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

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

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

Written comments were neither solicited nor received.

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) As the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the NASD 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 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. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov*. All comment letters should refer to File No. SR–NASD–2003–183. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR–NASD–2003–183 and should be submitted by January 21, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[8]

Jill M. Peterson,

Assistant Secretary.

[FR Doc. 03–32180 Filed 12–30–03; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48989; File No. SR–NASD–00–04]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendments Nos. 6, 7, 8, 9, and 10 by the National Association of Securities Dealers, Inc. Relating to Its Corporate Financing Rule

December 23, 2003.

I. Introduction

On January 21, 2000, the National Association of Securities Dealers, Inc. (''NASD'') filed with the Securities and Exchange Commission (''Commission'' or ''SEC''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] a proposed rule change amending NASD Conduct Rule 2710. NASD filed Amendments Nos. 1,[3] 2,[4] and 3[5] to the proposed rule change on March 6, 2000, March 21, 2000, and March 30, 2000, respectively. The proposed rule change was published for comment in the **Federal Register** on April 11, 2000.[6] The Commission received 14 comments.[7] NASD filed Amendment No. 4 on December 11, 2000.[8] NASD filed Amendment No. 5 on February 4, 2001,[9] which was published for comment in the **Federal Register** on March 14, 2001.[10] The Commission received eight comments.[11] NASD filed Amendment Nos. 6,[12] 7,[13] 8,[14] 9,[15] and 10[16] on November 19, 2001, and April

[8] 17 CFR 200.30–3(a)(12).

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

[2] 17 CFR 240.19b–4.

[3] Letter from Suzanne E. Rothwell, Chief Counsel, Corporate Financing, NASD Regulation, Inc. (''NASD Regulation''), to Katherine A. England, Assistant Director, Division of Market Regulation (''Division''), Commission, dated March 3, 2000 (''Amendment No. 1'').

[4] Letter from Suzanne E. Rothwell, Chief Counsel, Corporate Financing, NASD Regulation, to Katherine A. England, Assistant Director, Division, Commission, dated March 20, 2000 (''Amendment No. 2'').

[5] Letter from Suzanne E. Rothwell, Chief Counsel, Corporate Financing, NASD Regulation, to Katherine A. England, Assistant Director, Division, Commission, dated March 29, 2000 (''Amendment No. 3'').

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

[7] These comments, and NASD Regulation's response, are discussed in the release cited in footnote 9.

[8] Amendment No. 4, filed December 11, 2000, amends the original filing as modified by Amendment Nos. 1, 2, and 3 in response to comments.

[9] NASD submitted a new Form 19b–4, which replaced and superseded all previous versions of the proposed rule change in their entirety.

[10] *See* Securities Exchange Act Release No. 44044 (March 6, 2001), 66 FR 14949.

[11] These comments, and the amendments proposed by NASD Regulation in response, are summarized in Section III. of this order.

[12] NASD submitted a new Form 19b–4, which replaced and superseded all previous versions of the proposed rule change in their entirety.

[13] Letter from Gary L. Goldsholle, Associate General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division, Commission, dated April 3, 2002 (''Amendment No. 7''). Amendment No. 7 makes certain technical corrections to the rule text as it appears in Amendment No. 6, such as correcting the numbering of certain paragraphs in the rule text. As such, it is not subject to notice and comment.

[14] Letter from Gary L. Goldsholle, Associate General Counsel, NASD, to Katherine A. England, Assistant Director, Division, Commission, dated April 11, 2003 (''Amendment No. 8''). Among other things, Amendment No. 8: (i) Amends the definition of ''item of value'' in proposed Rule 2710(c)(3)(B) to exclude derivative instruments and certain other transactions; (ii) amends proposed NASD Rule 2710(a) to define ''fair price;'' (iii) modifies the requirement in proposed NASD Rule 2710(b)(6)(A)(iv) such that information initially filed in connection with debt securities and derivative instruments acquired or entered into for a ''fair price'' may be limited to a brief description of the transaction and a representation that the transaction was, or, if the pricing terms have not been set will, be entered into for a ''fair price;'' (iv) amends the lock-up requirements in proposed Rule 2710(g)(2) to exempt certain debt securities and derivative instruments; and (v) changes references in the rules from ''the Association'' to ''NASD.''

[15] Letter from Therese Woods, Deputy Director, Corporate Financing, NASD, to Katherine A. England, Assistant Director, Division, Commission, dated April 25, 2003 (''Amendment No. 9''). Amendment No. 9 makes technical corrections to the proposed rule text and amends proposed Rule 2710(b)(6)(A)(iv)(b) to state: ''information initially filed in connection with debt securities and derivative instruments acquired or entered into for ''fair price'' as defined in subsection (a)(9), but not excluded from items of value under subsection (c)(3)(B)(vi) or (vii), may be limited to a brief description of the transaction (additional information may be required in the review process) and a representation by the member that a registered principal or senior manager on behalf of the member has determined that the transaction was (or if the pricing terms have not been set) will be entered into at a fair price as defined in subsection (a)(9);''.

[16] Letter from Therese Woods, Deputy Director, Corporate Financing, NASD, to Katherine A. England, Assistant Director, Division, Commission, dated May 28, 2003 (''Amendment No. 10''). First, Amendment No. 10 makes technical corrections to the proposed rule text and revises the definition of ''fair price'' in proposed Rule 2710(a)(9) to include a cross reference to subsection (e)(5) and to clarify

3, 2002, April 14, 2003, April 29, 2003, and June 2, 2003, respectively. This order issues notice of, and grants accelerated approval to, the filing as modified by Amendment Nos. 6, 7, 8, 9, and 10.

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

In response to comments to Amendment No. 5, NASD 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 Nos. 6 through 10. For an explanation of the original filing, see the initial notice cited in footnote 6.

* * * * *

2710. Corporate Financing Rule—Underwriting Terms and Arrangements

(a) Definitions

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

(1) Issuer

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

(2) Net Offering Proceeds

Offering proceeds less all expenses of issuance and distribution[;].

(3) Offering Proceeds

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

(4) *Participating Member(s)*

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

[(4)]*(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].

(7) Listed Securities

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

(8) Derivative Instruments

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

(9) Fair Price

A derivative instrument or non-convertible or non-exchangeable debt security has been acquired or entered into at a fair price for purposes of subparagraphs (b)(6)(A)(iv), (c)(3)(B)(vi) and (vii), and (e)(5) if the underwriters and related persons have priced the debt security or derivative instrument in good faith; on an arm's length, commercially reasonable basis; and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions. A derivative instrument or other security received for acting as a private placement agent for the issuer, for providing or arranging a loan, credit facility, merger, acquisition or any other service, including underwriting services, is not included within this ''fair price'' definition.

(10) Required Filing Date

The required filing date shall be the dates provided in subparagraph (b)(4), and for a public offering exempt from filing under subparagraph (b)(7), the required filing date for purposes of subparagraph (d) and (g) shall be the date the public offering would have been required to be filed with the NASD but for the exemption.

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

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

[(i)]*a.* [with] the Commission; *or*

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

[(iii) with any other regulatory authority; or]

[(iv)]*(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] *NASD*; and

(ii) No change.

(C) No change.

(5) No change.

(6) Information Required To Be Filed

(A) Any person filing documents *with the NASD* that are required to be filed

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that a derivative instrument or other security received for acting as a private placement agent for the issuer for providing or arranging a loan, credit facility, merger, acquisition, or any other service, is not included within the definition of ''fair price.'' Second, Amendment No. 10 adds subsection (a)(10) to Rule 2710, regarding required filing dates. Third, Amendment No. 10 adds the following language to proposed Rule 2710(b)(6)(A)(iv)(b): ''provided, however, that information filed in connection with debt securities and derivative instruments acquired or entered into for a ''fair price'' as defined in subsection (a)(9) may be limited as described in subsection (b)(6)(A)(iv)b.'' Fourth, Amendment No. 10 adds the following language to the beginning of the first sentence of proposed Rule 2710(g): ''In any public equity offering, other than a public equity offering by an issuer that can meet the requirements in subparagraphs (b)(7)(C)(i) or (ii), any * * *.'' Fifth, Amendment No. 10 adds new subparagraph (e)(5) to Rule 2710, regarding valuation of items of value acquired in connection with a fair price derivative or debt transaction.

under paragraph (b)(4) above shall provide the following information with respect to the offering through [the Association's] NASD's electronic filing system:

(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 acquired during the 180-day period immediately preceding the required filing date of the public offering, except for purchases described in subparagraph (c)(3)(B)(iv) below. This statement must identify* [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, *provided however:* [; and]

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

b. information initially filed in connection with debt securities and derivative instruments acquired or entered into for a ''fair price'' as defined in subsection (a)(9), but not excluded from items of value under subsection (c)(3)(B)(vi) or (vii), may be limited to a brief description of the transaction (additional information may be required in the review process) and a representation by the member that a registered principal or senior manager on behalf of the member has determined that the transaction was or (if the pricing terms have not been set) will be entered into at a fair price as defined in subsection (a)(9).

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

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

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

b. any new arrangement that provides for the receipt of any additional item of value by any participating member subsequent to the [review and approval of such compensation] *issuance of an opinion of no objections to the underwriting terms and arrangements* by [the Association] *NASD and within 90 days immediately following the date of effectiveness or commencement of sales of the public offering, provided, however, that information filed in connection with debt securities and derivative instruments acquired or entered into for a ''fair price'' as defined in subsection (a)(9) may be limited as described in subsection (b)(6)(A)(iv)b.*

(vii) any other information required to be filed under this Rule.

(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;

(xii) fees of a qualified independent underwriter; and

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

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

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

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

(iii) listed securities purchased in public market transactions;

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

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

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

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

[(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 NASD prior to the date of effectiveness or commencement of sales of a public offering, including items of value received subsequent to the public offering, are subject to post-offering review to determine whether such items of value are, in fact, underwriting compensation for the public offering.

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

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

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

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

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

(i) any option, shareholder agreement, or other contractual right entered into at the time of a purchase of securities;

(ii) the terms of the security purchased;

(iii) the issuer's charter or by-laws; or

(iv) the domestic law of a foreign jurisdiction that regulates the issuance of the securities.

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

(i) common stock outstanding of the issuer; and

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

(5) Exceptions From Underwriting Compensation

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

(A) Purchases and Loans by Certain Entities—Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility before the required filing date of the public offering pursuant to subparagraph (b)(4) above by certain entities if:

(i) each entity:

a. either:

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

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

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

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

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

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

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

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

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

(B) Investments In and Loans to Certain Issuers—Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility before the required filing date of the public offering pursuant to subparagraph (b)(4) above by certain entities if:

(i) each entity:

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

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

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

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

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

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

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

(C) Private Placements With Institutional Investors—Securities of the issuer purchased in, or received as

placement agent compensation for, a private placement before the required filing date of the public offering pursuant to subparagraph (b)(4) above if:

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

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

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

(D) Acquisitions and Conversions to Prevent Dilution—Securities of the issuer if:

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

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

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

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

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

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

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

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

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

(E) Purchases Based On a Prior Investment History—Purchases of securities of the issuer if:

(i) the amount of securities purchased did not increase the purchaser's percentage ownership of the same generic class of securities of the issuer or of the class of securities underlying a convertible security calculated immediately prior to the investment; and

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

[(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] *have a compensation value based on* the following formula:

[(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, notwithstanding subparagraph (e)(4) below, such warrants shall have a compensation value of at least .2% of the offering proceeds for each amount of securities that is up to 1% of the securities being offered to the public (excluding securities subject to an overallotment option).

(4) Valuation Discount for Securities With a Longer Resale Restriction

[(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.

(5) Valuation of Items of Value Acquired in Connection with a Fair Price Derivative or Debt Transaction

Any debt or derivative transaction acquired or entered into at a ''fair price'' as defined in subsection (a)(9) and item of value received in or receivable in the settlement, exercise or other terms of such debt or derivative transaction shall not have a compensation value for purposes of determining underwriting compensation. If the actual price for the debt or derivative security is not a fair price, compensation will be calculated pursuant to this subsection (e) or based on the difference between the fair price and the actual price.

[(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] *NASD.*

[(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] *NASD* 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 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.

[(xiv)]*(M)* [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 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

In any public equity offering, other than a public equity offering by an issuer that can meet the requirements in subparagraphs (b)(7)(C)(i) or (ii) any common or preferred stock, options, warrants, and other equity securities of the issuer, including debt securities convertible to or exchangeable for equity securities of the issuer, that are unregistered and acquired by an underwriter and related person during 180 days prior to the required filing date, or acquired after the filing of the registration statement and deemed to be underwriting compensation by the NASD, and securities excluded from underwriting compensation pursuant to subparagraph (d)(5) above, shall not be sold during the offering, or sold, transferred, assigned, pledged, or hypothecated, or be the subject of any hedging, short sale, derivative, put, or call transaction that would result in the effective economic disposition of the securities by any person for a period of 180 days immediately following the date of effectiveness or commencement of sales of the public offering, except as provided in subparagraph (g)(2) below.

(2) Exceptions to Lock-Up Restriction

[(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)–(vii) above;

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

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

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

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

[(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] subparagraph*s* [(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)* Non-Cash Compensation

(1) Definitions

The terms ''compensation,'' ''non-cash compensation'' and ''offeror'' as used in this Section (d) of this Rule shall have the following meanings:

(A) ''Compensation'' shall mean cash compensation and non-cash compensation.

(B) ''Non-cash compensation'' shall mean any form of compensation received in connection with the sale and distribution of securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging.

(C) ''Offeror'' shall mean an issuer, an adviser to an issuer, an underwriter and any affiliated person of such entities.

(2) Restrictions on Non-Cash Compensation

In connection with the sale and distribution of a public offering of securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Non-cash compensation arrangements are limited to the following:

(A) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors [17] and are not preconditioned on achievement of a sales target.

(B) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not conditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (d)(2)(D);

(ii) the location is appropriate to the purpose of the meeting, which shall mean an office of the issuer or affiliate thereof, the office of the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

(iii) the payment or reimbursement is not applied to the expenses of guests of the associated person; and

(iv) the payment or reimbursement by the issuer or affiliate of the issuer is not conditioned by the issuer or an affiliate of the issuer on the achievement of a sales target or any other non-cash compensation arrangement permitted by subparagraph (d)(2)(D).

(D) Non-cash compensation arrangements between a member and its

[17] The current annual amount fixed by the Board of Governors is $100.

associated persons or a company that controls a member company and the member's associated persons, provided that no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and

(E) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in subparagraph (d)(2)(D).

A member shall maintain records of all non-cash compensation received by the member or its associated persons in arrangements permitted by subparagraphs (d)(2)(C)–(E). The records shall include: the names of the offerors, non-members or other members making the non-cash compensation contributions; the names of the associated persons participating in the arrangements; the nature and value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the member and its associated persons with subparagraph (d)(2)(C)–(E).

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

2720. Distribution of Securities of Members and Affiliates—Conflicts of Interest

(a) 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.

* * * * *

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

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

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

1. Purpose

In January 2000, NASD filed with the SEC proposed amendments to the Corporate Financing Rule (''Rule'') to modernize and simplify the Rule (''original proposal''). The SEC published the original proposal for comment on April 11, 2000 [18] and received 14 comment letters.[19] In January 2001, NASD submitted Amendment No. 5 to the original proposal to respond to the comments (''amended proposal''). The SEC published the amended proposal for comment on March 14, 2001[20] and received 8 comment letters [21] described later in this Section. Amendment Nos. 6 through 10 respond to the comments received.

The Corporate Financing Rule regulates underwriting compensation and prohibits unfair arrangements in connection with public offerings of securities. The Rule requires members to submit registration statements for public offerings and other supplemental information to the Corporate Financing Department (''Department'') for review. In January 2000, NASD proposed comprehensive amendments to the Rule to modernize the Rule so that it would better reflect the various financial activities of multi-service firms.

The Commission has twice published for comment the proposed amendments. Commenters praised NASD for its decision to bring clarity and consistency to the application of the Rule. They also believed that the Rule should accommodate bona fide advisory and investment activities of NASD members while continuing to protect issuers and investors from unfair or unreasonable underwriting activities.

The original proposal contained an objective standard that members and the Department could follow to determine whether any ''item of value,'' such as fees and securities received by underwriters and their affiliates should be included in the calculation of underwriting compensation under the Rule. Under this standard, all items of value received by participating members within the 180 day period before the filing of a registration statement and up to the time of the offering's effectiveness or commencement of sales (the ''Review Period'') would be included, unless the items were received in a transaction that met certain exceptions contained in the Rule. The exceptions are intended to distinguish securities and other items of value acquired as consideration for underwriting services from securities and other items of value acquired as consideration for venture capital investments and other financial services.

In the original proposal, securities acquired during the 90 days before the registration statement was filed would have been counted as compensation per se, notwithstanding whether their acquisition otherwise would meet an exception. Industry commenters strongly opposed the 90-day per se requirement and recommended the adoption of several alternative exceptions. They also recommended that the Department retain some flexibility under the Rule to make case-by-case determinations regarding whether certain items of value should be deemed to be underwriting compensation.

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[18] *See supra* note 6.

[19] As stated previously, these comment letters are discussed in the release cited in note.

[20] *See supra* note 10.

[21] Letters from Edward M. Alterman, Fried, Frank, Harris Shriver & Jacobson (''Fried Frank''), dated April 4, 2001; Goldman Sachs & Co. (''Goldman''), dated April 6, 2001; Michael T. Edsall, Kirkland & Ellis (Kirkland''), dated April 4, 2001; Christine Walsh, First Vice President and Co-Head of Investment Banking Counsel Corporate and Institutional Client Group, Merrill Lynch (''Merrill''), dated April 12, 2001; John Faulkner, Managing Director, Morgan Stanley Dean Witter (''Morgan''), dated April 10, 2001; Stuart J. Kaswell, General Counsel and Senior Vice President, Securities Industry Association (''SIA''), dated April 6, 2001; Linda DeRenzo, Testa, Hurwitz & Thibeault (''Testa''), dated April 3, 2001; and Morris N. Simkin, Winston & Strawn (''Winston''), dated February 27, 2001.

The amended proposal eliminates the 90-day *per se* requirement and adds the following:

• A 10% limitation on acquisitions of securities that meet the exception for ''purchases and loans by certain entities'' in paragraph (d)(5)(A) of Rule 2710 (''Exception 1'') and the exception for ''investments in and loans to certain issuers'' in paragraph (d)(5)(B) of Rule 2710 (''Exception 2'');

• A provision that excludes listed securities from being deemed an ''item of value;'

• The addition of insurance companies and banks as qualifying entities in Exception 1;

• An exception for securities received in connection with financial consulting and advisory arrangements, if the arrangement is detailed in a written agreement executed at least 12 months before filing; and,

• Tightened lock-up restrictions that prohibit derivative transactions that result in the effective economic disposition of locked-up shares.

The following is a description of proposed amendments to the amended proposal to which the Commission is granting accelerated approval. As noted previously, the Commission has published the filing for comment on two prior occasions.[22] All of the proposed changes from the amended proposal are in response to the comments on Amendment No. 5, except as indicated for non-substantive and conforming changes to the Rule. NASD also describes several suggestions made by the commenters that it does not support because they would not improve the Rule or would be inconsistent with its purposes.

1. Lock-Up Restrictions

The current Corporate Financing Rule imposes a one-year lock-up on securities deemed to be underwriting compensation. Securities of an issuer that are not deemed to be underwriting compensation, but are held by members of the underwriting syndicate in an IPO, are subject to a 90-day ''venture capital'' lock-up. The lock-up provisions in the Rule are intended primarily to protect the aftermarket in a new security from the potential for manipulation. The lock-up provisions as proposed to be amended also should ensure that securities acquired during the Review Period by an underwriter or related person that are not deemed to be compensation because they were acquired in transactions that meet one of the five proposed exceptions, were acquired and held as an investment in the issuer.

The original proposal replaced the one-year and 90-day lock-up provisions with a single 180-day lock-up. According to NASD, the 180-day lock-up is consistent with the industry practice to impose a 180-day lock-up on securities of the issuer held by its officers, directors and other insiders. The amended proposal further tightens the lock-up provision by prohibiting certain derivative transactions. NASD believes that this change should ensure that securities subject to the lock-up are held as an investment and minimize the opportunity for underwriters and related persons to realize a quick profit from cheap stock and warrants acquired from the issuer or its nominees during the Review Period.

Commenters (Goldman, Fried Frank, SIA and Testa) suggested changing language in the amended proposal that could be read to prevent members from participating in public offerings in which their affiliates or associated persons are selling security-holders. They also commented that the lock-up restrictions are too broad and recommended that the restrictions apply only to securities deemed to be underwriter compensation related to initial public offerings.

In response to these comments, NASD proposes to revise the language in the proposed amendments to clarify that members may participate in public offerings in which the members, their affiliates or associated persons are offering their shares or are selling security-holders of another issuer. NASD intended for the Rule to permit such participation, but the draft rule language was not clear on this point. The proposed amendments also would limit the 180-day lock-up to equity or convertible-to-equity securities and certain derivatives (''unregistered equity securities'') held by underwriters and related persons and acquired during the Review Period. NASD also proposes additional exceptions from the lock-up requirements in NASD Rule 2710(g)(2) to provide that debt securities and derivative instruments (1) that are not items of value, or (2) that are eligible for the limited filing requirement in NASD Rule 2710(b)(6)(A)(iv) and have not been deemed to be underwriting compensation by the Department under the Rule will not be locked up.

The proposed amendments retain the lock-up provision in connection with secondary offerings. Nevertheless, NASD believes that it is unusual for members and their affiliates to acquire privately placed, unregistered securities of issuers conducting secondary offerings, except pursuant to Rule 144A transactions. The proposed amendments would provide an exception from the lock-up restrictions for Rule 144A securities acquired after the completion of an issuer's IPO.

2. 10% Limitation

The original and amended proposals contained an objective standard that members and the Department would use to determine whether any ''item of value,'' such as fees and securities, received by underwriters and their affiliates must be included in the calculation of underwriting compensation under the Rule. Under this standard, all items of value received by a participating member during the Review Period would be included, unless the items were received in a transaction that met one of the enumerated exceptions contained in the proposal.

Exceptions 1 and 2 except from underwriting compensation, securities received as consideration for certain investments and loans by entities that are affiliates of members. These entities must meet certain capital and other requirements that are designed to ensure that they are engaged in bona fide businesses providing loans to, or venture capital investments in, other companies. The amended proposal also provided that the total amount of securities received by all entities related to a member in transactions meeting the requirements in Exceptions 1 and 2 may not exceed 10% of the issuer's total equity securities, calculated immediately following the transaction.

Some commenters (Fried Frank, Goldman, Kirkland, SIA and Testa) asserted that the 10% limitation undermined the usefulness of the exceptions and was unnecessary because the other requirements in the exceptions ensure that the transactions are bona fide investments or loans. NASD proposed to retain the limitation in Exceptions 1 and 2, but raise the threshold to 25%. NASD states that other conditions of the exceptions help to ensure that the transaction is a bona fide investment or loan, but a 25% limitation is a reasonable additional protection against the potential for overreaching and unfair arrangements. The 25% limitation would apply only to transactions that qualify for the particular exception. If, for example, a member receives unregistered equity securities as placement agent compensation in a transaction that qualifies under the third exception, those securities would not count toward the 25% limitation on the amount of securities that could be acquired by an

[22] *See supra* notes 6 and 10.

affiliated entity in a transaction that qualifies under Exception 1 or 2.

Exception 1 would apply the 25% threshold to all securities acquired during the Review Period, while Exception 2 would apply the 25% threshold to each acquisition of securities under that exception. Exception 1 is available for private placements and loans in which the only parties are the member's affiliate and the issuer. Accordingly, under Exception 1 a member's affiliate could structure a single financing as a series of transactions, each of which enable it to acquire no more than 25% of the issuer's total equity securities, but in combination would bring the affiliate's acquisitions well over the 25% level. By contrast, because the issuer's board of directors must approve each transaction in Exception 2, the amount of equity an issuer must provide as consideration for a particular mezzanine level financing would be certain and discrete. Consequently, Exception 1 would apply the 25% threshold to all securities acquired during the Review Period, while Exception 2 would apply the threshold on a transaction by transaction basis.

3. Entity Definition

A. *New Partnerships.* Exceptions 1 and 2 require entities to meet certain capital requirements and to be engaged in the business of making investments in or loans to other companies. Some commenters (Goldman and SIA) pointed out that many sponsors routinely carry out investment programs through a series of similar funds, although each individual fund may not meet the capital requirements in the exceptions. Other commenters (Fried Frank and Morgan) noted that a fund whose first investment is in the issuer would not be able to establish that it is engaged in the business of making investments and loans and thus it could not qualify for the exceptions, even though the fund is part of the investment program. These commenters recommended that NASD amend the Rule to treat as one entity all funds in a series of funds that are created to engage in the same business as prior funds in the series. The fund's capital and operating history thus would reflect those of the entire investment program for purposes of these exceptions. NASD does not support this change because it would introduce a highly subjective consideration (*i.e.*, whether a fund is part of an investment program) and would undermine the requirements that a qualifying entity demonstrate through its operating history that it is a bona fide business, and that it alone meets the capital standards in the exception.

B. *Group of Legal Persons.* The definition of ''entity'' for purposes of Exceptions 1 and 2 includes ''a group of legal persons'' that are contractually obligated to make co-investments *and* have previously made at least one such investment. This provision permits a group of entities to combine their capital for purposes of the exceptions, and thus permits certain joint ventures and partnerships that would not otherwise be deemed entities to take advantage of the exceptions. Some commenters recommended that the definition be broader and include: (1) entities that have entered into a co-investment agreement, but have not yet made a co-investment; or (2) entities that do not have a co-investment agreement, but have made previous co-investments. Given the potential abuse that could arise from an illegitimate ''grouping'' of different entities, the proposed amendments preserve the requirements of both a co-investment history and an agreement.

C. *Bank and Insurance Company Subsidiaries.* The amended proposal added insurance companies and banks as qualifying entities in Exception 1. These entities are separately regulated and engage in a line of business that is distinct from the underwriting business. Commenters (Goldman and SIA) suggested that because the definition of ''entity'' includes a wholly owned subsidiary of a qualifying entity, subsidiaries of banks and insurance companies could enjoy a competitive advantage over broker/dealer subsidiaries if they were not required to meet the capitalization requirements. The proposed amendments clarify that in order to qualify for the exception, subsidiaries and affiliates of banks and insurance companies that are not themselves regulated banks and insurance companies must separately meet the requirements in Exception 1.

4. Institutional Investor Definition

Rule 2710(d)(4)(B) defines ''institutional investor'' for purposes of Exception 2 and the exception for ''private placements with institutional investors'' in paragraph (d)(5)(C) of Rule 2710 (''Exception 3''). Under the amended proposal, no participating member could have any equity interest or management responsibility in an entity intending to qualify as an ''institutional investor.'' One commenter (Fried Frank) suggested that NASD amend the definition of ''institutional investor'' to permit some part of the equity interest in the entity to be held by participating members. The commenter claims that the application is otherwise too restrictive, especially with regard to widely held institutional entities like publicly owned companies or mutual funds.

In response to the comment, NASD proposes to amend the definition of ''institutional investor'' to permit a member to qualify for the exceptions so long as it holds no more than 5% of a publicly owned entity and no more than 1% of a non-public entity, such as a hedge fund.

5. Private Placements With Institutional Investors

Exception 3 addresses private placements in which: (1) Institutional investors acquire at least 51% of the total offering of the issuer's securities; (2) an institutional investor is the lead negotiator or lead investor with the issuer and establishes the terms of the private placement; and (3) underwriters and related persons do not acquire more than 20% of the total offering. Some commenters (Fried Frank and Goldman) claimed that it should be presumed that institutional investors participated in the negotiation of the transaction to the extent necessary to protect their interests if they acquire as much as 51% of an offering of privately placed securities, and that the ''lead negotiator'' or ''lead investor'' requirement is unnecessary. Some commenters further asserted that the 20% limitation is too low.

NASD does not propose any change to these provisions. NASD agrees that institutional investors generally will protect their interests, but the requirement that an unaffiliated institutional investor lead the negotiation or serve as lead investor is designed to prevent the potential overreaching that could occur if a member that is underwriting an issuer's public offering or its affiliate sets the price and terms of a private placement undertaken during the Review Period. Because the 20% limitation permits participating members to acquire only a relatively small portion of the issuer's equity in a private placement compared to the unaffiliated institutional investors, NASD views the limitation as reasonably designed to minimize the incentive for participating members to pressure an issuer to conduct the private placement for the member's benefit.

6. Transactions Completed Before Filing

Exceptions 1–3 require that the issuer's securities be acquired in transactions that occur before the required filing date of the public offering. Commenters (Fried Frank, Merrill, Morgan) suggested that, in view

of other safeguards built into the exceptions, this requirement should be deleted. Because an issuer's ability to negotiate at arm's length to raise capital directly from participating members may be particularly compromised once the members are actively engaged in soliciting investors in the public offering on behalf of the issuer, NASD believes it is appropriate to limit the exceptions to transactions that occur before filing a registration statement.

7. Preemptive Rights and Anti Dilution Rights

The exception for ''acquisitions and conversions to prevent dilution'' in paragraph (d)(5)(D) of Rule 2710 (''Exception 4'') would not apply to any purchase or acquisition that increases the participating member's percentage ownership of the same generic class of securities of the issuer. Some commenters (Fried Frank, Goldman, Merrill, Morgan and SIA) suggested that NASD revise Exception 4 to permit passive increases in ownership that may be the result of another investor's failure to exercise its own preemptive rights. NASD has revised the proposed amendments to make this change.

8. Purchases Based on a Prior Investment History

The exception for ''purchases based on a prior investment history'' in paragraph (d)(5)(E) of Rule 2710 (''Exception 5'') would provide an exception for acquisitions made in private placements during the Review Period by participating members in order to prevent dilution of a long-standing equity interest in the issuer. 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 must have been made at least 24 calendar months before the required filing date and another more than 180 days before the required filing date. Commenters (Merrill, Morgan, SIA) suggested various shorter time period requirements for the initial acquisitions that would broaden the availability of the exception. NASD included Exception 5 in response to comments on the original proposal. The time periods correspond roughly to investments the Department has recognized in the course of its filing reviews as typical of early round financing by long-term venture capital investors in start-up companies in the late 1990's and 2000. According to NASD, the trend in the current market environment is that these time periods are being extended, not shortened. NASD believes that the proposed time periods are consistent with the purposes of, and other protections in, Exception 5.

9. Financial Consulting and Advisory Arrangements

The exception for ''financial consulting and advisory arrangements'' in paragraph (d)(5)(F) of Rule 2710 (''Exception 6'') addresses securities acquired in connection with financial consulting and advisory services. Codifying an exception for the receipt of securities as consideration for these services is in contrast to the proposed treatment of *cash* paid in connection with financial consulting and advisory services, which the Department proposed to continue to evaluate on a case-by-case basis to determine whether fees were in fact received in connection with underwriting services. A commenter (Fried Frank) suggested that the Department continue to evaluate whether the receipt of securities paid in connection with these services is underwriting compensation on a case-by-case basis, rather than relying solely on the proposed exception. NASD agrees that these arrangements are so fact specific that in many cases they do not fit well into the codified exception. Accordingly, the proposed amendments delete the codified exception. The Department will continue to analyze the receipt of both cash and securities in connection with financial consulting and advisory services based on the particular facts and circumstances in the arrangements.

10. Listed Securities

The amended proposal excluded from ''items of value,'' listed securities of the issuer that are purchased in public market transactions. Commenters (Fried Frank, Goldman and SIA) suggest that the exclusion is too narrow and should instead extend to securities that are freely trading or acquired in transactions with persons unaffiliated with the issuer. Alternatively, one commenter (SIA) suggested that the definition of listed securities should be amended to specify the markets and exchanges on which securities may be listed to qualify for the exception. NASD has amended the Rule to specify eligible markets and exchanges. NASD believes that expanding the definition to include all freely trading securities or those acquired from unaffiliated persons would create unacceptable opportunities to evade the Rule and consequently NASD has not adopted the change.

11. When Securities Are Considered Received

The original and amended proposals provided that securities will be considered ''received'' as of the date of the closing of the private placement, not at the date a commitment letter is signed. One commenter (Fried Frank) suggested that one relevant date should be the date on which the buyer is unconditionally bound to purchase. The Department made several, ultimately unsuccessful attempts to review commitment letters and work with counsel to determine whether market-out and other termination clauses typically found in commitment letters render them binding contracts. The date of closing a private placement, when beneficial ownership is transferred, continues to be the best and most reliable indicator of when securities are received. Consequently, NASD has not made the recommended change.

12. Items of Value Received After Completion of an Offering

The amended proposal would require members to file information with the Department regarding the receipt of items of value by participating members during the 90 day period following the effective date of a registration statement. One commenter (Fried Frank) asserted that the provision would be too burdensome. NASD believes that the information is necessary to prevent fraudulent conduct and that the provision is a reasonable, narrowly defined mechanism to ensure that members comply with the Rule.

13. Non-Qualified Employee Benefit Plans

The amended proposal would have excluded from items of value securities acquired through certain plans that qualify under Section 401 of the Internal Revenue Code. Commenters (Fried Frank and Goldman) suggested that the provision be expanded to include securities received under non-qualified employee benefit plans. Under such a revision, the Department staff would be required to investigate and analyze who owns the assets, directs the trading and exercises control in the various non-qualified plans. NASD is not confident that the Department would always be provided with all necessary information on a timely basis from which it could conclude that a particular plan is not, for example, substantially an investment vehicle for employees in the investment banking or syndicate departments, or their relatives or nominees. Consequently, NASD has not made the recommended change.

14. Non-Cash Compensation

One commenter (Winston) suggested that the Rule be amended so that its treatment of non-cash compensation conforms to the requirements in the rules regulating investment company sales charges and variable annuities. The proposed amendments do not address this issue. NASD currently is working on rule amendments that would address the issue comprehensively under both the Corporate Financing Rule and NASD Conduct Rule 2810 (Direct Participation Programs).

15. Certain Derivative Securities

NASD also proposes additional amendments to the definition of ''item of value'' so that it does not have the unintended effect of capturing within ''underwriting compensation'' certain derivative and other instruments that are entered into by members or related persons in the ordinary course of business. As proposed, the definition of ''items of value'' would include derivative instruments and certain other transactions that were not intended to be included in the compensation provisions. Accordingly, NASD proposes to add subsections (c)(3)(B)(vi) and (vii) to NASD Rule 2710, which provide that nonconvertible or non-exchangeable debt securities and derivative instruments acquired or entered into: (i) for a fair price; (ii) in the ordinary course of business; and (iii) in transactions unrelated to the public offering; are not ''items of value'' under the Rule. Because they are not items of value, they would also be excluded from the lock-up requirements in the Rule, as discussed above. In addition, any securities received in settlement of the derivative entered into at a fair price would not have any compensation value.

The term ''fair price'' would be defined in NASD Rule 2710(a)(9) to require that the underwriters and related persons have priced the non-convertible or non-exchangeable debt security or derivative instrument in good faith, on an arm's length basis, in a commercially reasonable manner, and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions. This ''fair price'' definition is intended to distinguish covered debt and derivative transactions from a transaction in which the benefit to the underwriter or related person is related to the underwriting or similar services provided to the issuer. The proposed definition would exclude a derivative instrument or other security received for acting as a private placement agent for the issuer, for providing or arranging a loan, credit facility, merger, acquisition or any other service, including underwriting services.

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

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

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

IV. Commission Findings and Order Granting Accelerated Approval to Proposed Rule Change

The Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities association. In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,[23] which requires that an Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest.[24] The Commission believes that the proposed rule change should permit members to provide legitimate capital-raising services to issuers, while adopting restrictions that are designed to minimize the opportunity for abusive practices by members.

Current NASD Rule 2710 requires the terms of an underwriting to be fair and reasonable. Under the current Rule, any item of value, including certain securities of the issuer, acquired by the underwriter and related persons during the 12-month period before the filing date of a proposed public offering is examined by the Department to determine whether it was acquired ''in connection with the public offering'' and, therefore, is deemed to be underwriting compensation. The Rule presumes that any such item of value acquired during the six-month period before filing is underwriting compensation, but this presumption may be rebutted by the member based on information satisfactory to the Department. The proposed rule change replaces the current subjective standard with an objective standard under which all items of value received by an underwriter or related person during the 180 days before the required filing date of the registration statement or similar document will be considered to be underwriting compensation in connection with a public offering. Items

[23] 15 U.S.C. 78*o*–3(b)(6).

[24] In approving this rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

of value that are not disclosed to NASD, and items of value that are received subsequent to the public offering, would be subject to post-offering review to determine whether they were underwriting compensation for the public offering. The proposed rule also contains five exceptions from the general rule that an ''item of value'' is deemed to be underwriting compensation. The Commission believes that replacing the subjective test with an objective, bright-line test should provide greater clarity and predictability regarding whether equity securities of the issuer and other items of value acquired by the underwriter and related persons constitute underwriting compensation. In addition, it should permit the NASD to better use its resources.

A. Six-Month Pre-Offering Test

As stated above, the proposed rule change replaces the current subjective standard with an objective standard under which all items of value received by an underwriter or related person during the 180-day period before the required filing date of the registration statement or similar document will be considered to be underwriting compensation in connection with a public offering. Under the current Rule, the Department examines all items of value acquired by the underwriter and related persons during the 12-month period before the filing date of a proposed public offering. The Commission believes that a bright-line test should provide greater clarity and predictability concerning application of the Rule to specific transactions. Consequently, members and their venture capital and lending affiliates should find it easier to determine at the time of a private placement or other financing whether their investment will be treated as underwriting compensation when the subsequent public offering is filed with the Department for review. The Commission also believes that shortening the time-frame from one year to six months is reasonable and reflects the NASD's experience that a longer time frame has generally been unnecessary to minimize the opportunity for abusive practices by members. The Commission also notes that commenters generally supported shortening the look-back period to 180 days.

Several commenters 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. According to NASD, 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 during the 180-day period preceding the filing date. Consequently, the NASD is not going to amend the rule. The Commission believes it is reasonable for the NASD to measure the review period from the required filing date, rather than the date the preliminary prospectus is circulated.

B. Undisclosed and Post-Offering 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 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.''

In response to the concerns of commenters, NASD narrowed the scope of the rule. As amended, proposed Rule 2710(d)(2) would provide that all items of value received and all arrangements entered into for the future receipt of an item of value by a participating member that are not disclosed to NASD before 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. In addition, 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 NASD and during the 90-day period following the date of effectiveness or commencement of the public offering. These provisions will enable NASD staff to 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.

C. Items of Value

Current Rule 2710(c)(3)(A) sets forth the items of value that are to be included in the calculation of underwriting compensation. NASD proposed to make non-substantive amendments to the description of the types of equity securities that are included. In addition, in response to comments, NASD is proposing several changes to Rule 2710(c)(3)(B), which sets forth exclusions from ''items of value.'' The proposal would expand this section by adding: (i) 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; (ii) listed securities purchased in public market transactions; (iii) securities acquired through any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code; (v) securities acquired by an investment company registered under the Investment Company Act of 1940; (vi) non-convertible or non-exchangeable debt securities acquired for a fair price in the ordinary course of business in transactions unrelated to the public offering; and (vii) derivative instruments (and any securities received in settlement thereof) entered into for a fair price in the ordinary course of business in a transaction unrelated to the public offering.

The Commission believes that the proposal codifies exclusions for ''items of value'' that should not raise concerns about abuse and overreaching. As noted above, securities received in settlement of a derivative entered into at a fair price would not be considered an item of value. The Commission believes that it is reasonable to exempt any securities received in settlement of a derivative entered into at a fair price because the derivative transaction itself is not considered to be an item of value and, thus, the securities received in settlement (like any cash received in settlement in the case of a cash-settled derivative) would not represent any additional value.

Some commenters suggested that the exclusion for listed securities that are purchased in public market transactions is too narrow and should instead extend to securities that are freely trading or acquired in transactions with persons not affiliated with the issuer. Another commenter suggested that the definition of listed securities should be amended to specify the markets and exchanges on which securities may be listed to qualify for the exception. NASD has amended the Rule to specify eligible markets and exchanges. NASD believes that expanding the definition to include all freely trading securities or those acquired from unaffiliated persons would create unacceptable opportunities to evade the Rule. The Commission agrees.

D. Exceptions to the General Rule

The proposed rule change provides five exceptions from the general rule that items of value received within 180 days of the required filing date of a registration statement or similar document will be considered to be underwriting compensation.

1. 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 would be available to an entity that: (i) 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; (ii) 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; (iii) is an insurance company as defined under Section 2(a)(13) of the Securities Act of 1933, or a foreign insurance company that has been given an exemption; or (iv) is a bank as defined in Section 3(a)(6) of the Act or is a foreign bank that has been granted an exemption. In addition to those requirements, the entity must: (i) Be a separate and distinct legal person from any member and not be registered as a broker-dealer; (ii) make investments or loans subject to the evaluation of individuals who have a contractual or fiduciary duty to select investments and loans based on risks and rewards, not on opportunities for the member to earn investment banking revenues; (iii) not participate directly in investment banking fees received by any participating member for underwriting public offerings; and (iv) have been primarily engaged in the business of making investments in or loans to other companies. Finally, all entities related to each member in acquisitions that qualify for this exemption cannot acquire more than 25% of the issuer's total equity securities during the review period.

The Commission believes that the proposed exceptions accommodate bona fide acquisitions by entities that regularly make venture capital investments. The Commission also believes that the limitations of the exception, such as the capital under management requirement, and the 25% acquisition limit, are reasonably designed to minimize the opportunity for abusive practices. The Commission notes that the acquisition limitation was previously proposed to be 10% of the issuer's total securities. In response to the concerns of commenters, NASD has proposed to raise this limit to 25%. The Commission believes that the other conditions of the exception should help to ensure that the transactions are bona fide investments or loans, and the 25% limitation is sufficient as a reasonable additional protection against overreaching and unfair arrangements.

2. 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 in their corporate governance. Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility would be exempt if each entity: (i) Manages capital contributions or commitments of at least $50 million; (ii) is a separate and distinct legal person from any member and is not registered as a broker/dealer; (iii) does not participate directly in investment banking fees received by the member for underwriting public offerings; and (iv) has been primarily engaged in the business of making investments in or loans to other companies. The following additional requirements would apply: (i) Institutional investors must beneficially own at least 33% of the issuer's total equity securities, calculated immediately before the transaction; (ii) 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 (iii) all entities related to each member in acquisitions that qualify for this exception do not acquire more than 25% of the issuer's total equity securities, calculated immediately following the transaction.

The Commission believes this exception is reasonable and should permit bona fide investments in issuers with significant institutional investor involvement in their corporate governance. The Commission believes that the limitations of this exception, such as the requirement of substantial involvement of institutional investors, should minimize the potential for overreaching and abuse. As stated above, the Commission notes that the acquisition limitation was previously proposed to be 10% of the issuer's total securities. In response to the concerns of commenters, NASD has proposed to raise this limit to 25%. The Commission believes that the other conditions of the exception should help to ensure that the transactions are bona fide investments or loans, and the 25% limitation is sufficient as a reasonable additional protection against overreaching and abuse.

a. Definition of ''Entity''

Exceptions 1 and 2 require entities to meet certain capital requirements and to be engaged in the business of making investments in or loans to other companies. Some commenters recommended that NASD amend the Rule to treat as one entity all funds in a series of funds that are created to engage in the same business as prior funds in the series. NASD determined not to adopt the suggested amendment because it believed that it would introduce a highly subjective consideration (*i.e.*, whether a fund is part of an investment program) and would undermine the requirement that a qualifying entity demonstrate through its operating history that it is a bona fide business, and that it alone meets the capital standards in the exception. The Commission believes that the proposed definition of ''entity'' is an objective standard that should be more easily administered by the Department than the standard suggested by comments. The Commission also believes that it is reasonable for the NASD to retain the requirement that each qualifying entity demonstrate through its operating history that it is a bona fide business.

In addition, the definition of ''entity'' for purposes of exceptions 1 and 2 includes ''a group of legal persons'' that are contractually obligated to make co-investments and have previously made at least one such investment. Some commenters recommended that the definition be broader and include: (1) Entities that have entered into a co-investment agreement, but have not yet made a co-investment; or (2) entities that do not have a co-investment agreement, but have made previous co-investments. NASD determined not to make this change because of the potential abuse that could arise from an illegitimate ''grouping'' of different entities; the proposed rule preserves the requirements of both a co-investment history and an agreement. The Commission believes that the proposed definition is reasonable and should minimize any potential for abuse.

3. Private Placements With Institutional Investors

Exception 3 would permit acquisitions in private placements that have significant institutional investor participation. This exception would permit private placements in which: (1)

Institutional investors acquire at least 51% of the total offering of the issuer's securities; (2) an institutional investor is the lead negotiator or lead investor with the issuer and establishes the terms of the private placement; and (3) underwriters and related persons do not acquire more than 20% of the total offering. Some commenters claimed that it should be presumed that institutional investors participated in the negotiation of the transaction to the extent necessary to protect their interests if they acquire as much as 51% of an offering of privately placed securities, and that the ''lead negotiator'' or ''lead investor'' requirement is unnecessary. Some commenters further asserted that the 20% limitation is too low.

NASD did not propose any changes in response to these comments. The Commission believes that the 20% limitation and the requirement that an unaffiliated institutional investor lead the negotiation or serve as lead investor are reasonable limitations designed to prevent the potential for overreaching that could occur if a member that is underwriting an issuer's public offering or its affiliate sets the price and terms of a private placement undertaken during the Review Period.

a. Definition of ''Institutional Investor''

For purposes of exceptions 2 and 3, ''institutional investor'' is defined as any individual or legal person that has at least $50 million invested in securities in the aggregate in its portfolio or under management, including investments held by its wholly owned subsidiaries; provided that no participating members direct or otherwise manage the institutional investor's investments or have an equity interest in the institutional investor, either individually or in the aggregate, that exceeds 5% for a publicly owned entity or 1% for a nonpublic entity. Under a previous version of the proposal, no participating member could have any equity interest or management responsibility in an entity intending to qualify as an ''institutional investor.'' Commenters stated that the definition of ''institutional investor'' should be amended to permit some part of the equity interest in the entity to be held by participating members. Other commenters stated that equity interest should not be the determinative factor, but rather control. In response to comments, NASD decided to amend the definition to allow an equity interest in the institutional investor, either individually or in the aggregate, of up to 5% for a publicly owned entity or 1% for a nonpublic entity. The Commisison believes that this limitation is reasonable and should help to ensure that only institutional investors that are independent of the influence of members will count for purposes of exceptions 2 and 3.

4. Acquisitions and Conversions To Prevent Dilution

Under the proposal, securities of the issuer would be excluded from underwriting compensation if the securities were acquired as the result of: (i) A qualifying right of preemption or a stock-split or a pro-rata rights or similar offering, or (ii) the conversion of securities that have not been deemed by NASD to be underwriting compensation. In addition, the only terms of the purchased securities that could be different from the terms of securities purchased by other investors would be pre-existing contractual rights that were granted in connection with a prior purchase. Further, the opportunity to purchase must have been provided to all similarly situated securityholders. Finally, the amount of securities purchased or received must not have increased the recipient's percentage ownership of the same generic class of securities of the issuer, except in the case of conversions and passive increases that result from another investor's failure to exercise its own rights.

Under a previous version of the proposal, this exception would not have applied to any purchase or acquisition that increased the participating member's percentage ownership of the same generic class of securities of the issuer. In response to comments, NASD revised the exception to permit passive increases in ownership that may be the result of another investor's failure to exercise its own preemptive rights.

The Commission agrees with NASD that this exception does not raise concerns about overreaching and abusive practices that the Rule was designed to address because purchases pursuant to a right of preemption are based on a purchase right granted to the purchaser in a prior investment and thus, the acquisition is not compensation for a subsequent public offering. The Commission further believes that the limitations of the exception should help to ensure that only securities acquired pursuant to a valid right of preemption will be eligible to be excluded from the underwriting exception. The Commission also believes that it is reasonable to permit passive increases in ownership that may be the result of another investor's failure to exercise its own preemptive rights. The Commission notes that shareholders frequently must decide whether to exercise their preemptive rights without knowing whether other shareholders will do the same. Consequently, without an exception for passive increases, it would be virtually impossible to determine in advance whether shares acquired pursuant to a right of preemption would be deemed underwriting compensation.

5. Purchases Based on a Prior Investment History

This exception would exempt acquisitions made in private placements during the Review Period by participating members in order to prevent dilution of a long-standing equity interest in the issuer. 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 must be made at least 24 calendar months before the required filing date and another more than 180 days before the required filing date. Commenters suggested various shorter time period requirements for the initial acquisitions that would broaden the availability of the exception. NASD included this exemption in response to comments on the original proposal. NASD has stated that the time periods correspond roughly to investments the Department has recognized in the course of its filing reviews as typical of early round financing by long-term venture capital investors in start-up companies in the late 1990's and 2000. The Commission believes that this exemption is reasonable and would codify NASD's historic practice of exempting such securities from underwriting compensation. In addition, the Commission believes that the proposed time periods are reasonable in that they reflect NASD's experience with such acquisitions.

6. Financial Consulting and Advisory Arrangements

Prior versions of the proposal contained an exemption that addressed securities acquired in connection with financial consulting and advisory services. A commenter suggested that the Department continue to evaluate whether the receipt of securities paid in connection with these services are underwriting compensation on a case-by-case basis, rather than solely relying on the proposed exception. NASD determined that these arrangements are so fact specific that in many cases they do not fit well into a codified exception and, thus, proposed to delete this exception. Consequently, the Department would continue to analyze the receipt of both cash and securities in connection with financial consulting

and advisory services based on the particular facts and circumstances in the arrangements. The Commission believes that it is within NASD's discretion to delete this exception and to continue to review such acquisitions based on the particular facts and circumstances.

E. Lock-Up Restriction

Under the proposal, common or preferred stock, options, warrants, and other equity securities of the issuer that are unregistered and acquired by an underwriter and related person within 180 days before the filing of the registration statement, or acquired after the filing of the registration statement and deemed to be compensation by NASD, would be subject to a 180-day lock-up. The proposed lock-up also would prohibit certain derivative transactions.[25] In addition, the proposal contains several exceptions to the lock-up restriction for transfers of securities, including, but not limited to, transfers of securities that are not considered to be an item of value, transfers by operation of law or reorganization of the issuer, and transfers of securities that were previously, but no longer are, subject to a lock-up restriction in connection with a prior public offering.

Under the original version of the proposal, a 180-day lock-up restriction would have applied to 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. In response to comments, NASD determined to limit the 180-day lock-up to unregistered equity or convertible-to-equity securities and certain derivatives held by underwriters and related persons and acquired during the Review Period. Despite contrary views of commenters, NASD determined to retain the lock-up provision in connection with secondary offerings. However, the proposal would provide an exception from the lock-up restrictions for Rule 144A securities acquired after the completion of the issuer's IPO. In addition, in response to comments, NASD is proposing to amend the proposed rule change to clarify that members may participate in public offerings in which the members, their affiliates or associated persons are offering their shares or are selling security-holders of another issuer.

[25] However, as discussed above, debt securities and derivative instruments (1) that are not items of value, or (2) that are eligible for the limited filing requirement in NASD Rule 2710(b)(6)(A)(iv) and have not been deemed to be underwriting compensation by the Department under the Rule will not be subject to the lock-up.

NASD has stated that it intended to permit such participation, but the prior version of the proposal was unclear.

The Commission believes that the proposed lock-up restrictions, and exceptions thereto, are reasonably designed to protect the aftermarket in a new security from the potential for fraud and manipulation that exists when a member is an underwriter, actively trades the securities, and is a selling security-holder. The Commission further believes that the proposed prohibition against any hedging, short sale, derivative, put, or call transaction that would result in the effective economic disposition of the securities should help to prevent circumvention of the lock-up restrictions.

F. Exemptive Authority

Under the proposal, the NASD has retained the ability to grant exemptions from any provision of the Rule, if such exemption is consistent with the purposes of the Rule, the protection of investors, and the public interest. The Commission believes that this exemptive authority is reasonable and should give NASD the authority to exempt transactions that, although covered by the Rule, the Rule was not intended to address.

The Commission finds good cause for accelerating approval of Amendment Nos. 6, 7, 8, 9, and 10. The Commission notes that the proposed rule change has been previously published twice for comment.[26] Amendment Nos. 6 through 10 respond to the concerns previously raised by commenters and make certain technical corrections to the proposed rule change. Accordingly, the Commission finds that good cause exists, consistent with Sections 15A(b)(6) of the Act,[27] and Section 19(b)(2) of the Act [28] to accelerate approval of Amendment Nos. 6 through 10 to the proposed rule change prior to the thirtieth day after publication in the **Federal Register**.

V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 6 through 10, including whether the amendments are 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. Comments may also be submitted electronically at the following e-mail address: *rulecomments@sec.gov.* All comment letters should refer to File No. SR–NASD–00–04. This file number should be included on the subject line if e-mail is used. To help the Commission process and review comments more efficiently, comments should be sent in hard copy or by e-mail but not by both methods.

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 NASD. All submissions should refer to File No. SR–NASD–00–04 and should be submitted by January 21, 2004.

VI. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[29] that the proposed rule change (SR–NASD–00–04), as amended, is approved, and Amendment Nos. 6 through 10 are approved on an accelerated basis.

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

Jill M. Peterson,

Assistant Secretary.

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[26] *See supra* notes 6 and 10.

[27] 15 U.S.C. 78*o*–3(b)(6).

[28] 15 U.S.C. 78s(b)(2).

[29] 15 U.S.C. 78s(b)(2).

[30] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–48976; File No. SR–PCX–2003–68]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Pacific Exchange, Inc. Relating to Exchange Fees and Charges

December 23, 2003.

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 December 16, 2003, the Pacific Exchange, Inc. (''PCX'' or ''Exchange'') filed with the Securities and Exchange Commission

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

[2] 17 CFR 240.19b–4.