public interest. The Commission believes that the existing eQPriority pilot provides beneficial services to investors. Acceleration of the operative date will allow the pilot to continue without interruption and ensure that those benefits do not lapse. Accordingly, the Commission waives the 30-day pre-operative period, and the proposed rule change has become operative immediately.[10]

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. 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 Exchange. All submissions should refer to File No. SR–Amex–01–13 and should be submitted by April 4, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[11]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 01–6323 Filed 3–13–01; 8:45 am]

BILLING CODE 8010–01–M

[10] For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. *See* 15 U.S.C. 78c(f).

[11] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–44044; File No. SR–NASD–00–04]

Self-Regulatory Organizations; Notice of Filing of Amendment No. 5 to a Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to its Corporate Financing Rule

March 6, 2001.

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 February 4, 2001, 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'') Amendment No. 5 [3] to the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The proposed rule change, incorporating Amendment Nos. 1, 2, and 3, was published for comment in the **Federal Register** on April 11, 2000.[4] The Commission is publishing this notice to solicit comments on Amendment No. 5 from interested persons.

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

In response to comments on the original proposal, NASD Regulation is proposing additional amendments to Rules 2710 and 2720 of the NASD's Conduct Rules. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets. The text of the proposed rule change is marked to show additions and deletions from the NASD Corporate Financing Rule as it currently exists. The discussion section of this notice, however, focuses on the changes made in Amendment No. 5. For an explanation of the original filing, see the release cited in footnote 4.

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

[2] 17 CFR 240.19b–4.

[3] Amendment No. 4, filed December 11, 2000, amends the original filing and Amendment Nos. 1, 2, and 3 to respond to comments. Amendment No. 5 supersedes Amendment No. 4 in its entirety and makes certain technical corrections to the proposed rule change.

[4] *See* Securities Exchange Act Release No. 42619 (April 4, 2000), 65 FR 19409.

2710. Corporate Financing Rule—Underwriting Terms and Arrangements

(a) Definitions

(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[; and].

[(5)] *(6)* Underwriter and Related Persons

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

(b) Filing Requirements

(1)–(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 the documents and information with respect to the offering specified in subparagraphs (5) and (6) below*:*

(i) No later than one business day after [the filing of:] any such documents [with] *are filed with or submitted to:*

[(a)] *a.* The Commission; *or*

[(ii)] *b.* [with the] *Any* state securities commission *or other regulatory authority*; or

[(iii)] *(ii)* If not filed with or submitted to any regulatory authority, at least fifteen (15) business days prior to the anticipated [offering] date *on which offers will commence.*

(B) No [offering] *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; and (ii) the Association has provided an opinion that it has no objections to the proposed underwriting and other terms and arrangements or an opinion that the proposed underwriting and other terms and arrangements are unfair and unreasonable. If the Association's opinion states that the proposed underwriting and other terms and arrangements are unfair and unreasonable, the member may file modifications to the proposed underwriting and other terms and arrangements for further review.

(C) No change.

(5) No change.

(6) Information Required to be Filed

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

(i)–(ii) No change.

(iii) a statement of the association or affiliation with any member of any officer, or director *of the issuer, of any* [or security holder] *beneficial owner* of [the issuer in an initial public offering of equity securities, and with respect to any other offering provide such information with respect to any officer, director or security holder of five percent] *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 purchased during the 180-day period immediately preceding the required filing date of the public offering, except for purchases described in subparagraph (c)(3)(B)(v) below. This statement must identify* [to include]:

a. [the identity of] The person;

b. [the identity of] 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 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 *required* 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]

(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 or of any* item of underwriting compensation[,] *; or*

b. Any new arrangement that provides for the receipt of any additional item of value by any participating member 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 date of effectiveness or commencement of sales of the public offering.*

(B) No change.

(7)–(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 [which] *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)–(D) No change.

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

(3) Items of [Compensation] *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 [sub]paragraph [(4)] *(d)* below shall be included:

(i)–(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,* [including securities] received [as underwriting compensation, for example]:

a. [in connection with a] *For acting as* private placement *agent* [of securities] for the issuer;

b. For providing or arranging *a loan, credit facility,* [bridge financing] *merger or acquisition services, or any other service* for the issuer;

[c. As a finder's fee;]

[d. For consulting services to the issuer; and]

[e.] *c.* [securities purchased] *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 [in compliance with subparagraph (6)(B)(xi)];

(ix) Any right of first refusal provided to [the underwriter and related persons] *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 [(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 subparagraph (c)(3)(A) above, the following shall not be considered an item of value:*

(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] *a participating member;*

(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;

(iii) 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;

(iv) Listed securities purchased in public market transactions;

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

(vi) Securities acquired by an investment company registered under the Investment Company Act of 1940.

[(4)] *(d)* Determination of Whether [Compensation Is Received in Connection With the Offering] *Items of Value Are Included In Underwriting Compensation*

[(A)] *(1) Pre-Offering Compensation*

All items of value received [or to be received] *and all arrangements entered into for the future receipt of an item of value* by the underwriter and related persons during the [twelve (12) month] period *commencing 180 days* immediately preceding the *required* filing *date* of the registration statement or similar document *pursuant to subparagraph (b)(4) above*[, and at the time of and subsequent to] *until the date of effectiveness or commencement of sales of* 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].

(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 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.

[(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.]

(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 Form 13D or 13G with the SEC that identifies the legal persons as members of a group who 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 member has an equity interest in or manages or otherwise directs the institutional investor's investments.

(C) 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.

(D) ''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) The total amount of securities received by all entities related to each member does not exceed 10% of the issuer's total equity securities, 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) The total amount of securities received by all entities related to each member does not exceed 10% 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 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 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.

(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.

(F) Financial Consulting and Advisory Arrangements—Compensation received by a financial consultant or advisor if:

(i) The consulting/advisory relationship was established pursuant to a written and executed agreement entered into more than one year before the required filing date of the public offering pursuant to subparagraph (b)(4) above;

(ii) Any securities received or to be received do not exceed the amount and type specified in the agreement;

(iii) Substantive services were provided on an ongoing basis to the issuer during the one-year period; and

(iv) The consultant/advisor has routinely provided similar services to other companies.

[(5)] *(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[:].

[(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.]

(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.

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

[s] *S*ecurities that [are not options, warrants or convertible securities] *do not have an exercise or conversion price* shall *have a compensation value* [be valued on the basis of] *based on:*

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

(i) 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*

(ii) The per security cost;

[(ii)] *(B)* Multiplied by the number of securities received or to be received as underwriting compensation;

[(iii)] *(C)* Divided by the offering proceeds; and

[(iv)] *(D)* Multiplied by one hundred [(100)].

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

[(C) o] *O*ptions, warrants or convertible securities *that have an exercise or conversion price (''warrants'')* shall [be valued on the basis of the following formula] *have a compensation value based on:*

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

[(ii)] *(B)* Minus the [difference between] *resultant of* the exercise or conversion price per [security] *warrant* [and] *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 [proposed (and actual)] public offering price per security;

[(iii)] *(C)* Divided by two [(2)];

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

[(v)] *(E)* Less the total price paid for the [securities] *warrants;*

[(vi)] *(F)* Divided by the offering proceeds; and

[(vii)] *(G)* Multiplied by one hundred [(100).]*;*

(H) Provided, however, that 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

[(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 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.

[(6)] *(f)* Unreasonable Terms and Arrangements

[(A)] *(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.

[(B)] *(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[:].

[(i)] *(A)* [a]*A*ny accountable expense allowance granted by an issuer to the underwriter and related persons [which] *that* includes payment for general overhead, salaries, supplies, or similar expenses of the underwriter incurred in the normal conduct of business[;].

[(ii)] *(B)* [a]*A*ny non-accountable expense allowance in excess of [three (3) percent;] *3% of offering proceeds.*

[(iii)] *(C)* [a]*A*ny 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[;].

[(iv)] *(D)* [t]*T*he payment of any compensation by an issuer to a member or person associated with a member in connection with an offering of securities [which] *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[;].

[(v)] *(E)* [a]*A*ny ''tail fee'' arrangement granted to the underwriter and related persons that has a duration of more than two [(2)] 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 that an arrangement of more than two [(2)] years is not unfair or unreasonable under the circumstances.

[(vi)] *(F)* [a]*A*ny right of first refusal provided to the underwriter or related persons to underwrite or participate in future public offerings, private placements or other financings [which] *that:*

[a.] *(i)* Has a duration of more than three [(3)] years from the [effective] date *of effectiveness or commencement of* sales of the *public* offering; or

[b.] *(ii)* Has more than one opportunity to waive or terminate the right of first refusal in consideration of any payment or fee[;].

[(vii)] *(G)* [a]*A*ny 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 [which] *that:*

[a.]*(i)* Has a value in excess of the greater of [one percent (] 1% [)] of the offering proceeds in the public offering where the right of first refusal was granted (or an amount in excess of [one percent] *1%* if additional compensation is available under the compensation guideline of the original offering) or [five percent (] 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

[b.]*(ii)* Is not paid in cash[;].

[(viii)] *(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 [which] *that:*

[a.] *(i)* Is exercisable or convertible more than five [(5)] years from the effective date of the offering;

[b. Is exerciseable or convertible at a price below either the public offering price of the underlying security or, if a bona fide independent market exists for the security or the underlying security, the market price at the time of receipt;]

[c.] *(ii)* Is not in compliance with subparagraph [(5)(A)] *(e)(1)* above;

[d.] *(iii)* Has more than one demand registration right at the issuer's expense;

[e.] *(iv)* Has a demand registration right with a duration of more than five [(5)] years from the [effective] date *of effectiveness or the commencement of sales* of the *public* offering;

[f.] *(v)* Has a piggyback registration right with a duration of more than seven [(7)] years from the [effective] date *of effectiveness or the commencement of sales* of the *public* offering;

[g.] *(vi)* Has anti-dilution terms [designed to provide] *that allow* 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)] *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*

[h.] *(vii)* Has anti-dilution terms [designed to provide for the receipt or accrual of] *that allow the underwriter and related persons to receive or accrue* 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)] *(I)* [t]*T*he 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[;].

[(x)] *(J)* [w]*W*hen 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 [fifteen (15) percent] *15%* of the amount of securities being offered, computed excluding any securities offered pursuant to the over allotment option[;].

[(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 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)] *(K)* [t]*T*he 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:

[a.]*(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;

[b.](*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;

[c.]*(iii)* The arrangements whereby compensation is to be paid are not disclosed:

[1.]*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

[2.]*b.* In the prospectus or offering circular provided to security holders at the time of exercise or conversion; or

[d.]*(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[;].

[(xiii)] *(L)* [f]*F*or 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[; or].

[(xiv)] *(M)* [f]*F*or 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 and applicable state law.

[(xv)] *N* [f] *F*or 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 to 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.

[(C) In the event that the underwriter and related persons receive securities deemed to be underwriting compensation in an amount constituting 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)] *(g) Lock-Up* Restriction[s] on Securities

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

[(i) Securities deemed to be underwriting compensation 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 following the effective date of the offering. 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) 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.]

(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 beneficially owned by any person that is an underwriter and related person on the date of effectiveness or commencement of sales of the public offering 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

[(B) The provisions of subparagraph (A) notwithstanding:]

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 [shall not be prohibited.]*;*

(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;

[(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)] *(iii)* If the aggregate amount of [such] securities *of the issuer* held by [such a member and its related persons enumerated above would] *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)(iv)–(vi) above;

(vi) 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

(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

(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.

[(8)] *(h)* [Conflicts of Interest] 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 [ten (10) percent] *10%* of the net offering proceeds, not including underwriting compensation, are intended to be paid to [members participating in the distribution of the offering or associated or affiliated persons of such members, or members of the immediate family of such persons] *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).

[(A)] *(2) Disclosure*

All offerings included within the scope of [this] subparagraph [(8)] *(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.

[(B)] *(3) Exception From Compliance*

The provisions of [this] subparagraphs [(8)] (h)*(1) and (2)* shall not apply to:

[(i)] *(A)* An offering otherwise subject to the provisions of Rule 2720;

[(ii)] *(B)* An offering of securities exempt from registration with the Commission under Section 3(a)(4) of the Securities Act of 1933;

[(iii)] *(C)* An offering of a real estate investment trust as defined in Section 856 of the Internal Revenue Code; or

[(iv)] *(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.

[(d)] *(i)* 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] *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) General

No Change.

(b) Definitions

(1)–(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* [or] any other person who [is supported, directly or indirectly, to a material extent by] *either lives in the same household as, provides material support to, or receives material support from* an employee [of,] or *associated* person [associated, with] *of* a member.

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

1. Purpose

On December 11, 2000 and February 1, 2001, NASD Regulation filed

proposed amendments to the Corporate Financing Rule (''Rule'') that were intended to modernize and simplify the Rule (''original rule filing'' or ''original proposal''). The original rule filing contained an objective standard that members and the staff could follow to determine whether any ''items of value,'' such as fees and securities, provided by an issuer to underwriters and related persons should be included in the calculation of underwriting compensation under the Rule. Under this standard, all items of value received by underwriters and related persons from 180 days before the filing of a registration statement until the date of effectiveness or commencement of sales of the public offering (''180-day review period'') would be deemed to be underwriting compensation, unless the items were received in a transaction that met one of four exceptions. The exceptions were intended to establish transaction criteria that would distinguish between securities acquired as bona fide investments from securities acquired as underwriting compensation.

In addition, the original rule filing proposed a 180-day lock-up restriction on sales of any securities of the issuer held by any person covered by the definition of underwriter and related person at the time of the public offering, with certain exceptions. The original rule filing also proposed to delete the 10% limitation on the amount of securities deemed to be underwriting compensation, known as the Stock Numerical Limitation, and the prohibition on warrants having an exercise price below the public offering price. In addition, the original rule filing proposed to amend provisions that had become problematic or unnecessary as applied to current industry practices or particular types of issuers.

The SEC published the original proposal for comment [5] and received 14 comment letters.[6] Commenters generally supported the original proposal, but requested additional changes and clarifications. In particular, commenters believed that the proposal did not go far enough in excluding investments by affiliates of members in light of the creation of large financial institutions that include commercial and investment banking and insurance operations.

Amendment No. 5 responds to the comments received. Following is a description of proposed amendments to the original proposal that: (i) Expand the circumstances under which purchases and other acquisitions of the issuer's securities by members and their affiliates will not be considered underwriting compensation; (ii) incorporate increased flexibility in the Rule while maintaining the objective review standards of the original proposal; (iii) clarify parts of the original proposal; and (iv) impose a minimum compensation value on warrants deemed to be underwriting compensation (''amended proposal''). All proposed amendments are in response to comments, except as indicated and for non-substantive and conforming changes to the Rule. In addition, the following description addresses, where appropriate, comments that are opposed to provisions retained in the amended proposal. Other comments are addressed in Section II.C. below.

The material in current paragraph (c) of Rule 2710 would be divided into paragraphs (c) through (g). In addition, the amended proposal would adopt a new definition of the term ''participating member'' in subparagraph (a)(4)[7] to include participating broker/dealers, their associated persons and employees, any members of their immediate family, and any affiliate of the member. This term is used in the Rule and in the discussion below to distinguish between members that participate in the public offering and the broader category in the definition of ''underwriter and related persons'' that includes non-members and other persons related to a member.

a. Pre-Offering Objective Test

The original rule filing proposed to measure the 180-day review period in the same manner as the one-year review period in the current Rule.[8] The amended proposal would modify subparagraph (d)(1) to provide that the 180-day period is measured from the date the public offering is required to be filed with the Association pursuant to subparagraph (b)(4) (''required filing date'').[9] NASD Regulation also proposes to amend this provision to clarify that the review period commences 180 days before the required filing date and ends when the offering is effective or when the public offering commences.

Several commenters (SIA, Fried Frank, Goldman, Merrill, Morgan, and Salomon) requested that the Rule be amended to provide that the 180-day review period be measured from the date that the preliminary prospectus is circulated, particularly because certain issuers file early with the SEC. NASD Regulation believes that the commenters misunderstand the purpose of measuring the review period from the filing date. Members typically provide significant underwriting services in connection with the preparation and filing of a registration statement or other offering document. These underwriting activities are likely to have commenced within the 180-day period preceding the filing date. Accordingly, the Corporate Financing Department (''Department'') will review any items of value received by the underwriters beginning 180 days prior to the filing date because they may constitute compensation for underwriting services. Although the first distribution of a preliminary prospectus is more relevant than the filing date in determining whether an offering is likely to be completed, it is irrelevant to determining whether an issuer has begun to pay its investment bankers for underwriting services.

b. Common Requirements of the Exceptions From Underwriting Compensation

The original proposal included four ''safe harbors'' that establish transaction criteria that are intended to distinguish between securities acquired as bona fide investments from securities acquired as underwriting compensation. NASD Regulation is proposing to clarify and expand the ''safe harbors''—now called ''exceptions''—to cover additional types of transactions. Following is a discussion of certain of the requirements that are common to two or more exceptions.

1. *Deletion of Reference to ''Safe Harbors''*—The original rule filing proposed four ''safe harbors'' that would exclude certain acquisitions of the issuer's securities during the 180-day review period from underwriting compensation. Some commenters (Fried Frank, Goldman, Morgan, Prudential, M&F, and Merrill) were correct in

[5] Securities Exchange Release No. 42619 (April 4, 2000); 65 FR 19409 (April 11, 2000).

[6] Akin, Gump, Strauss, Hauer & Feld (''Akin''); The Bond Market Association (''TBMA''); Chase Manhattan Corporation (''Chase''); CIBC World Markets Corporation (''CIBC''); Fried, Frank, Harris, Shriver & Jacobson (''Fried Frank''); Goldman, Sachs & Company (''Goldman''); Merrill Lynch (''Merrill''); Morgan Stanley Dean Witter (''Morgan''); Morrison & Foerster (''M&F''); North American Securities Administrators Association (''NASAA''); Ohio Department of Commerce, Division of Securities (''Ohio''); Prudential Securities, Inc. (''Prudential''); Salomon Smith Barney, Inc. (''Salomon''); and Securities Industry Association (''SIA'').

[7] All references are to the provisions of Rule 2710, as proposed to be amended, unless otherwise specified.

[8] The original rule filing stated that the 180-day review period would be measured from 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.

[9] This same calculation is used in the first three exceptions for acquisitions of securities from underwriting compensation and in the exceptions to the lock-up restriction on securities.

noting that, although described as ''safe harbors,'' the original rule filing required that a transaction meet all of the criteria of a safe harbor in order to qualify for exclusion from underwriting compensation. Therefore, the proposed ''safe harbors'' in subparagraph (d)(5) will be treated under the amended Rule as ''exceptions.'' [10]

2. *Ninety-Day Limitation on Availability of Exceptions*—The original rule filing would have prohibited reliance on the first three exceptions from underwriting compensation in the 90-day period prior to the filing date of the public offering. NASD Regulation proposes to amend the exceptions in subparagraphs (d)(5)(A)–(C) to delete the 90-day limitation and include language stating that transactions that occur before the required filing date are eligible for the exceptions.[11]

The deletion of the 90-day limitation was recommended by many commenters (SIA, TBMA, Fried Frank, Goldman, Merrill, Morgan, Prudential, and Salomon) who stated that the other conditions in the proposed exceptions were sufficient to prevent abusive practices during the entire 180-day review period. For example, Prudential stated that ''the criteria in the safe harbors provide a more reliable guide than proximity in time for distinguishing between a payment for services and financing other than underwriting and compensation for underwriting.'' Consistent with the industry's position, NASD Regulation believes that the other criteria should generally be retained as proposed.

3. *Price and Terms of Securities*—The third and fourth exceptions would have required that any securities purchased under an exception must be purchased at the same price and with the same terms as securities purchased by other investors. NASD Regulation proposes to amend the introduction to the exceptions in subparagraph (d)(5) to apply this criterion to any purchase under any exception provided that the purchase occurs at approximately the same time as purchases by other investors. In addition, NASD Regulation agrees with commenters (SIA and Goldman) that the price and terms requirement is not applicable to securities received as placement agent fees and, therefore, the language only refers to ''any securities *purchased*'' (emphasis provided).

4. *Conditioning a Member's Participation on a Securities Acquisition*—The first three exceptions would have required that a member have written procedures to ensure that its participation in the public offering was not contingent on its participation in the private placement or loan that is covered by the exception. Commenters (Merrill and Fried Frank) recommended that this provision be eliminated as a condition of the exceptions, stating that it would require that the Department determine the intent of the member in each transaction, that the original proposal was unclear on the type of written procedures required, and that the provision is unnecessary in light of the other criteria of each exception. Commenters also believed that the rule language would require members to submit their written procedures for compliance with this provision for Department review in order to rely on an exception.

NASD Regulation agrees that the specific written procedures requirement in the exceptions is not necessary, especially because members remain subject to the general standards of NASD Rule 3010(b)(1), which requires members to establish written procedures that are reasonably designed to ensure compliance with NASD rules. However, NASD Regulation continues to be concerned that participating members not use their position as an issuer's underwriter to require the issuer to sell cheap stock or warrants to the member or the member's affiliates in a transaction that is eligible for an exception. In response to this concern, NASD Regulation proposes to include a statement in the introduction to subparagraph (d)(5) emphasizing that an exception is only available if a member has not conditioned its participation in the public offering on an acquisition of securities under the exception.

5. *Definition of Institutional Investor*—The second and third exceptions rely on the involvement of ''institutional investors'' in the issuer or private placement to help ensure that securities are acquired by participating members in bona fide transactions that were negotiated at ''arms-length.'' To ensure that the institutional investors are in fact independent of any participating member,[12] NASD Regulation proposes to amend the definition of ''institutional investor'' in subparagraph (d)(4)(B) to require that no participating member may have an equity interest in or manage or otherwise direct the institutional investor's investments.[13] The definition in the original proposal required that the ''institutional investor will not include any member participating in the public offering, any of its associated or affiliated persons, or any immediate family member of its associated or affiliated persons.'' This amendment clarifies that the word ''included'' was intended to prevent participating members from being ''included'' as equity owners of the institutional investor. This amendment also adds a requirement that none of the participating members should manage or otherwise direct the institutional investor's investments.

6. *Investment/Lending Subsidiary*—In response to a comment (Fried Frank), NASD Regulation proposes to amend the definition of entity in subparagraph (d)(4)(A) to permit a qualifying entity to make its investment or loan through a wholly-owned subsidiary. NASD Regulation is not persuaded by the argument, however, that a subsidiary formed by two or more entities or institutional investors is indistinguishable from its parents.

In addition, NASD Regulation proposes to amend the definition of institutional investor in subparagraph (d)(4)(B) to provide that the calculation of the $50 million threshold will include investments held by a wholly owned subsidiary of an institutional investor. This amendment will, therefore, also permit an institutional investor to make its investment under the third exception through a wholly owned subsidiary. (*See* comment of Akin).

7. *Venture Capital Experience*—NASD Regulation proposes to amend the provision in the first and second exceptions requiring that the investing/lending entity have prior experience in making venture capital investments to require that the entity ''*has been* primarily engaged in the business of making investments in or loans to other companies'' (emphasis provided). Contrary to opposing comments (SIA and Goldman), NASD Regulation believes that the protections of the criteria in these exceptions cannot be effective unless the entity has a history of at least one prior investment or loan transaction and that the business of the

[10] Subparagraph (b)(6)(A)(v) would require that members submit information to the Association that demonstrates compliance with all of the criteria of the exception being relied upon.

[11] The fourth, fifth, and sixth exceptions, discussed below, would be available during the 180-day review period and subsequent to the filing of the public offering.

[12] However, an institutional investor may be or include equity owners that are a member, or a person associated or affiliated with a member, so long as the member is not participating in the public offering.

[13] In accordance with another comment (SIA and Goldman), the word ''entity'' in the definition is proposed to be changed to ''legal person'' to avoid confusion with the separate definition of the term ''entity'' intended for use under the first and second exceptions.

entity primarily involves investments in or loans to other companies.[14]

c. Exceptions From Underwriting Compensation

1. *First Exception: Purchases and Loans By Certain Entities*—The first exception in subparagraph (d)(5)(A) is intended for acquisitions of the issuer's securities by certain entities that routinely make investments in or provide loans or credit facilities to other companies. The exception, as amended, would be available: (1) To any qualifying entity related to a participating member that meets a capital under management test, or is a bank or insurance company; and (2) for purchases in a private placement and for the receipt of securities as compensation for a loan or credit facility before the required filing date of the public offering, with a 10% limitation on the amount of securities acquired.

A. *Expansion of Exception:* A number of commenters (Chase, Goldman, Merrill, Prudential, Salomon, and SIA) discussed the impact of the current Rule and the original proposal on large financial institutions that include commercial and investment banking and insurance operations. The commenters recommended that NASD Regulation amend the Rule to exclude purchases of the issuer's securities if a large financial institution maintains information barriers between its broker/dealer and its other affiliates in a distinct line of business or it otherwise can demonstrate that it does not collaborate to secure underwriting business.

The Department is concerned that information barriers are not an appropriate mechanism for preventing abusive practices. However, to address the impact of the Rule on large financial institutions affiliated with members, NASD Regulation proposes to expand the first exception in subparagraph (d)(5)(A) to be available to any insurance company or bank. NASD Regulation believes that U.S. banks and insurance companies generally are structured and regulated in a manner that ensures that the institution is primarily engaged in a line of business that is distinct from the underwriting business.

U.S. banks and insurance companies would be those that come within the definitions of those terms in section 3(a)(6) of the Act and section 2(a)(13) of the Securities Act of 1933 (''Securities Act''), respectively. Foreign banks and insurance companies would not be able to rely on the exception unless the staff grants an exemption on a case-by-case basis under the NASD Rule 9600 Series. NASD Regulation proposes to grant such an exemption based on information demonstrating that the foreign institution operates and is regulated in a manner similar to a bank or insurance company in the U.S.

B. *Capital Under Management Test:* NASD Regulation proposes to revise the definition to allow the required capital to have been contributed or committed to the qualifying entity.

C. *Fiduciary Duty Requirement:* NASD Regulation proposes to amend the provision requiring an independent review of the investment or loan to delete the word ''review'' as redundant of the word ''evaluation.''

D. *Ten Percent Limitation on Acquisition:* The amended rule filing would restrict investments by all entities related to a member to 10% of the issuer's ''total equity securities, calculated immediately following the transaction.'' [15] NASD Regulation believes this added protection is necessary in light of the proposal to eliminate the 90-day limitation on the availability of the exception and to eliminate the stock numerical limitation.

The term ''total equity securities'' is defined in subparagraph (d)(4) to include the total shares of common stock outstanding of the issuer and the total shares of common stock of the issuer underlying all convertible securities. The term includes voting and non-voting common stock since the NASD does not differentiate between the two types of securities. Also, the calculation aggregates all series of common stock, *i.e.,* series A and series B. By ''convertible,'' the NASD means all securities that convert to common stock without payment of any additional consideration. As a result, the calculation of total equity securities does not include any warrants or options that give the holder the right to purchase the issuer's securities at a price.[16] Further, the convertible securities need not be those of the issuer; rather, the convertible securities can be those of any company that converts, without the payment of additional consideration, to the common stock of the issuer.[17]

E. *Sharing in Investment Banking Fees:* NASD Regulation agrees with commenters (Goldman and SIA) that the requirement that the investing or lending entity ''not participate directly in investment banking fees received by the member for underwriting public offerings' is satisfied even if the member is the general partner of the investing entity, so long as no part of the underwriting fees are directed to the entity itself.

2. *Second Exception: Investments In and Loans to Certain Issuers*—The second exception in subparagraph (d)(5)(B) is intended for acquisitions of securities of issuers that have significant institutional investor involvement. The exception, as amended, would be available: (1) When institutional investors own at least 33% of the issuer's total equity securities, calculated on a pre-transaction basis; (2) to any related entity of a participating member that manages capital contributions or commitments of at least $50 million; and (3) for purchases in a private placement and for the receipt of securities as compensation for a loan or credit facility before the required filing date of the public offering, with a 10% limitation on the amount of securities acquired.

A. *Ten Percent Limitation on Acquisition:* NASD Regulation proposes to increase the investment limitation on all entities related to each participating member from 5% to 10% of the issuer's ''total equity securities'' calculated on a post-transaction basis.

B. *Board Membership Requirement:* In response to commenter's concerns that the original proposal appeared to require an issuer to put an institutional investor on its board of directors in order for its underwriters to be eligible to rely on the exception, NASD Regulation proposes to delete the requirement that an institutional investor be a member of the issuer's board of directors.

C. *Board Vote:* Consistent with the deletion of the requirement that an institutional investor be a member of the issuer's board of directors and other comments, NASD Regulation proposes

[14] The definition of ''entity'' in subparagraph (d)(4) will continue to require that there have been at least one prior joint investment for a group of legal persons, to qualify as an entity. Therefore, when an entity is composed of a group of legal persons, one prior investment or loan by a group will also satisfy the requirement for at least one prior investment or loan under subparagraphs (d)(5)(A) and (B). In addition, each member of the group will be required to demonstrate that it is primarily engaged in the business of making investments in or loans to other companies.

[15] NASD Regulation agrees with commenters (Fried Frank, Goldman, Merrill, and SIA) that the calculation should not include stock options or employee options and warrants and, has, therefore deleted the requirement that the amount of the issuer's securities be calculated on a ''fully diluted'' basis.

[16] In comparison, purchasers of convertible securities have fully paid for the security and any underlying security regardless of when or if they convert.

[17] In some cases, a parent company will issue securities convertible to securities of a subsidiary.

to revise the provision requiring approval of the investment by the issuer's board of directors and the affirmative vote of all institutional investors on the board, to require approval by a majority of the issuer's board of directors and a majority of any institutional investors, or their designees, that are board members.

3. *Third Exception: Private Placements With Institutional Investors*—The third exception in paragraph (d)(5)(C) is intended for acquisitions in private placements with institutional participation. The exception, as amended, would be available to any person that is covered under the definition of underwriter and related person for purchases before the required filing date of the public offering of securities in a private placement and for the receipt of securities as placement agent compensation, so long as institutional investors purchase at least 51% of the total offering and underwriters and related persons, in the aggregate, do not purchase more than 20% of the total offering.

A. *Definition of the ''Total Offering''*: NASD Regulation proposes to revise the exception to clarify, as recommended by commenters, that the 51% investment requirement for institutional investors and the 20% limitation on investments by underwriters and related persons is based on the ''total offering,'' which is comprised of the total number of securities sold in the private placement and the securities received or to be received as placement agent compensation by any member.[18]

B. *Lead Negotiator Requirement:* The original proposal required an institutional investor to be the lead negotiator with the issuer to establish the terms of the private placement. NASD Regulation proposes to amend this requirement as recommended by the Corporate Financing Committee of NASD Regulation to provide that, when the terms of the private placement are not negotiated with an institutional investor, an institutional investor must at least be the lead investor in establishing or approving the terms of the private placement.

4. *Fourth Exception: Acquisitions and Conversions to Prevent Dilution*—The fourth exception in paragraph (d)(5)(D) is intended for the purchase or receipt of securities to prevent dilution of the investor's position in the issuer. The exception, as amended, would be available to any person who is covered under the definition of underwriter and related person for acquisitions of securities before the effective date of the public offering resulting from a preemptive right or a pro-rata rights offering, and acquisitions resulting from a stock-split or stock conversion, provided that: (1) The opportunity to purchase or receive securities is provided to all similarly situated securityholders; and (2) the amount of securities purchased or received does not increase the investor's percentage ownership.

A. *Availability of Exception:* The exception would be available during the 180-day review period and subsequent to the filing of the public offering.

B. *Definition of Right of Preemption:* To clarify the application of this exception, NASD Regulation proposes to include a definition of ''right of preemption'' in subparagraph (d)(4)(C) to list all the circumstances under which it is anticipated that a purchaser may receive a preemptive right.[19]

C. *Revisions to Limitation on Acquisition of the Preemptive Right:* NASD Regulation proposes to exclude an acquisition under a right of preemption acquired in connection with securities purchased in a private placement from underwriting compensation so long as the securities purchased in the private placement are not deemed to be underwriting compensation.

D. *Limitation on Securities Received Upon Conversion:* The exception is available to securities that are received upon conversion of securities only if the convertible security is not deemed to be underwriting compensation.

E. *Limitation on Increasing the Purchaser's Percentage Ownership:* NASD Regulation proposes to amend the language prohibiting the investor from increasing its percentage ownership of the same class of security[20] to refer to the ''same generic class of securities of the issuer'' and to the ''class of securities underlying any convertible security.'' In addition, NASD Regulation proposes to amend this provision to clarify that the investor's level of percentage ownership will be calculated immediately prior to the investment.

F. *Pre-Existing Contractual Rights:* As previously discussed, any securities purchased under an exception must be purchased at the same price and with the same terms as securities purchased by any other purchasers. NASD Regulation proposes to include a provision clarifying that it is not contrary to this limitation for a purchaser to retain a pre-existing contractual right, such as a preemptive right, that was granted in connection with a prior purchase.

5. *Fifth Exception: Purchases Based on a Prior Investment History*—A fifth exception in paragraph (d)(5)(E) is proposed in response to a comment (CIBC) so that members or their affiliates that established a long-term relationship with an issuer would be able to purchase additional securities of the issuer to prevent dilution before the effective date of the public offering. The exception would only be available to investors that have previously purchased the issuer's securities. NASD Regulation believes that the terms of this exception are consistent with historic NASD Regulation practice.

A. *Prior Investment Requirement:* In order to be eligible for the exception, the investor must have made at least two prior purchases of the issuer's securities: One investment at 2 years before the required filing date and another more than 180 days before the required filing date of the public offering.

B. *Limitation on Increasing the Purchaser's Percentage Ownership:* The securities purchased under the exception cannot increase the investor's percentage ownership of the generic class of securities of the issuer calculated immediately prior to the investment.

C. *Availability of Exception:* The exception would be available during the 180-day review period and subsequent to the filing of the public offering.

6. *Sixth Exception: Financial Consulting and Advisory Agreements*—A sixth exception is proposed in subparagraph (d)(5)(F) for cash fees and securities paid to a financial consultant or advisor to the issuer when the relationship was established more than one year before the required filing date of the public offering.

This exception is consistent with an exception in the Rule, which excludes from the definition of ''item of value'' financial consulting and advisory fees if an ongoing relationship between the issuer and the financial advisor or consultant was established more than 12 months before the filing date of the

[18] For example, if the private placement consists of 100,000 shares of common stock and the issuer pays placement agent compensation that includes a warrant for 10,000 shares of common stock, the total offering is 110,000 shares of common stock.

[19] An investor may only rely on this exception to purchase the enumerated classes of the issuer's securities that are covered by the right of preemption.

[20] This limitation does not apply in the case of conversions of securities. For example, the calculation of percentage ownership of preferred stock will be based on all series of preferred stock outstanding and the calculation of percentage ownership of convertible preferred stock will be based on the company's equity outstanding on an as-converted basis.

public offering. The original proposal included this exclusion. The sixth exception would codify objective standards that help clarify which long-term arrangements can qualify for the exception.

Among other criteria, the consulting or advisory relationship must have been entered into more than one year before the required filing date of the public offering. Commenters (Chase and Fried Frank) recommended that the time period be decreased to 180 days before the filing date of the public offering. NASD Regulation does not agree that a 180–day period is sufficient to identify a ''long term'' relationship between a consultant and the issuer that justifies excluding fees and securities paid to the consultant during the 180-day review period, particularly when the consultant may have provided services related to the preparation, structuring, or conduct of the public offering.

d. When Securities Are Considered ''Received''

In the original proposal, subparagraph (d)(3) included a provision to establish when securities are considered ''received'' under the Rule for purposes of determining if the securities were received within the 180-day review period and are, therefore, considered to be underwriting compensation.

The original proposal treated securities received as compensation for a loan or credit facility as ''received'' on the execution of the agreement for the loan or credit facility. NASD Regulation proposes to amend this provision to treat a put option like a loan or credit facility and to require a written contract with detailed provisions for any agreement for a loan, credit facility, or put option. Therefore, a contract for a loan or credit facility must specify the amount and terms of the loan or credit facility and the amount of securities that will be paid as a fee. In the case of a put option, the contract must unconditionally require the investor to purchase securities upon demand of the issuer and must include a formula for determining the amount and price of the securities that must be purchased. If the required information is provided, the securities will be considered received as of the date the written agreement is executed. Absent this required information, securities received for a loan or credit facility or purchased from the issuer in accordance with a put option will be considered received as of the date of transfer of beneficial ownership.

Commenters (Chase, Fried Frank, Goldman, Merrill, and SIA) recommended that the date a commitment letter is signed be relied upon as the date of receipt with respect to securities purchased in a private placement. NASD Regulation has not amended the Rule as commenters suggest. In the NASD Regulation's experience, commitment letters do not serve as reliable indicators of the date of ''receipt of securities.'' In many cases, commitment letters allow one or both parties to withdraw from the transaction or impose other contingencies that may prevent the purchase of the securities. In NASD Regulation's experience, the date that the private placement closes is a more reliable indicator of when securities are ''received.'' Moreover, beneficial transfer of the securities typically occurs at closing.

In addition, in response to a comment (M&F), the relevant ''closing of a private placement'' for a private placement with different closing dates would be the closing where the issuer receives its funding from the investor.

e. Post-Offering Review Authority/ Undisclosed Compensation

The original proposal would have required the staff to examine items of value received by underwriters and related persons during the 90-day period immediately following the effective date of a public offering to determine whether they constitute underwriting compensation. Commenters (Fried Frank, Goldman, Merrill, and SIA) expressed concern that the provision may subject members to disciplinary actions based upon the unknown activities by unaffiliated entities included in the definition of ''underwriter and related person.'' The purpose of this provision was to ensure that the staff could consider whether items of value received after the public offering need to be included as underwriting compensation in order to avoid circumvention of the Rule.

NASD Regulation agrees that this provision could be more narrowly tailored to address those specific circumstances where compensation arrangements are not disclosed to the Association. New subparagraph (d)(2) would provide that all items of value received and all arrangements entered into for the future receipt of an item of value that are not disclosed to the Association prior to the date of effectiveness or the commencement of sales of a public offering (including items of value received after the public offering), are subject to post-offering review to determine whether such items of value are additional underwriting compensation for the public offering. Subparagraph (b)(6)(vi)(b) would require the filing of any new arrangement that provides for receipt of an additional item of value subsequent to the issuance of an opinion of no objections to the underwriting arrangements by the Association and within 90 days following the date of effectiveness or commencement of the public offering.

f. Cash and Securities That Are Not Items of Value

The following amendments are proposed to subparagraph (b)(3)(B), which lists the items of value that will be excluded from underwriting compensation.[21]

1. *Cash Compensation Excluded As An Item of Value*—The exception for ''cash discounts or commissions received in connection with a prior distribution of the issuer's securities'' was unintentionally deleted in the original proposal. NASD Regulation proposes to reinstate and broaden the exclusion from underwriting compensation to cover *cash* compensation for services provided to the issuer for private placement agent or merger and acquisition services, or for providing a loan or credit facility, as recommended by commenters.

2. *Securities Excluded As An Item of Value*—In addition, as recommended by commenters, the proposed Rule would exclude receipt of the issuer's securities from being considered an item of value if they are:

(1) Listed and purchased in the public market transactions;

(2) Purchased through the issuer's employee stock purchase plan; or

(3) Acquired by an investment company registered under the Investment Company Act of 1940.

g. Flexibility in the Application of the Rule

1. *General Request for Flexibility*—Commenters (Fried Frank, Goldman, Morgan, Prudential, and Merrill) requested that the Rule be amended to allow the staff to grant exemptions from the Rule. The commenters stated that exemptions should be granted in new or unanticipated situations that were not contemplated by the Rule or where a transaction narrowly fails to meet the criteria of one of the enumerated exceptions. One of the commenters (Prudential) also stated that the exemption process under the NASD Rule 9600 Series was too cumbersome to be useful and preferred a structure where members can receive a quick response from Department staff on a request to consider a fact situation that

[21] NASD Regulation also proposes to amend the language of subparagraphs (c)(3)(a)(iv) and (vii) to eliminate redundancies.

does not fall within one of the exceptions to the Rule.

NASD Regulation agrees with the commenters that the staff should be able to grant exemptions to respond to new or unanticipated situations. NASD Regulation proposes to amend paragraph (i) of Rule 2710 to articulate the substantive standard upon which exemptions may be granted. Specifically, paragraph (i) would state that the staff has authority to grant an exemption from the Rule, if it is consistent with the purposes of the Rule, the protection of investors, and the public interest. NASD Regulation intends to use its exemption authority sparingly, principally for situations not addressed in the Rule. NASD Regulation generally does not believe that its exemption authority should be used to exclude transactions that narrowly fail to meet one or more criteria of the Rule, because these are the types of transactions that are addressed in the Rule.[22]

The NASD Rule 9600 Series sets forth the procedures to obtain exemptive relief from those NASD Rules that provide for such relief. NASD Regulation believes that the exemptive procedures set forth in the Rule 9600 Series allow Department staff to consider and grant exemptions from any provision of the Rule on an immediate basis.

2. *Exemptions for Consulting Fees and Founder's Stock*—Commenters recommended that NASD Regulation adopt additional exceptions from underwriting compensation. In certain situations, NASD Regulation believes that there are circumstances where the recommended exception is appropriate, but a specific exception with objective criteria cannot be developed to ensure the bona fide nature of the transaction. Therefore, NASD Regulation proposes to consider exemptions on a case-by-case basis pursuant to the standards in paragraph (i) in the following situations.

A. *Financial Consulting and Advisory Fees:* Commenters (Goldman and SIA) objected that the original rule filing proposed to delete current subparagraph (c)(4)(E), which excludes financial consulting and advisory fees if ''the relationship * * * was not entered into in connection with the offering and * * * actual services have been or will be rendered which were not or will not be in connection with or related to the offering.'' These commenters believed that there are many services for which a member may legitimately be retained at the time of or shortly before a public offering for which it ought to receive financial and advisory fees that are not included as underwriting compensation. It is our experience that the rule language that NASD Regulation proposed to delete in the original proposal is so indefinite in nature that it has not generally provided the guidance sought by the commenters. NASD Regulation proposes instead to consider on a case-by-case basis excluding securities and cash fees from underwriting compensation for services that:

(1) Solely relate to the business or management of the issuer; and

(2) Are not related to the preparation, structuring, or conduct of the public offering, or to raising capital in a transaction related to the public offering.

For example, if an agreement is for post-offering merger and acquisition services, NASD Regulation would consider excluding fees that will only be paid upon the occurrence of a merger or acquisition. If an agreement is for post-offering public relations services, NASD Regulation would consider excluding fees paid to an experienced public relations firm that is not affiliated with a member.

B. *Founder's Stock:* NASD Regulation proposes to consider on a case-by-case basis excluding acquisitions of ''founder's stock'' and any subsequent purchases by a founder from underwriting compensation. Founder's stock is acquired at the time of incorporation of the issuer as a start-up company or upon purchase of substantially all of the assets of the issuer from another company.

3. *Interpretations of Rule*—Commenters also recommended amendments to the Rule to exclude purchases of securities in a number of common-sense situations. NASD Regulation proposes to interpret the Rule to address on a case-by-case basis excluding purchases of securities when the:

(1) Purchaser was not affiliated or associated with a member participating in the public offering at the time of the acquisition;

(2) Securities acquired are those of the member or the parent of the member and the purchaser is an associated person of the member or employee of the parent, or members of their immediate family;

(3) Securities were acquired in a resale transaction under Rule 144A from a shareholder of the issuer who is not an affiliate, officer, director, general partner, or employee of the issuer, or a selling security holder in the public offering; or

(4) Securities were purchased from the issuer for immediate resale under Rule 144A and the member failed to place the securities.

h. Lock–Up Restrictions on Securities

The original rule filing proposed to delete the current one-year lock-up restriction on securities included in underwriting compensation and the current three-month lock-up restriction on securities of the issuer held by a member and certain senior persons and subsidiaries at the time of the offering. These restrictions would have been replaced by a single, 180-day lock-up restriction on all equity securities of the issuer that are held by any underwriter and related person at the time of effectiveness of the public offering, unless the securities or transaction complied with an exception. NASD Regulation proposes to clarify the language of the restriction and to adopt additional exceptions, as discussed by commenters (Fried Frank, Goldman, M&F, Merrill, and SIA).

1. *Lock-Up Restriction Language*—NASD Regulation proposes to amend subparagraph (g)(1) to prohibit any hedging, short sale, derivative, put, or call transaction that would result in the effective economic disposition of the securities. This amendment was recommended by the Corporate Financing Committee of NASD Regulation and is necessary to ensure that the lock-up restriction remains effective in light of practices that have developed since the restriction was first adopted in the original version of the Rule.

2. *Exceptions to Lock-Up Restriction For Securities Acquired At Any Time*—The original proposal included exceptions from the lock-up restriction in subparagraph (g)(2) for transfers of securities: by operation of law or reorganization of the issuer; to any member participating in the offering and the officers and partners thereof; if the aggregate amount of securities held by an underwriter and its related persons do not exceed 1% of the securities being offered; and if the class of security qualifies as an ''actively traded security'' for purposes of SEC Regulation M. NASD Regulation proposes to amend subparagraph (g)(2)

[22] The original proposal stated, ''[t]he current subjective, factor-weighing process for determining whether securities were acquired in connection with a public offering is an inefficient method * * * 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.''

to adopt additional exceptions from the lock-up restriction for securities:

(1) Held by an investment fund, provided that no participating member manages or otherwise directs the investments of the fund, and members participating in the offering do not own more than 10% of the equity in the fund;

(2) Previously subject to the lock-up restriction (thereby allowing the sale of such securities after the expiration of the previous lock-up restriction);

(3) That are listed and were purchased in the public market;

(4) Acquired under the issuer's employee stock purchase plan; or

(5) Purchased by an investment company registered under the Investment Company Act of 1940.

3. *Exceptions to the Lock-Up Restriction for Securities Acquired Before the 180-Day Review Period*—The original rule filing included an exception from the lock-up restriction for securities considered ''actively traded'' under SEC Regulation M.[23] NASD Regulation proposes to narrow this exception to make it available only to securities that were acquired before the 180-day review period. NASD Regulation believes this revision is necessary because NASD Regulation also proposes to eliminate the 90-day limitation on the availability of the exceptions in subparagraphs (d)(5)(A)–(C). The application of the lock-up restriction to securities acquired within the 180-day review period will ensure that securities received in transactions that meet an exception, and thus are not included in compensation calculations, are held as an investment for at least six months. Accordingly, members would be prevented from making a quick profit on securities received from issuers to whom they are providing underwriting services.

In addition, NASD Regulation proposes a new exception from the lock-up restriction for securities acquired before the 180-day review period that are owned by any person that is not a participating member (*e.g.,* underwriter's counsel, consultants, and finders).

i. Regulation of Terms of Securities

1. Stock Numerical Limitation—The amended rule filing, like the original rule filing, would eliminate the 10% stock numerical limitation in current subparagraph (c)(6)(B)(xi). In making this change, NASD Regulation believed that the number of securities received by a member as underwriting compensation would be limited by the compensation guideline applicable to the offering. Commenters (NASAA and Ohio) pointed out that the compensation guidelines would not be effective in this regard. They noted, for example, that warrants with an exercise price of 165% of the public offering price do not have any compensation value[24] and, consequently, an unlimited amount of warrants with such a high exercise price could be obtained as underwriting compensation.

NASD Regulation believes that the low valuations that are assigned to warrants that have an exercise price in excess of 125% of the public offering price no longer accurately reflect the economic value of the warrants. NASD Regulation proposes to amend subparagraph (e)(3) to require that all warrants have a minimum compensation value of .2% of the offering proceeds[25] for each amount of securities that is up to 1% of the securities being offered to the public, excluding securities subject to the overallotment option.[26] As a result of this amendment, the compensation guideline will limit the amount of securities that can be obtained through the exercise of any warrant.

2. *Other Amendments to Regulation of Terms of Convertible/Exercisable Securities*—A commenter (Goldman) requested a number of amendments to and questioned the continued usefulness of subparagraph (f)(2)(H), which prohibits unfair and unreasonable arrangements in connection with securities that are exercisable or convertible to another security. NASD Regulation finds that this provision continues to be necessary to prevent abusive arrangements when a member receives exercisable or convertible securities as underwriting compensation and proposes a number of modifications to clarify the applicability of the requirements.

A. *Scope of Regulation:* NASD Regulation proposes to amend subparagraph (f)(2)(H) to clarify that members are not only prohibited from including terms and arrangements in agreements for exercisable or convertible securities that are not permitted under the Rule, but they also are prohibited from exercising the securities in a manner that is prohibited under the Rule. Although this position is intuitively obvious, some members have argued that if the terms of the agreement are ambiguous, the securities can be exercised in a manner that otherwise would violate the Rule.

B. *Anti-Dilution Terms:* NASD Regulation proposes to amend the provisions prohibiting unfair ''anti-dilution'' arrangements in subparagraphs (f)(2)(H)(vi) and (vii) to incorporate a clearer explanation of the requirements. The revised language would state that the recipient may only receive a larger amount of securities or exercise at a lower price than originally agreed upon if the public shareholders have been proportionally affected by a stock split, stock dividend, or other similar event. NASD Regulation proposes minor changes to the prohibition on receipt or accrual of cash dividends prior to the exercise or conversion of the security.

C. *Exercise Price of Security:* NASD Regulation proposes to delete the provisions in current subparagraphs (c)(6)(B)(viii)(b) and (i) that prohibit underwriters and related persons from receiving a security that is exercisable or convertible at a price below the public offering price or on terms more favorable than the terms of the securities being offered to the public.

3. *Securities Received as Underwriting Compensation That Are Different Than the Securities Offered to the Public*[27]—The original rule filing proposed to amend current subparagraph (c)(5)(A) to allow ''upon good cause shown'' 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. A commenter (Ohio) requested reinstating the requirement that an exception only be permitted in ''exceptional and unusual circumstances.'' NASD Regulation agrees with other commenters (TBMA

[23] If a security qualifies as ''actively traded'' under SEC Regulation M as of the date of effectiveness of the public offering, then the security is considered ''actively traded'' at any time thereafter when the securityholder determines to sell its securities.

[24] The ''warrant formula'' for valuing warrants is in subparagraph (e)(3) of the amended Rule.

[25] The proposed valuation is the equivalent of the 2% valuation that would be applied to warrants for 10% of the securities underwritten on a firm-commitment basis that have an exercise price of 125% of the public offering price. The standard exercise price for warrants has long been 120% of the public offering price.

[26] For example, warrants exercisable for securities equal to 4% of the offered securities would have a compensation value of at least .8%. Warrants exercisable for securities equal to 9% of the offered securities would have a compensation value of at least 1.8%.

[27] NASD Regulation agrees with commenters (Goldman and SIA) that securities that will be converted into the securities offered to the public at the time of the public offering are considered to the identical to the securities offered to the public.

and Morgan) that the Rule should permit a member to receive securities as underwriting compensation that are different than those offered to the public, so long as the securities can be assigned a compensation value. Therefore, NASD Regulation proposes to amend subparagraph (e)(1) to require the security to be able to be accurately valued to comply with subparagraph (f)(2)(I). The burden will be on the member to demonstrate to the satisfaction of Association staff that the securities can be assigned an appropriate value.

j. Other Proposed Amendments [28]

1. Definitions

A. *Definition of Participating Member:* NASD Regulation proposes to add a definition in subparagraph (a)(4) of the term ''participating member'' to include any member that is participating in a public offering, any associated person of the member, any members of the immediate family of the associated persons, and any affiliate of the member. In developing the amended Rule, it became clear that certain provisions were intended to apply only to the ''participating member,'' whereas others were to apply more broadly to all underwriters and related persons, which includes certain non-members such as underwriter's counsel, financial consultants and advisors, and finders and persons that are related to a participating member.

B. *Definition of Underwriter and Related Persons:* In light of the new term ''participating member,'' NASD Regulation also must amend the term ''underwriter and related persons'' in subparagraph (a)(6). The revised definition includes the term ''participating member'' and deletes references to ''underwriters,'' ''members of the selling or distribution group,'' and ''members of the immediate family of the aforementioned person,'' all of which are now incorporated into the Rule through the definition of ''participating member.''

C. *Definition of Immediate Family:* NASD Regulation proposes in response to comments (Goldman, M&F, Morgan, and SIA) to amend the definition of ''immediate family'' in Rule 2720(b)(9) to exclude family members other than the spouse and children who do not live in the same household as, have a business relationship with, and are not materially supported by the employee or associated person. NASD Regulation believes that the current definition is too broad and places unnecessary burdens on members. With the new definition, members will only be required to submit information to the Association under Rule 2710(b)(6)(A)(iii) on the shareholdings of the spouse and children of the associated persons and employees of members, when other family members qualify for an exclusion. In addition, the definition will be expanded to include any other person living in the same household as the associated person or employee.

2. Filing Requirements

A. *Treatment of Confidential SEC Submissions:* NASD Regulation proposes to amend subparagraph (b)(4) to provide that the filing requirements of the Rule apply when any offering document is ''filed with or submitted to'' another regulatory authority, in order to eliminate any ambiguity when offering documents are ''submitted'' to the SEC for confidential review, thereby addressing comments (Fried Frank, Morgan, and Salomon) received on the SEC's confidential ''submission'' process.[29]

B. *Obligation to File Before Offers Commence:* The current filing requirements cover public offerings that are not filed or submitted to the SEC or any other federal or state regulatory authority for review. For these offerings, NASD Regulation proposes to amend the Rule to state that the offering documents must be filed at least 15 business days prior to the date ''on which offers will commence,'' replacing current language that looked to the ''anticipated offering date.'' Thus, members may not commence any efforts to offer the securities unless the offering memoranda and related documents and information have been filed with the Association for at least 15 business days.[30]

C. *Obligation to File and Receive Opinion of No Objections Before Sales Commence:* NASD Regulation proposes to revise the introduction of subparagraph (b)(4)(B) to clarify that the documents and information must have been filed as required by the Rule and the Association must have issued an opinion of no objections prior to the commencement of ''sales of securities,'' replacing the current language that looked to the commencement of the ''offering.'' [31]

D. *Information on NASD Affiliation:* Subparagraph (b)(6) requires members to submit information to the Department on the NASD affiliation or association with any member of any officer, director or security holder of the issuer in an initial public offering and with respect to any other offering provide such information with respect to any officer, director or security holder of 5% or more of any class of the issuer's securities. Commenters (Goldman, M&F, Morgan, and SIA) stated that non-public companies increasingly have a large number of investors and that the burden of compliance outweighs the value of the information when each investor holds a small interest in the issuer. NASD Regulation understand that members have had increasing difficulty obtaining complete and accurate information about shareholder ownership under the 5% threshold on a timely basis, thereby impacting the schedule for requesting effectiveness for the offering. Information on the NASD affiliation or association of issuer's shareholders that are not officers or directors, are not 5% or greater shareholders, and that have not purchased their securities within the 180 days preceding the filing date of the public offering is only necessary for identifying the persons who may be subject to the proposed 180-day restricted period with respect to securities that are not included in underwriting compensation.

NASD Regulation proposes to amend subparagraph (b)(6)(iii) to eliminate the requirement to file information on the NASD affiliation or association of *all* shareholders of the issuer. The revised provision would require the filing of information on the NASD affiliation of any:

(1) Officer or director of the issuer;

(2) Beneficial owner of 5% or more of any class of the issuer's securities; and

(3) Beneficial owner of the issuer's unregistered equity securities purchased during the 180-day period immediately proceeding the filing date of the public offering (except purchases through issuer's employee stock purchase plan).

As a result of this change, members will be obligated to identify those entities and persons that are covered by the proposed lock-up restriction in subparagraph (g)(1) and beneficially own securities of the issuer that were

[28] Other amendments are proposed to the Rule to make minor grammatical and punctuation changes. References in the Rule to the ''date of effectiveness'' have been amended to also refer to the ''commencement of sales'' to encompass offerings not filed with the SEC.

[29] The use of the word ''filed'' in the Rule was intended to have the common meaning of the term to identify a point in time when offering documents have been submitted to a regulatory authority and was not intended to distinguish between ''filed'' and ''submitted'' documents under SEC procedures for purposes of members' obligations to file public offerings with the Association.

[30] This amendment was developed in connection with consideration of the comments on the treatment of confidential submissions to the SEC under the filing requirements of the Rule.

[31] *ID.*

acquired before the period commencing 180 days immediately preceding the required filing date, and that are not also an officer, director, or 5% or greater shareholder of the issuer. Members will be responsible for ensuring compliance by any such shareholders with the lock-up restrictions.

E. *Information on New Arrangements:* NASD Regulation proposes to amend subparagraph (b)(6)(A)(vi), to narrow the filing requirement relating to any new arrangements after the issuance of an opinion of no objections. Under the revised proposal, the filing obligation will apply only to participating members, rather than all persons covered by the term ''underwriter and related persons.''

3. *Valuation of Securities*—Paragraph (e) regulates the manner in which securities are assigned a value for purposes of the calculation of underwriting compensation.

A. *Distinguish Securities With an Exercise or Conversion Price:* NASD Regulation proposes to amend subparagraphs (e)(2) and (3),[32] as recommended by commenters (Goldman, M&F, and SIA), to clarify that the application of the valuation method depends on whether the security has an exercise or conversion price. Convertible securities that have no conversion price will be valued in the same manner as common stock.

B. *Valuation of Securities With a Longer Resale Restriction:* NASD Regulation proposes to amend subparagraph (e)(4) to clarify that a lower value of 10% will be deducted for each 180-day period that securities are restricted from resale beyond the mandatory lock-up restriction.[33]

C. *Valuation of Securities That Have an Exercise or Conversion Price:* As discussed above, NASD Regulation is proposing to amend the Rule to no longer require that securities have an exercise or conversion price that is at least equal to the public offering price. As a result of this change, NASD Regulation proposes to amend subparagraph (e)(3) to clarify that the market price or public offering price of the underlying security is deducted from the exercise/conversion price of the security. In the case of a security with an exercise/conversion price below the public offering price, that subtraction would result in a negative number.

4. Sales of Securities Considered To Be Underwriting Compensation

When members are found to have exceeded the permissible underwriting compensation limits, they frequently seek to dispose of securities that have been deemed to be underwriting compensation to bring their compensation within acceptable levels. Current subparagraph (c)(6)(C) addresses such sales by requiring securities to be returned to the issuer or the source from which received at cost and without recourse in order for the securities to be excluded from underwriting compensation. NASD Regulation believes that this provision is unnecessary because, under the Rule, the Department may consider whether a sale of securities deemed to be underwriting compensation is bona fide, without recourse, and at cost before excluding the securities from underwriting compensation. Accordingly, NASD Regulation proposes to eliminate this provision from the Rule.

5. Reorganization of the Rule

NASD Regulation proposes to reorganize the Rule to make it easier to read by dividing it into more sections as follows:

(a) Definitions
(b) Filing Requirements
(c) Underwriting Compensation and Arrangements
(d) Determination of Whether Items of Value Are Included in Underwriting Compensation
(e) Valuation of Non-Cash Compensation
(f) Unreasonable Terms and Arrangements
(g) Lock-Up Restriction on Securities
(h) Proceeds Directed to a Member
(i) Exemptions

2. Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of section 15A(b)(6) of the Act,[34] 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. NASD Regulation 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 will 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

Section C, below, includes a discussion of the potential impact on small members of the proposed $50 million standard for entities eligible to rely on the second exception from underwriting compensation. 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.

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

On April 11, 2000, the SEC published the original proposal for comment in the **Federal Register**.[35] The SEC received fourteen comment letters. Following is a discussion of the comments received that are not addressed above because NASD Regulation did not incorporate them into the proposed revisions.

1. Listed Company Exclusion

Some commenters (TBMA, Goldman, Merrill, and SIA) recommended that the NASD adopt a ''listed company exception'' to the Rule. Under this proposal, any public offering by an issuer that is listed or would be listed after its initial public offering on the Nasdaq National Market, the New York Stock Exchange, or the American Stock Exchange or any issuer expecting to have market capitalization of at least $75 million would be exempt from the Rule's filing requirements and substantive provisions.[36] The commenters argued that such issuers are sufficiently large to negotiate favorable terms with prospective underwriters without the protections of the Rule.

Our experience indicates that abuses can occur in the underwriting arrangements with listed companies. NASD Regulation does not believe that the investor protection purposes of the listing standards are an adequate proxy for the review of offering documents and underwriting agreements to prevent unfair or unreasonable arrangements. Moreover, the changes proposed to the Rule that modernize its provisions and provide exceptions for legitimate investment transactions should

[32] As discussed above, NASD Regulation also proposes to amend subparagraph (e)(3) to impose a minimum conpensation value on securities with an exercise or conversion price.

[33] For example, the underwriting compensation value of securities with a value of 2.50% will be reduced to 2.25% if the securities are restricted for one year from the effective date and to 2% if the securities are restricted for 18 months following the effective date.

[34] 15 U.S.C. 78*o*–3(b)(6).

[35] *See supra*, note 4.

[36] Morgan and Salomon recommended an exception for a company with market capitalization of $100 million.

eliminate the need for such a sweeping exception.

2. Other Proposed Exclusions From Underwriting Compensation

a. *Exclusion of Cash and Non-Cash Fees for Other Services*—Commenters (Chase, M&F, Prudential, and Salomon) recommended that fees be excluded from underwriting compensation that are for merger and acquisition advice, a loan or credit facility, a currency hedge, an insurance policy, services provided by the business unit of a bank, and other services provided at arm's length.

As discussed in Section II.A., NASD Regulation is proposing to broaden the current exclusion from underwriting compensation for private placement agent cash fees to include cash fees received by participating members during the review period for providing a loan or credit facility, or for services in connection with a merger or acquisition. NASD Regulation has traditionally interpreted the Rule to exclude cash fees received by banks for cash management or trust services, and would extend that position to insurance policies (although this issue has not arisen in connection with our review of an offering). In addition, NASD Regulation has traditionally interpreted the Rule to include in underwriting compensation any securities paid during the review period to participating members for related capital raising activities, including loans, credit facilities, and merger/acquisition services. Services as a financial advisor and consultant are specifically included within the definition of underwriter and related person, and are addressed in Section II.A. above. NASD Regulation will address the question about the payment of cash fees for a currency hedge provided by a bank or member, when that issue actually arises in connection with our review of a public offering.

b. *Payments to a Previous Underwriter*—The original rule filing proposed to adopt an exclusion from the calculation of underwriting compensation in subparagraph (b)(3)(ii) for 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. Several commenters (SIA, Goldman, Fried Frank, and Merrill) urged NASD Regulation to exclude fees paid to a member for a failed offering even when the member participates in the revised offering. NASD Regulation believes excluding these fees would provide an opportunity for members to evade the compensation limits of the Rule and, thus, has not amended the Rule as suggested by commenters.[37]

c. *Exclusion for Investments by Foreign Affiliates*—Chase and CIBC recommended that investments in the issuer's securities by foreign affiliates of a member, particularly when the issuer is also domiciled outside the U.S., should be excluded from the calculation of underwriting compensation. NASD Regulation believes it is appropriate to apply the compensation limitations of the Rule to all members participating in a public offering made in the U.S., regardless of the location of the issuer or any affiliate of a participating member. Any other position would unfairly discriminate between members of the NASD depending on where their affiliates are located and whether the member has developed a business in underwriting the securities of foreign companies. Moreover, NASD Regulation believes that an exclusion for investments by foreign affiliates could easily be used to circumvent the Rule's compensation limits.

d. *Exclusion of Investments by Certain Employees/Employee Investment Funds*—Commenters (Merrill, Morgan, and Prudential) requested that the Rule exclude investments by employees of the member, either because the employees are not related to the member's underwriting activities or because the employees (and their immediate families) invest through an ''employee securities company.'' NASD Regulation finds that the suggested exclusion for ''employee securities companies'' would not distinguish between bona fide investments and investments for the purpose of obtaining additional underwriting compensation. Moreover, the six exceptions proposed herein provide sufficient opportunity for employees of members, as well as members, to acquire the securities of the issuer during the 180-day review period.

3. 180-Day Review Period

NASAA requested that NASD Regulation monitor the effectiveness of the 180-day review period by reviewing arrangements between issuers and underwriters in the 6-month period before the 180-day review period. According to NASAA's proposal, if NASD Regulation determines that the 180-day review period is not effective in regulating underwriting compensation, then it should expand the review period to 12 months. NASD Regulation notes that the information requested by NASAA will be contained in the public offering document filed with the Department for review. Department staff will have an opportunity to be alerted to the existence of any egregious arrangements that occur before the 180-day review period.

NASD Regulation does not agree with the request by M&F that the Rule should specifically exclude any items of value received by underwriters and related persons *prior* to the 180-day review period from the calculation of underwriting compensation, in light of the Association's general regulatory goals.

4. Requirements of the Exceptions From Underwriting Compensation

Commenters recommended the elimination and/or modification of many of the criteria and definitions of the proposed exceptions from underwriting compensation, in many cases arguing that the criteria was unnecessary to advance the purposes of the exception.[38] Of these, NASD Regulation has proposed to eliminate the provision prohibiting reliance on the exceptions during the 90-day period prior to filing; the provision in the second exception that would have required that an institutional investor be a member of the issuer's board of directors; and the requirement that members submit written procedures demonstrating that the member did not make its participation in the offering contingent on an acquisition of the issuer's securities. In addition, in response to comments, NASD Regulation is clarifying the application of many of the remaining criteria. NASD Regulation believes that the criteria, as amended, will be effective in distinguishing between securities acquired as bona fide investments from securities that are underwriting compensation for the public offering.

a. *Definition of Entity*—Commenters (Fried Frank, Goldman, and SIA) recommend that two or more entities that propose to be treated as a group should be permitted to demonstrate their bona fide identity as a group, even though they have not previously made a joint investment, through the terms of their contractual obligations, the occurrence of subsequent investments or otherwise, and should include

[37] The amendment proposed to subparagraph (b)(3)(ii) would eliminate the current requirement that fees paid to a previous underwriter for a failed offering be included in the calculation of underwriting compensation, even if the previous underwriter does not participate in the revised offering. The Rule would continue to prohibit payment of any compensation to a member for a failed offering, except for reimbursement of out-of-pocket expenses, in subparagraph (f)(2)(D) of this amended rule filing.

[38] However, Goldman and the SIA agreed with the 51% standard for institutional investor participation under the third exception.

entities that intend to file a Schedule 13D or 13G with the SEC in connection with the investment under consideration or a subsequent investment. Fried Frank also recommends that an entity include any entity that is, or the control persons of which are, under common control and entities whose investments are made under the direction of a common investment advisor or financial advisor. Chase requests that the definition of entity be expanded to include third-level subsidiaries under the common control of second-level subsidiaries that are contractually obligated to invest together and are under the common control of a bank.

NASD Regulation believes that the structures proposed by commenters would diminish the protections that are intended to be provided by the capital-under-management and non-participating member capital requirements in the first and second exceptions. Moreover, the commenters' proposal would appear to contradict the requirement that the entity (including a group qualifying as an entity) have a minimal history in being ''primarily engaged in the business of making investments in or loans to other companies.''

b. *Definition of Institutional Investor*—Fried Frank states that the requirement that an institutional investor have $50 million in securities under management for purposes of the second and third exceptions is excessive because it will disadvantage small members and prevent the issuer from choosing the underwriter that best suits its needs. NASD Regulation notes that small members that act as underwriters are generally better capitalized than members that engage only in retail brokerage activity—in part because of the net capital necessary to engage in underwriting activities. NASD Regulation does not believe that the Rule improperly disadvantages smaller underwriters, particularly as the exceptions are proposed to be expanded in this filing.[39]

c. *Second Exception—33% Limitation*—The second exception requires that institutional investors beneficially own at least 33% of the issuer's equity securities. Several commenters (Goldman, M&F, Merrill, Morgan, Salomon, and SIA) suggested decreasing the 33% threshold. NASD Regulation does not believe that this suggestion is consistent with the purposes underlying the exception because the second exception does not place any limitations on whether the investing entity is managed by a member, is funded by a member or its associated persons, or is a subsidiary of a member. Therefore, NASD Regulation believes that the 33% standard for institutional investor participation is necessary to prevent potential overreaching by a participating member.

d. *Fourth Exception—Limitation on Increasing Percentage Ownership*—The fourth exception prohibits investors from increasing their percentage ownership of the issuer's securities in reliance on the exception. Goldman and the SIA believe that investors should have the benefit of indemnification provisions with issuers that give the investor the right to receive additional shares if it appears later that the issuer misrepresented, for example, its capitalization at the time of the investment. NASD Regulation believes that the concerns articulated by the commenters are best addressed on a case-by-case basis.

These commenters recommend that the Association also permit investors to take advantage of anti-dilution protection for subsequent issuances to others, regardless of whether the investor has a preemptive right. Under the proposed rule change, any purchases for anti-dilution protection during the 180-day review period and subsequent to filing of a public offering must comply with the fourth or fifth exceptions in order to be excluded from underwriting compensation. Thus, additional purchases of the issuer's securities to prevent dilution are only permitted to maintain the purchaser's percentage ownership of the issuer's securities, if the purchaser exercises a preemptive right, is the subject of a pro-rata rights offering, or has a two-year prior investment history.

Fried Frank, Goldman, and Merrill state that there are circumstances in which some rights holders elect not to purchase, with the result that other rights holders who elect to purchase experience an increase in their percentage ownership. In addition, these commenters state that rights holders are generally permitted to purchase additional shares that are made available by the decision of other rights holders not to exercise. They recommend that such purchases not be treated as underwriting compensation. NASD Regulation disagrees. This exception is intended to recognize that an investor that has a preemptive right, or is the subject of a stock split, pro-rata rights offering, or stock conversion should not be disadvantaged by application of the Rule to the securities thereby acquired in order to prevent the investor's interest from being diluted. Thus, except for conversions, this exception, and exception five, allows the investor to *maintain* its percentage interest in the issuer, but does not allow the investor to *improve* its position.

5. Lock-Up Restriction

a. *Application To Securities That Are Not Deemed To Be Underwriting Compensation*—Goldman, Fried Frank, Merrill, and the SIA recommend that the lock-up restriction only apply to securities deemed to be underwriting compensation, arguing that the scope of the lock-up requirement does not protect investors when securities are not considered to be underwriting compensation and seriously threatens the economic interests of venture capital and other investors. NASD Regulation disagrees. In regulating resales of securities, the goals of the Rule are to:

- Protect the issuer and public investors by ensuring that the public market for the securities sold by participating members has an opportunity to develop prior to the sale of securities into the market by the underwriters and related persons that dilutes the public investors; and
- Prevent opportunities for fraud and manipulation in the after-market of a company's initial public offering or an offering of securities that are not sufficiently liquid when a member is an underwriter, actively trades the securities, and is a selling securityholder.

NASD Regulation's concern regarding potential market dilution and the opportunity for fraud and manipulation is the same, regardless of whether the securities that are sold by participating members into the public market are deemed to be underwriting compensation or were excluded from underwriting compensation.

b. *Time Period of Lock-Up*—Ohio favors the extension of the 90-day venture capital lock-up from 90 to 180 days, but joins with NASAA in opposing the shortening of the compensation lock-up to 180 days, believing the current one-year period to be an appropriate and prudent standard for securities deemed to be underwriting compensation, particularly in smaller offerings where there may be less information about the issuer. M&F is opposed to the imposition of a flat 180-day lock-up period on securities of an issuer held by underwriters, preferring that NASD Regulation lock-up be the same as that imposed by the issuer on its management and other major

[39] Moreover, small members will benefit from the shortening of the review period, the elimination of the 10% stock numerical limitation, and the elimination of the prohibition on members receiving warrants with an exercise price below the public offering price.

securityholders. In addition, Fried Frank and M&F suggest that the lock-up be 30 or 90 days for follow-on offerings.

NASD Regulation continues to believe that a lock-up period of 180-days for initial public offerings and follow-on or secondary offerings where the market for the security is not sufficiently liquid is necessary to protect the after-market from potential manipulation.

c. *Exceptions to the Lock-Up*—Goldman recommends an additional exception from the proposed lock-up requirement for transfers to an affiliate of a member. NASD Regulation believes that such transfers to affiliates of members are best addressed on a case-by-case basis. Department staff have previously permitted such transfers when the securities were owned by the member firm, the transfer was without any payment, and the purpose of the transfer was to avoid net capital or other tax consequences to the member during the time of the resale restriction.

Fried Frank requests that the exception for securities priced by a qualified independent underwriter be retained, citing the statement in Notice to Members 86–1 where the Association stated that ''[t]he presence of an independent underwriter to conduct pricing and due diligence is sufficient protection against potential conflicts of interest to justify an exemption from the [venture capital] restrictions.'' NASD Regulation has reconsidered the efficacy of this exception and now believes that the presence of a qualified independent underwriter fails to address the potential negative dilutive effect of such sales on the public market in the case of an initial public offering or any offering of a security that is not sufficiently liquid. NASD Regulation believes that a better standard is the ''actively traded security'' test of SEC Regulation M that is proposed as an exception to the lock-up restriction for securities acquired prior to the 180-day review period, as the Regulation M standard would define a liquid market.

6. Other Comments

a. *Exemption for Shelf Offerings on Forms S–3 and F–3*—The SIA and Merrill request that NASD Regulation amend its current exemption from filing for shelf offerings on Forms S–3 and F–3 to rely on the current standards for these forms to reduce unnecessary complexity and burden. In addition, the SIA requested that the NASD eliminate its interpretation published in Notice to Members 93–88 that the exemption is only available for shelf offerings for which there is a genuine intention to make a delayed offering (*i.e.,* the filing exemption is not available where the Rule 415 box is checked only for convenience). Alternatively, the SIA recommends that NASD Regulation specifically incorporate this interpretation into the Rule. The staff is currently developing a proposal related to the application of the Rule to shelf registered offerings and NASD Regulation plans to address these comments in connection with that proposal.

b. *Exemption from Compliance for Investment Grade Debt Offerings*—TBMA recommends that the exemption under Rule 2710(b)(7) for offerings by issuers with investment grade debt outstanding and for investment grade debt offerings should be moved to Rule 2710(b)(8) in order to provide an exemption from the substantive requirements of the Rule. Investment grade debt offerings rarely involve issues concerning underwriting terms and arrangements. However, the practical effect of TBMA's recommendation would be to exempt such offerings from the filing and substantive requirements of Rule 2720, the NASD's conflict-of-interest rule, when the offering is of the securities of a member, the member's parent, or an affiliate of a member. NASD Regulation does not believe this exemption is warranted at this time.

c. *Delayed Offerings*—Chase believes that the Rule should provide that in situations where a registration statement has been on file for more than three months without an amendment filing, the NASD Regulation value underwriting compensation by reviewing the 180-day period prior to filing of an amendment. The staff considers circumstances such as these on a case-by-case basis. The Department has, at times, granted requests to exclude from underwriting compensation securities that were acquired within the 180-day review period, but more than a year before the anticipated public offering date of a delayed offering.

d. *Definition of Underwriter and Related Person*—The SIA and Goldman recommend that the definition of ''underwriters and related persons'' be amended to exclude selling group members, arguing that issuers do not have a relationship with selling group members and do not have an economic incentive to provide extra or illicit compensation to selling group members in the form of low-cost securities or otherwise. These commenters argue that applying the compensation rules to selling group members would present a burden on capital formation, excluding willing sellers with no demonstrable benefit. NASD Regulation believes that this proposal would provide an opportunity for circumvention of the Rule's compensation limits by members willing to limit their role in the offering in exchange for the ability to acquire the securities of the issuer on a pre-offering basis. NASD Regulation believes that the broad scope of the definition of underwriter and related persons has operated effectively in carrying out the issuer and investor protection purposes of the Rule.

Merrill recommends that the definition be amended to exclude only those persons or entities affiliated with a member that have knowledge of the offering based on their roles at the member or ownership interest in the issuer. NASD Regulation does not believe that ''knowledge of the offering'' is a verifiable standard for determining the scope of the application of the Rule to acquisitions of the issuer's securities. In addition, if the purpose of this proposal is to exclude cash fees received for ordinary business by affiliates of a member, NASD Regulation believes that the proposed rule change properly identifies situations where fees received by members' affiliates are considered to be unrelated to the public offering.

e. *Calculation of Underwriting Compensation Based on Integrated Transactions*—Morgan recommends that several registered transactions that are part of a coherent financing schedule where each is contingent on each other, should be treated as a single offering for the calculation of underwriting compensation. NASD Regulation will consider such treatment on a case-by-case basis, where allocation of a member's acquisition of the issuer's securities to a coherent group of related financing transactions appears appropriate in light of the total capital-raising obligations of the member.

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 NASD Regulation consents, the Commission will:

(A) By order approve such proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and

arguments concerning the foregoing, including whether Amendment No. 5 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. 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 the filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the File No. SR–NASD–00–04 and should be submitted by April 4, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[40]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 01–6275 Filed 3–13–01; 8:45 am]

BILLING CODE 8010–01–P

[40] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–44042; File No. SR–NASD–99–66]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 2, 3, and 4 by the National Association of Securities Dealers, Inc. Relating to the Implementation of Mandatory Trade Reporting for PORTAL Securities

March 6, 2001.

I. Introduction

On October 28, 1999, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association''), filed with the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'' or ''Exchange Act'')[1] and Rule 19b–4 thereunder,[2] a proposed rule change relating to the implementation of mandatory trade reporting for PORTAL securities. On December 30, 1999, the NASD filed Amendment No. 1.[3] The proposed rule change, including Amendment No. 1, was published for comment in the **Federal Register** on January 13, 2000.[4] The Commission received one comment letter regarding the proposal.[5] In response thereto, on April 4, 2000, the NASD filed Amendment No. 2.[6] On January 23, 2001, the NASD filed Amendment No. 3.[7] On February 22, 2001, the NASD filed Amendment No. 4.[8]

This order approves the proposed rule change, as amended. In addition, the Commission is approving on an accelerated basis, and soliciting comments on, Amendment Nos. 2, 3 and 4.

II. Description

A. Overview

The Nasdaq Stock Market, Inc. (''Nasdaq'') operates the PORTAL Market for securities that were sold in private placements and are eligible for resale under SEC Rule 144A, adopted under the Securities Act of 1933 (''Securities Act'').[9] The NASD is proposing to amend the rules governing The PORTAL Market (''PORTAL Rules'') in the Rule 5300 Series to require that NASD members submit trade reports of secondary market transactions in PORTAL-designated equity securities through the Automated Confirmation Transaction Service (''ACT'') and in PORTAL U.S. high-yield debt securities through the Trade Reporting And Comparison Entry Service (''TRACE'').[10]

Under the proposed revisions to the PORTAL Rules, members will be required to report secondary market transactions in PORTAL equity securities through ACT, subject to certain exemptions. Members will not be required to use ACT's automated services for comparison, confirmation, and the forwarding of confirmed trades to Depository Trust Corporation (''DTC'') for settlement, however, these services will remain available for members that chose to use them. There will be no public dissemination of information in trade reports submitted to the association with respect to PORTAL securities and depository-eligible Rule 144A investment grade rated debt issues.

The NASD intends to amend several of the definitions contained in Rule 5310 of the PORTAL Rules as well as the Reporting Requirements contained in Rule 5332 of the PORTAL Rules to mandate reporting of secondary market transactions in PORTAL debt and equity securities. NASD has also proposed revisions to the PORTAL Rules governing the security designation application process. As a result of these revisions, a majority of the remaining provisions will be obsolete, and the NASD proposes to delete them.

B. Definitions

As part of its proposal to revise the PORTAL Market, the NASD has proposed new definitions for the terms ''PORTAL equity security'' and ''PORTAL debt security.'' Under the proposed definition, a PORTAL equity security will include any:

> Security that represents an ownership interest in a legal entity, including but not limited to any common, capital, ordinary, preferred stock, or warrant for any of the foregoing, shares of beneficial interest, or the equivalent thereof (regardless of whether voting or non-voting, convertible or non-convertible, exchangeable or non-exchangeable, exercisable or non-exercisable, callable or non-callable, redeemable or non-redeemable).

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

[2] 17 CFR 240.19b–4.

[3] *See* Letter from Suzanne Rothwell, Chief Counsel, Corporate Financing, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation (''Division''), Commission, dated December 29, 1999 (''Amendment No. 1'').

[4] *See* Securities Exchange Act Release No. 42310 (January 3, 2000), 65 FR 2207. A correction notice was published in the **Federal Register** correcting a typographical error in the docket number on February 14, 2000. *See* 65 FR 7418.

[5] *See* Letter from Douglas L. Williams, Executive Vice President, Wachovia Securities, Inc., to Secretary, Commission, dated February 2, 2000.

[6] *See* Letter from Suzanne Rothwell, Chief Counsel, Corporate Financing, NASD, to Katherine A. England, Assistant Director, Division, Commission, dated April 4, 2000 (''Amendment No. 2''). In Amendment No. 2, the NASD responded to comments made by a commenter, and submitted substantive amendments to the proposal. The substance of Amendment No. 2 is reflected throughout this order.

[7] *See* Letter from Suzanne Rothwell, Chief Counsel, Corporate Financing, NASD, to Katherine A. England, Assistant Director, Division, Commission, dated January 18, 2001 (''Amendment No. 3''). In Amendment No. 3, the NASD revised the proposed definition of ''PORTAL Debt Securities'' to conform it to the definition of TRACE-eligible security approved in File No. SR–NASD–99–65. *See* Securities Exchange Act Release No. 43873 (January 23, 2001), 66 FR 8131 (January 29, 2001).

[8] *See* Letter from Suzanne Rothwell, Chief Counsel, Corporate Financing, NASD, to Katherine A. England, Assistant Director, Division, Commission, dated February 16, 2001 (''Amendment No. 4''). In Amendment No. 4, the NASD made a technical amendment to the language of Rule 5350 of the PORTAL Rules and to clarify the proposed effective date for the PORTAL Rules.

[9] 15 U.S.C. 77(a).

[10] ACT is a system, operated by Nasdaq, that accommodates the reporting and dissemination of last sale reports for secondary market transactions in equity securities (including preferred stock issues), and provides automated comparison and confirmation services and forwards confirmed trades to DTC for settlement. TRACE is a service to be operated by Nasdaq to provide services similar to those of ACT for secondary market transactions in certain SEC registered debt and Rule 144A investment grade rated debt issues that are eligible for book-entry services at DTC.