchased or received did not increase the recipient's percentage ownership of the same generic class of securities of the issuer or of the class of securities underlying a convertible security calculated immediately prior to the investment, except in the case of conversions and passive increases that result from another investor's failure to exercise its own rights.

**(E) Purchases Based On A Prior Investment History -**

Purchases of securities of the issuer if:

(i) the amount of securities purchased did not increase the purchaser's percentage ownership of the same generic class of securities of the issuer or of the class of securities underlying a

convertible security calculated immediately prior to the investment; and

(ii) an initial purchase of securities of the issuer was made at least two years and a second purchase was made more than 180 days before the required filing date of the public offering pursuant to subparagraph (b)(4) above.

**(e) 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.

**(1) Limitation on Securities Received Upon Exercise or Conversion of Another Security**

An underwriter and related person may not receive a security (including securities in a unit), a warrant for a security, or a security convertible into another security as underwriting compensation in connection with a public offering unless:

(A) the security received or the security underlying the warrant or convertible security received is identical to the security offered to the public or to a security with a bona fide independent market; or

(B) the security can be accurately valued, as required by subparagraph (f)(2)(I) below.

**(2) Valuation of Securities That Do Not Have an Exercise or Conversion Price**

Securities that do not have an exercise or conversion price shall have a compensation value based on:

(A) the difference between:

(i) either the market price per security on the date of acquisition, or, if no bona fide independent market exists for the security, the public offering price per security; and

(ii) the per security cost;

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

(C) divided by the offering proceeds; and

(D) multiplied by one hundred.

**(3) Valuation of Securities That Have an Exercise or Conversion Price**

Options, warrants or convertible securities that have an exercise or conversion price (“warrants”) shall have a compensation value based on the following formula:

(A) the public offering price per security multiplied by .65;

(B) minus the resultant of the exercise or conversion price per warrant less either:

(i) the market price per security on the date of acquisition, where a bona fide independent market exists for the security, or

(ii) the public offering price per security;

(C) divided by two;



- (D) multiplied by the number of securities underlying the warrants;
- (E) less the total price paid for the warrants;
- (F) divided by the offering proceeds; and
- (G) multiplied by one hundred;
- (H) provided, however, that, notwithstanding subparagraph (e)(4) below, such warrants shall have a compensation value of at least .2% of the offering proceeds for each amount of securities that is up to 1% of the securities being offered to the public (excluding securities subject to an overallotment option).

#### **(4) Valuation Discount For Securities With a Longer Resale**

##### **Restriction**

A lower value equal to 10% of the calculated value shall be deducted for each 180-day period that the securities or underlying securities are restricted from sale or other disposition beyond the 180-day period of the lock-up restriction required by subparagraph (g)(1) below. The transfers permitted during the lock-up restriction by subparagraphs (g)(2)(A)(iii)-(iv) are not available for such securities.

#### **(f) Unreasonable Terms and Arrangements**

##### **(1) General**

No member or person associated with a member shall participate in any manner in a public offering of securities after any arrangement proposed in connection with the public offering, or the terms and conditions relating thereto,

has been determined to be unfair or unreasonable pursuant to this Rule or inconsistent with any By-Law or any Rule or regulation of NASD.

**(2) Prohibited Arrangements**

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.

(A) Any accountable expense allowance granted by an issuer to the underwriter and related persons that includes payment for general overhead, salaries, supplies, or similar expenses of the underwriter incurred in the normal conduct of business.

(B) Any non-accountable expense allowance in excess of 3% of offering proceeds.

(C) Any payment of commissions or reimbursement of expenses directly or indirectly to the underwriter and related persons prior to commencement of the public sale of the securities being offered, except a reasonable advance against out-of-pocket accountable expenses actually anticipated to be incurred by the underwriter and related persons, which advance is reimbursed to the issuer to the extent not actually incurred.

(D) The payment of any compensation by an issuer to a member or person associated with 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 those negotiated and paid in connection with a transaction that occurs in lieu of the proposed offering

as a result of the efforts of the underwriter and related persons and provided, however, that the reimbursement of out-of-pocket accountable expenses actually incurred by the member or person associated with a member shall not be presumed to be unfair or unreasonable under normal circumstances.

(E) Any "tail fee" arrangement granted to the underwriter and related persons that has a duration of more than two years from the date the member's services are terminated, in the event that the offering is not completed in accordance with the agreement between the issuer and the underwriter and the issuer subsequently consummates a similar transaction, except that a member may demonstrate on the basis of information satisfactory to NASD that an arrangement of more than two years is not unfair or unreasonable under the circumstances.

(F) Any right of first refusal provided to the underwriter or related persons to underwrite or participate in future public offerings, private placements or other financings that:

(i) has a duration of more than three years from the date of effectiveness or commencement of sales of the public offering; or

(ii) has more than one opportunity to waive or terminate the right of first refusal in consideration of any payment or fee.

(G) Any payment or fee to waive or terminate a right of first refusal regarding future public offerings, private placements or other financings provided to the underwriter and related persons that:

(i) has a value in excess of the greater of 1% of the offering proceeds in the public offering where the right of first refusal was granted (or an amount in excess of 1% if additional compensation is available under the compensation guideline of the original offering) or 5% of the underwriting discount or commission paid in connection with the future financing (including any overallotment option that may be exercised), regardless of whether the payment or fee is negotiated at the time of or subsequent to the original public offering; or

(ii) is not paid in cash.

(H) The terms or the exercise of the terms of an agreement for the receipt by the underwriter and related persons of underwriting compensation consisting of any option, warrant or convertible security that:

(i) is exercisable or convertible more than five years from the effective date of the offering;

(ii) is not in compliance with subparagraph (e)(1) above;

(iii) has more than one demand registration right at the issuer's expense;

(iv) has a demand registration right with a duration of more than five years from the date of effectiveness or the commencement of sales of the public offering;

(v) has a piggyback registration right with a duration of more than seven years from the date of effectiveness or the commencement of sales of the public offering;

(vi) has anti-dilution terms that allow the underwriter and related persons to receive more shares or to exercise at a lower price than originally agreed upon at the time of the public offering, when the public shareholders have not been proportionally affected by a stock split, stock dividend, or other similar event; or

(vii) has anti-dilution terms that allow the underwriter and related persons to receive or accrue cash dividends prior to the exercise or conversion of the security.

(I) The receipt by the underwriter and related persons of any item of compensation for which a value cannot be determined at the time of the offering.

(J) When proposed in connection with the distribution of a public offering of securities on a "firm commitment" basis, any over allotment option providing for the over allotment of more than 15% of the amount of securities being offered, computed excluding any securities offered pursuant to the over allotment option.

(K) The receipt by a member or person associated with a member, pursuant to an agreement entered into at any time before or after the effective date of a public offering of warrants, options, convertible securities or units containing such securities, of any compensation or

expense reimbursement in connection with the exercise or conversion of any such warrant, option, or convertible security in any of the following circumstances:

(i) the market price of the security into which the warrant, option, or convertible security is exercisable or convertible is lower than the exercise or conversion price;

(ii) the warrant, option, or convertible security is held in a discretionary account at the time of exercise or conversion, except where prior specific written approval for exercise or conversion is received from the customer;

(iii) the arrangements whereby compensation is to be paid are not disclosed:

a. in the prospectus or offering circular by which the warrants, options, or convertible securities are offered to the public, if such arrangements are contemplated or any agreement exists as to such arrangements at that time, and

b. in the prospectus or offering circular provided to security holders at the time of exercise or conversion; or

(iv) the exercise or conversion of the warrants, options or convertible securities is not solicited by the underwriter or related person, provided however, that any request for exercise or conversion will be presumed to be unsolicited unless the customer states in writing that the transaction was solicited and designates in

writing the broker/dealer to receive compensation for the exercise or conversion.

(L) For a member or person associated with a member to accept, directly or indirectly, any non-cash sales incentive item including, but not limited to, travel bonuses, prizes and awards, from an issuer or an affiliate thereof in excess of \$100 per person per issuer annually. Notwithstanding the foregoing, a member may provide non-cash sales incentive items to its associated persons provided that no issuer, or an affiliate thereof, including specifically an affiliate of the member, directly or indirectly participates in or contributes to providing such non-cash sales incentive.

(M) For a member to participate with an issuer in the public distribution of a non-underwritten issue of securities if the issuer hires persons primarily for the purpose of distributing or assisting in the distribution of the issue, or for the purpose of assisting in any way in connection with the underwriting, except to the extent in compliance with SEC Rule 3a4-1 and applicable state law.

(N) For a member or person associated with a member to participate in a public offering of real estate investment trust securities, as defined in Rule 2340(c)(4), unless the trustee will disclose in each annual report distributed to investors pursuant Section 13(a) of the Act a per share estimated value of the trust securities, the method by which it was developed, and the date of the data used to develop the estimated value.

**(g) Lock-Up Restriction on Securities**

**(1) Lock-Up Restriction**

Any common or preferred stock, options, warrants, and other equity securities of the issuer, including debt securities convertible to or exchangeable for equity securities of the issuer, that are unregistered and acquired by an underwriter and related person during 180 days prior to the required filing date, or acquired after the required filing date and deemed to be underwriting compensation by NASD, and securities excluded from underwriting compensation pursuant to subparagraph (d)(5) above, shall not be sold during the offering, or sold, transferred, assigned, pledged, or hypothecated, or be the subject of any hedging, short sale, derivative, put, or call transaction that would result in the effective economic disposition of the securities by any person for a period of 180 days immediately following the date of effectiveness or commencement of sales of the public offering, except as provided in subparagraph (g)(2) below.

**(2) Exceptions to Lock-Up Restriction**

Notwithstanding subparagraph (g)(1) above, the following shall not be prohibited:

(A) the transfer of any security:

(i) by operation of law or by reason of reorganization of the issuer;

(ii) to any member participating in the offering and the officers or partners thereof, if all securities so transferred remain subject to the lock-up restriction in subparagraph (g)(1) above for the remainder of the time period;



(iii) if the aggregate amount of securities of the issuer held by the underwriter or related person do not exceed 1% of the securities being offered;

(iv) that is beneficially owned on a pro-rata basis by all equity owners of an investment fund, provided that no participating member manages or otherwise directs investments by the fund, and participating members in the aggregate do not own more than 10% of the equity in the fund;

(v) that is not an item of value under subparagraphs (c)(3)(B)(iii) - (vii) above;

(vi) that is eligible for the limited filing requirement in subparagraph (b)(6)(A)(iv)b. and has not been deemed to be underwriting compensation under the Rule;

(vii) that was previously but is no longer subject to the lock-up restriction in subparagraph (g)(1) above in connection with a prior public offering (or a lock-up restriction in the predecessor rule), provided that if the prior restricted period has not been completed, the security will continue to be subject to such prior restriction until it is completed; or

(viii) that was acquired subsequent to the issuer's initial public offering in a transaction exempt from registration under SEC Rule 144A; or

(B) the exercise or conversion of any security, if all securities received remain subject to the lock-up restriction in subparagraph (g)(1) above for the remainder of the time period.

**(h) Proceeds Directed to a Member**

**(1) Compliance With Rule 2720**

No member shall participate in a public offering of an issuer's securities where more than 10% of the net offering proceeds, not including underwriting compensation, are intended to be paid to participating members, unless the price at which an equity issue or the yield at which a debt issue is to be distributed to the public is established pursuant to Rule 2720(c)(3).

**(2) Disclosure**

All offerings included within the scope of subparagraph (h)(1) shall disclose in the underwriting or plan of distribution section of the registration statement, offering circular or other similar document that the offering is being made pursuant to the provisions of this subparagraph and, where applicable, the name of the member acting as qualified independent underwriter, and that such member is assuming the responsibilities of acting as a qualified independent underwriter in pricing the offering and conducting due diligence.

**(3) Exception From Compliance**

The provisions of subparagraphs (h)(1) and (2) shall not apply to:

- (A) an offering otherwise subject to the provisions of Rule 2720;
- (B) an offering of securities exempt from registration with the Commission under Section 3(a)(4) of the Securities Act of 1933;

(C) an offering of a real estate investment trust as defined in Section 856 of the Internal Revenue Code; or

(D) an offering of securities subject to Rule 2810, unless the net offering proceeds are intended to be paid to the above persons for the purpose of repaying loans, advances or other types of financing utilized to acquire an interest in a pre-existing company.

**(i) Exemptions**

Pursuant to the Rule 9600 Series, the appropriate NASD staff, for good cause shown after taking into consideration all relevant factors, may conditionally or unconditionally grant an exemption from any provision of this Rule to the extent that such exemption is consistent with the purposes of the Rule, the protection of investors, and the public interest.

**2720. Distribution of Securities of Members and Affiliates – Conflicts of Interest**

**(a) No Change**

**(b) Definitions**

(1) through (8) No Change

(9) Immediate family - the parents, mother-in-law, father-in-law, [husband or wife] spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children of an employee or associated person of a member, except any person other than the spouse and children who does not live in the same household as, have a business relationship with, provide material support to, or receive material support from, the employee or associated person of a member.

In addition, the immediate family includes any other person who either lives in the same household as, provides material support to, or receives material support from, an employee or associated person of a member.