

Notice To Members

National Association of Securities Dealers, Inc.

May 1992

Number 92-28**Suggested Routing:***

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| <input checked="" type="checkbox"/> Senior Management | <input type="checkbox"/> Internal Audit | <input type="checkbox"/> Operations | <input checked="" type="checkbox"/> Syndicate |
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*These are suggested departments only. Others may be appropriate for your firm.

Subject: SEC Approval of Corporate Financing Rule and Code of Procedure for Corporate Financing and Direct Participation Program Matters**EXECUTIVE SUMMARY**

The Securities and Exchange Commission (SEC or Commission) has approved new Article III, Section 44 of the Rules of Fair Practice (Corporate Financing Rule or Rule), for the review of underwriting terms and arrangements in connection with public offerings. The new Rule replaces the current Interpretation of the Board of Governors — Review of Corporate Financing, Article III, Section 1 of the Rules of Fair Practice (Inter-

pretation) in its entirety. Simultaneously, the SEC approved new Article XII to the Code of Procedure (Code) to provide a procedure for the review of NASD staff determinations regarding compliance with NASD rules relating to corporate financing and direct participation program matters. The new provisions are effective immediately. A copy of the SEC release approving these changes and the text of the Rule and the Code are attached to this Notice.

BACKGROUND

Article III, Section 1 of the NASD Rules of Fair Practice obligates members, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade. In the early 1960s, the NASD began reviewing underwriting terms and arrangements of public securities offerings in which members participated to determine whether those terms and arrangements complied with the broad standard of fairness in Article III, Section 1. By 1970, the criteria for determining fairness and reasonableness had become more defined. These were incorporated into the Interpretation, which made it a violation of NASD rules to participate in any public offering

where the underwriting terms and arrangements are unfair and unreasonable. By the 1980s, the NASD had determined that the Interpretation no longer accurately reflected the standards of fairness applied to NASD members participating in public offerings and proposed a new Corporate Financing Rule to replace the Interpretation.

Attached to this Notice is a copy of the SEC release approving the adoption of the Rule and the Code for your review. The SEC release sets out in detail a description of each section of the Rule and the Code and specifically identifies those provisions which change the current requirements of the Interpretation or current practice as implemented by the NASD. Incorporated in the new Rule are

new filing requirements related to offerings filed with the SEC on Forms F-9 and F-10 by Canadian private and crown corporations. The SEC approved these forms as part of the Multi-Jurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers ("MJDS"). Also attached is a copy of the text of the new Rule and the new Code provision. Schedule A to the NASD By-Laws will also be amended to reflect the revised description of the calculation of the Corporate Financing filing fee that is set forth in Subsection (b)(10) of the Rule.

Following is a discussion of certain provisions of the new Rule that the NASD believes should be clarified or explained in greater detail. Commenters on these provisions as originally published for comment by the NASD in *Notice to Members 88-92* (November 1988) raised a number of issues that the NASD considered and addressed in its rule filing with the SEC proposing to adopt the Rule.

Subsection (b) Filing Requirements

Information Required To Be Filed

The Rule requires persons filing documents to provide certain information on the offering. The required information sets forth the basic compensation terms and arrangements and identifies whether any officer, director, or security holder of the issuer is associated or affiliated with any member. The importance of providing a reliable statement as to the association or affiliation which may exist between the issuer and any members cannot be overstated. The proper application of several provisions of the Rule as well as Schedule E to the By-Laws depends on understanding the precise nature of such relationships. In its review of a proposed offering, NASD staff will accept a statement of a member or its counsel based on their reasonable inquiry into the background of the stockholders of the issuer and any transactions between the issuer and the underwriter and related persons. Statements provided to the NASD that are limited to the issuer's knowledge and belief are not sufficient. Members and their counsel must determine which procedures to use and whether those procedures permit them to represent to the NASD that they have made a reasonable inquiry sufficient to provide statements that the NASD can rely on when reviewing the offering.

Filing Fees

The Rule provides that a filing fee equal to \$500 plus .01 percent of the gross dollar amount of the offering must be paid at the time the initial documents relating to any offering are filed. The maximum filing fee is \$30,500 and may be rounded to the nearest dollar. The Rule provides that the filing fee be paid, only in the form of a check or money order, to the National Association of Securities Dealers, Inc. The NASD will no longer accept cash tendered with the filing of an offering.

Subsection (c) Underwriting Compensation And Arrangements

Unreasonable Terms and Arrangements

■ **Nonaccountable Expense Allowance —**

This subsection of the Rule contains several provisions that deal with the treatment of nonaccountable expense allowances, out-of-pocket expenses, and payment for transactions in lieu of a public offering. The list of unfair and unreasonable arrangements includes a new provision prohibiting any nonaccountable expense allowance in excess of 3 percent of offering proceeds. Nonaccountable expense allowances of up to 3 percent are usually justified by members as being reflective of actual out-of-pocket offering expenses. The NASD also determined that it would be unduly burdensome to require an accounting of expenses as long as the level of reimbursement is below 3 percent. The Rule permits expense reimbursements in excess of 3 percent of offering proceeds only if the entire reimbursement is paid on an accountable basis. Accountable expenses may not include general overhead, salaries, supplies, or similar expenses incurred in the normal conduct of business.

■ **Prepayment of Expenses —** It is also an unreasonable arrangement for an underwriter to receive commissions or reimbursements for expenses before the public offering of securities, except for reimbursing direct out-of-pocket accountable expenses the underwriter and related persons actually incurred in preparation for the offering. A member may receive an advance on such expenses provided that the amount of the advance bears a reasonable relationship to the actual amount of accountable expenses anticipated to be incurred during the registration period and before the effectiveness of the offering.

■ **Uncompleted Offerings —** The Rule also

clarifies that paying compensation to a member or person associated with a member in an uncompleted public offering is considered unfair and unreasonable. This provision reflects a long-standing policy that members should not be reimbursed for lost profits in offerings that are not completed in accordance with the agreement between the issuer and the underwriter. This discourages members from entering into underwriting agreements to obtain payment of what are, in essence, consulting fees without a bona fide intent to distribute the issuer's securities.

At the same time, the NASD has also applied its long-standing policy not to object to a "merger or acquisition" clause in the letter of intent that would permit the member to receive a specific fee pursuant to a formula if, as a result of the member's efforts, the issuer enters into a merger with or is acquired by another company. Therefore, this provision excludes any payment that is "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."

Valuation of Noncash Compensation — the Warrant Formula

The Rule contains the warrant formula utilized by the Corporate Financing Department to determine the value of options, warrants, or convertible securities received as underwriting compensation. The following example illustrates the application of the warrant formula when an underwriter proposes to receive a warrant to purchase common stock. An offering of one million shares of common stock at \$3 per share where the underwriter proposes to receive, for no consideration, warrants for 100,000 shares of common stock (the maximum number permitted under the terms of the Stock Numerical Limitation) exercisable at 120 percent of the public offering price, the formula would be applied as follows.

- Step (i) — The proposed public offering price per security multiplied by 65 percent:

$$\$3.00 \times .65 = \$1.95$$

- Step (ii) — Minus the difference between the exercise price per security (\$3.00 x 120 percent = \$3.60) and the public offering price:

$$\$1.95 - (\$3.60 - \$3.00) = \$1.35$$

- Step (iii) — Divided by 2:

$$\frac{\$1.35}{2} = 0.675$$

- Step (iv) — Multiplied by the number of warrants to be received as underwriting compensation:

$$\$0.675 \times 100,000 = \$67,500$$

- Step (v) — Less the price paid for the securities:

$$\$67,500 - \$0.00 = \$67,500$$

- Step (vi) — Divided by the offering proceeds:

$$\frac{\$67,500}{\$3,000,000} = .0225$$

- Step (vii) — Multiplied by 100:

$$.0225 \times 100 = 2.25\%$$

The Department also utilizes a simplified warrant valuation formula (simplified formula), derived from the formula illustrated above. This simplified formula is most useful when the consideration paid for an underwriter's warrant is nominal, which is usually the case. The formula is:

$$\frac{165 \text{ percent} - (\text{variable 1}) \times (\text{variable 2})}{2} = \text{compensation value}$$

Variable 1 is the underwriter's exercise price, expressed as a percentage of the public offering price. Variable 2 is the number of securities underlying the underwriter's warrants, expressed as a percentage of the total number of shares being offered to the public. The compensation value is the value attributable to the warrants, expressed as a percentage of the aggregate offering proceeds. Using the same example illustrated earlier, the simplified formula can be applied by inserting values for variable 1 and variable 2. Variable 1 in the preceding example would be 120 percent, as the

underwriter's exercise price of \$3.60 was 120 percent of the public offering price of \$3, and variable 2 would be 10 percent, as the underwriter received a warrant to acquire 100,000 shares which, when divided by the one million shares being offered to the public, equals 10 percent. Therefore, the simplified formula would also yield a valuation of 2.25 percent of the aggregate offering proceeds.

$$\frac{165 \text{ percent} - 120 \text{ percent}}{2} \times 10 \text{ percent} = 2.25 \text{ percent}$$

Underwriters generally propose to receive warrants representing 10 percent of the securities offered. With 10 percent as a constant number of securities, and assuming that the underwriter pays little or nothing for the warrants, the following compensation values result from application of the formula at various warrant exercise prices:

Warrant exercise price as percent of the public offering price	Compensation value (percent)
100	3.25
107	2.90
110	2.75
115	2.50
120	2.25
125	2.00
130	1.75
135	1.50
140	1.25
145	1.00
150	.75
155	.50
160	.25
165	0

In the event an underwriter receives a unit purchase option in a public offering of units, the NASD must adjust application of the formula to reflect both the composition of the units and the difference between the underwriter's exercise price and the public offering price of each component of the units. For example: an offering of one million units at \$1 per unit, where each unit is comprised of one share of common stock and two common stock purchase warrants, each such warrant exercisable at \$1.50 per share. The underwriter proposes to receive a unit purchase warrant to acquire

100,000 units at \$1.20 per unit, or 120 percent of the public offering price per unit. Each underwriter unit is identical to the public units, which means the common stock purchase warrants underlying the units are also exercisable at \$1.50 per share, or 100 percent of the public exercise price. The compensation calculation would involve the following steps.

(1) Fully dilute the offering — determine the total number of shares underlying the units distributed to the public including those shares underlying warrants within the units:

shares within the units	1,000,000
shares underlying unit warrants	2,000,000
total number of shares	3,000,000

The number of fully diluted shares does *not* include any shares to be received by the underwriter.

(2) Divide the shares within the underwriter's unit by the number of fully diluted shares obtained in step (1):

shares within underwriter's unit	100,000
fully diluted shares	3,000,000
	= 3.33 percent

(3) Divide the number of shares issuable on exercise of the warrants included in the underwriter's unit by the number of fully diluted shares:

shares underlying underwriter's unit warrants	200,000
fully diluted shares	3,000,000
	= 6.67 percent

(4) Calculate the compensation value of the shares to be valued at the underwriter's unit exercise price:

$$\frac{165 \text{ percent} - 120 \text{ percent}}{2} \times 3.33 \text{ percent} = .75 \text{ percent}$$

This is the value attributable to the shares within the unit to be acquired by the underwriter.

(5) Calculate the compensation value of the shares issuable on exercise of the underwriter's

unit warrants:

$$\frac{165 \text{ percent} - 100 \text{ percent} \times 6.67 \text{ percent}}{2} = 2.17 \text{ percent}$$

This is the value attributable to the shares issuable on exercise of the warrants contained in the unit to be acquired by the underwriter.

(6) Add the compensation values obtained in steps (4) and (5):

$$.75 \text{ percent} + 2.17 \text{ percent} = \underline{2.92 \text{ percent}}$$

The total compensation value (2.92 percent) is expressed as a percentage of the aggregate proceeds of the offering.

SUMMARY OF CODE OF PROCEDURE

The Code of Procedure for Corporate Financing and Direct Participation Program Matters provides procedures for requesting review of determinations based on the Corporate Financing Department staff's review of public offerings. Only a

member aggrieved by a determination of the Department may make application for review of the Department's determination. A hearing committee of a national standing committee of the Board of Governors will conduct the review. In appealing a hearing committee's determination, the Code specifies that such appeal must be requested within 15 business days following the hearing committee's written determination. The Director of Corporate Financing will issue the hearing committee's written determination on its behalf. The Code also clarifies that determinations of hearing committees or standing committees are advisory in nature and that only a District Business Conduct Committee shall make a finding of a violation of any rule, interpretation, or policy.

EFFECTIVENESS OF RULE AND CODE

The Corporate Financing Rule and the Code of Procedure were approved by the SEC on April 15, 1992 and are effective immediately. Questions concerning this Notice may be directed to Charles L. Bennett, Director, or Richard J. Fortwengler, Associate Director, NASD Corporate Financing Department, at (202) 728-8258.

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[Release No. 34-30587; File No. SR-NASD-91-19]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to Codification of the Corporate Financing Interpretation

April 15, 1992.

Introduction

The National Association of Securities Dealers, Inc. ("NASD" or "Association")

submitted on April 26, 1991, and amended on November 22, 1991, December 16, 1991, March 3, 1992 and March 20, 1992¹ a proposed rule change pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")² and rule 19b-4 thereunder.³ The proposal adopts a new Rule of Fair Practice (the "Corporate Financing Rule" or "Rule") to replace in its entirety the current Interpretation of the Board of Governors—Review of Corporate Financing (the "Corporate Financing Interpretation" or "Interpretation").

The NASD also proposes to codify the Association's practice related to procedures governing requests for review of NASD Corporate Financing Department determinations in new article XII to the NASD Code of Procedure ("Article XII"). Attached as *Exhibit A* to this Order is the complete language of the Rule. In addition, the NASD is also proposing to make conforming changes to Schedule A to the NASD By-Laws to reflect the revised description of the calculation of the Corporation Financing filing fee that is

¹ Notice of Amendment No. 1 to SR-NASD-91-19 was provided in notice of SR-NASD-91-82 (Securities Exchange Act Release No. 30281, January 22, 1992) (57 FR 3449, January 23, 1992). In SR-NASD-91-82, the NASD proposed to amend exemptions from the Filing Requirements of the Corporate Financing Interpretation to recognize SEC Forms F-9, F-10, and F-3 (i.e., public offerings of securities registered with the SEC on those forms need not be filed with the Association for review). Amendment No. 1 to SR-NASD-91-19 made parallel changes to the Corporate Financing Rule. The NASD requested in a letter from Suzanne E. Rothwell, Associate General Counsel, NASD, to Katherine A. England, Branch Chief, Over-the-Counter Regulation, SEC, dated March 19, 1992 that SR-NASD-91-82 be withdrawn simultaneously with the approval by the SEC of SR-NASD-91-19.

Amendment No. 2 to SR-NASD-91-19 made technical changes to this filing to withdraw the language set forth in Amendment No. 1 that would have unintentionally narrowed Subsection (b)(7)(A) of the Filing Requirements. Amendment No. 3 to SR-NASD-91-19 made technical changes to this filing clarifying that offerings on Form F-10 (only with respect to Canadian issuers) will be exempt if the offering is pursuant to the home jurisdiction's shelf prospectus offering procedures, rather than Rule 415. Amendment No. 4 to SR-NASD-91-19 made technical changes to this filing that clarified the wording of section (c)(5)(C)(ii) and section (c)(5)(C)(iv). These amendments are available for inspection and copying in the Commission's Public Reference Room.

² 15 U.S.C. 78a(b)(1) (1988).

³ 17 CFR 240.19b-4 (1990).

⁴ NASD Securities Dealers Manual, Rules of Fair Practice, Article III, section 1. CCH ¶ 2151.02.

set forth in subsection (b)(10) of the proposed Corporate Financing rule.

Notice of the proposed rule change together with the terms of substance of the proposal was provided by the issuance of a Commission release (Securities Exchange Act Release No. 29928, November 12, 1991) and by publication in the *Federal Register* (56 FR 58257, November 18, 1991).⁵ No comments were received with respect to the proposed rule change.

Background and Description

I. The Interpretation

Article III, section 1 of the NASD's Rules of Fair Practice obligates members, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade. In the early 1960s, the NASD began reviewing underwriting terms and arrangements of securities offerings in which members were participating to determine whether those terms and arrangements were in compliance with the broad standard of fairness in article III, section 1.⁶ By 1970, the criteria for determining fairness and reasonableness had become more defined and were incorporated into the Corporate Financing Interpretation, which made it a violation of the NASD rules to participate in any public offering where the underwriting terms and arrangements are unfair and unreasonable.

Although the language of the Interpretation has been amended from time-to-time, it no longer accurately reflects all current industry practices or the guidances used by the NASD to determine the fairness and reasonableness of underwriting terms and arrangements. Thus, the NASD is proposing to replace the current Corporate Financing Interpretation with the Corporate Financing Rule.

II. The Rule

The Corporate Financing Rule will codify many of the practices and policies that the NASD's Corporate Financing Department now follows in reviewing the underwriting compensation arrangements of NASD members, when participating in an offering of securities to the public.

Additionally, the Rule sets forth substantive modifications to the Association's policy and codifies for the first time a number of different unpublished factors the NASD uses to determine the fairness and reasonableness of underwriting terms and arrangements of NASD members. The proposed Rule is divided into four subsections: (a) Definitions, (b) Filing Requirements, (c) Underwriting Compensation and Arrangements, and (d) Power of the Board of Governors.

Below is a brief summary, divided into the Rule's subsections, highlighting how the proposed Rule differs from the current Interpretation; whether it be the addition of something new, in deletion of a provision of the Interpretation, or a clarification of an existing practice of procedure.

a. Definitions

The Definitions section explains the meaning of terms used in the Rule. The meaning of words and/or phrases already defined in the NASD's Rules of Fair Practice or By-Laws are found therein. A specific reference to the definitions contained in Schedule E to the By-Laws has been incorporated into the proposed Rule since a number of terms used in the Rule, including "immediate family," "bona fide independent market," "qualified independent underwriter," and "public offering" are already defined in Schedule E.

The Definitions section, in general, includes the following changes:

- The term *issuer* is defined for the first time to include any selling security holders offering securities to the public, which includes any affiliate of the issuer or selling security holder. Defining the term issuer broadly obviates the need to utilize the term "issuer/selling security holder" throughout the Rule and obviates the need to reference all enumerated persons. The broad definition allows the NASD the opportunity to review thoroughly the contractual relationships between members and issuers and their affiliates to determine the applicability of the Rule.

- The term *offering proceeds* is defined for the first time in the definition section (as opposed to "net offering proceeds" and "gross dollar amount of offering," which are defined and used for other purposes in the Rule). "Offering proceeds" means the public offering price of all securities offered to the public, exclusive of securities subject to any overallotment option, securities to be received by the underwriter and related persons, or securities underlying other securities. Offering proceeds, as opposed to net and gross proceeds, is used in connection with the calculation of the amount of

underwriting compensation to be received in connection with an offering by the underwriter or related person.

- The term "*participation or participating in a public offering*" is defined for the first time so as to codify the NASD's policy with respect to when a member is considered to be participating in a public offering. It is included in the Rule to determine when a member's activities in connection with a public offering will trigger the filing requirements of the Rule and whether a particular member is responsible for filing.

- The term "*underwriter and related persons*," already defined in the Interpretation, is expanded in the Rule to clarify that the definition includes NASD members acting as agent for an issuer or providing advice to an issuer in a self-underwritten offering; and also clarifies that the term includes members of the underwriter's "immediate family" (as that term is defined in Schedule E to the By-Laws). The modified, expanded definition of underwriter and related persons will now correlate with "participating in a public offering," so that a member considered to be participating in an offering under Section (a)(5) will also be considered an "underwriter and related person."

b. Filing Requirements

The Filing Requirements section sets out the requirements for filing public offerings with the NASD's Corporate Financing Department, provides for the confidential treatment of such filings, and lists the documents and information required to be filed with the Corporate Financing Department. This section also lists the types of offerings that are exempt from filing as well as those offerings that are exempt from both filing and compliance with the Corporate Financing Rule. The Filing Requirements section codifies without substantial change existing requirements in the Interpretation for the filing of public offerings.⁷

In addition to substantially incorporating the filing requirements of the Interpretation, the Filing Requirements section of the Rule, in general, includes the following changes:

- Under the Filing Requirements, the Rule prohibits the commencement of an offering unless all necessary documents have been filed and the Corporate Financing Department has provided an opinion that it has no objections to the proposed underwriting, or an opinion that the proposed underwriting is unfair and unreasonable. The latter modification is new, clarifying the NASD's policy that a member may not

⁷ It should be noted that the filing requirements section focuses on "public offerings", a term defined in Schedule E to the NASD's By-Laws, rather than on SEC-registered offerings, on the basis that the NASD's obligation to review its members' participation in offerings of securities is paramount when the offering is made to the public, regardless of whether the offering is exempt from the filing requirements of the Securities Act of 1933.

⁵ See *supra* footnote 1.

⁶ Art. III, § 1 of the NASD Rules of Fair Practice provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

participate in an offering until the Corporate Financing Department issues a letter expressing an opinion as to the fairness and reasonableness of the arrangement (the Interpretation does not clearly state that a member may not proceed with an offering without an opinion from the Corporate Financing Department, and the NASD has found that some members have gone forward with an offering without an opinion letter).

- The Rule makes some minor administrative changes to the filing requirements concerning the filing of final offering documents with the NASD, and also clarifies what "supplementary" materials need to be filed with the Corporate Financing Department (e.g., statement of association or affiliation of any member with officer, director, etc. of issuer), which will obviate the need for the Corporate Financing Department to issue a "defer" opinion letter requesting additional information on the offering.

- The underwriters must now also, where applicable, file a statement addressing the published factors in the Rule which the NASD uses to determine whether an item of value received by the underwriter was received in connection with the offering (e.g., the length of time between receipt of the item and the filing of the offering documents).

- The Rule requires that the NASD be notified in writing, that an offering has been declared effective or approved by the appropriate regulatory agency no later than one business day following such approval, or in the alternative, notified that the offering has been abandoned within three business days of the withdrawal or decision to abandon the offering. The Interpretation only requires "prompt" notification by telephone or telegram.

- The Filing section contains a list of offerings exempt from filing but still subject to compliance with the Rule. The Rule clarifies that there is a filing exemption for the issuance of equity securities by issuers that are "seasoned" under the NASD's definition (equity offerings by issuers are considered "seasoned" if the issuer has outstanding investment grade debt with a term of issue of at least four years), as well as a *separate exemption* for the issuance of debt or preferred securities "rated investment grade." The Interpretation did not make this distinction.

c. Underwriting Compensation and Arrangements

The Underwriting Compensation and Arrangements section of the Rule addresses the amount of underwriting compensation that can be received by underwriters and related persons, the items of compensation that will be deemed to be underwriting compensation, the criteria for determining whether compensation is received in connection with a public offering, and the valuation of non-cash compensation received as underwriting compensation. The section also described presumptively unfair and unreasonable underwriting terms and arrangements, enumerates restrictions

on securities received as underwriting compensation, and addresses conflicts of interest present when the proceeds of a public offering are directed to members participating in the offering.

In addition to clarifying certain elements of the Interpretation's compensation guideline, the section incorporates, in general, the following changes into the rule:

- The Rule requires that all underwriting compensation be disclosed in that portion of the offering document dealing with underwriting arrangements, and that there must be a footnote to the offering proceeds table on the cover page of the offering document, referencing the underwriting section, if the underwriting compensation consists of more than commissions or discounts disclosed on the cover page of the offering document (e.g., stock as compensation).

- The Rule lists the factors considered by the NASD (e.g., the amount of risk assumed by the underwriter, the type of securities being offered) used to determine the "currently effective guideline" on the maximum amount of compensation considered fair and reasonable. The Interpretation does not list such factors, and states only that the NASD will determine whether the amount of underwriting compensation is fair and reasonable. The NASD believes that publishing the factors will serve to allay concerns that the Corporate Financing Department is subjective in its review of offerings and establishes a different guideline for each offering. The Rule, like the Interpretation, does not list the actual guideline with the maximum amount of compensation considered fair and reasonable because the NASD believes that it would be counterproductive and discourage competition to do so.

- In an effort to make information available as to the structure of the corporate compensation guideline, the Rule has a new provision which states that the amount of compensation which is considered fair and reasonable will generally vary directly with the amount of risk to be assumed by the underwriter, and vary inversely with the dollar amount of the offering proceeds.

- The Rule establishes that the Corporate Financing Department will examine all items of value, not just securities, received by an underwriter within 12 months immediately preceding the filing of the offering to determine if such items are received in connection with the offering. The NASD will presume that items received during the six month period immediately preceding the filing of the offering document are compensation (such presumption may be rebutted). The Interpretation looks only to securities received.

- The Rule sets forth the previously unpublished factors that the Corporate Financing Department considers (along with any other relevant factors) in determining whether an item of value was or will be received in connection with the offering. The Rule also sets forth certain of the traditional

factors already found in the Interpretation to determine whether securities received should be considered in connection with the offering.

- The Rule codifies the practice set out in the Interpretation for valuing stock (as opposed to warrants, options, etc.) received as compensation, i.e., the difference between the per security cost and either the market price per security or the proposed public offering price of an initial public offering. Additionally, the Rule, unlike the Interpretation, provides the mathematical model used to determine the percentage of value of the securities.

- The Rule, for the first time, discloses the warrant mathematical formula used by the Corporate Financing Department to determine the value of options, warrants, or convertible securities received as underwriting compensation. The NASD believes that publishing the formula for valuing warrants will assist members and their counsel in more accurately determining the value the Corporate Financing Department will apply to securities included in underwriting compensation.

- The Rule prohibits the receipt of any item of compensation for which value cannot be determined at the time of the offering. This provision is proposed to address novel forms of compensation by establishing the general requirements that all items of value deemed to be underwriting compensation must have a determinable value at the time of the offering in order for the Corporate Financing Department to calculate the aggregate underwriting compensation in connection with an offering.

- The Rule codifies the Interpretation's 10 percent stock numerical limitation, i.e., underwriting compensation in the form of securities cannot be in an amount in excess of 10 percent to the securities sold to the public. However, unlike the Interpretation, the Rule does not contain the provision which allows the Corporate Financing Department to limit underwriting compensation in the form of securities to less than the 10 percent limitation, or in the alternative, allow the amount of securities received to exceed the 10 percent guideline. It has been the policy of the NASD not to use the exceptions to the 10 percent guide so as to prevent subjective analysis of compensation packages.

- The Rule contains the same mandatory one-year lock-up provision in the Interpretation (securities deemed underwriting compensation cannot be sold, assigned, etc. for the period of one year following the effective date of the offering for which the securities were received). However, the Rule does not contain the Interpretation provisions that provide the NASD with authority to impose a longer restriction period, a shorter restriction period, or address installment payments for securities. It has been the NASD's policy not to rely on the Interpretation provisions which allow variations from the one-year lock-up provision.

- The Rule also changes the current lock-up policy by permitting convertible or exercisable securities to be converted or exercised during the one-year restricted period, so long as the securities received as a result thereof remain subject to the required one-year restriction.

d. Power of the Board of Governors

The proposed rule provides authority to the NASD Board of Governors to amend the Filing Requirements of the Rule without recourse to the membership for approval. The NASD believes it important that it be able to expeditiously amend the Corporate Financing filing requirements in order to respond to changes in the federal securities laws or in the types of offerings made or the fees applicable to Corporate Financing filings.

III. Code of Procedure

The proposed Corporate Financing and Direct Participation Program Code of Procedure to be included as new Article XII of the NASD Code of Procedure (included also in Exhibit A) codifies the present informal procedures for requesting review of Corporate Financing Department determinations in connection with the review of public offerings. The Article delineates the procedure for requesting a review of a determination by the Corporate Financing Department, including requesting a hearing, notice particulars, composition of the reviewing body, and appeals to the Board of Governors.

Pursuant to Article XII, only a "member" aggrieved by a determination of the Corporate Financing Department in connection with the underwriting terms or arrangements may submit an application for review of the Corporate Financing Department's determination to a hearing committee of a national standing committee of the Board of Governors. The subsection is consistent with the NASD's position that it is the

responsibility of members participating in an offering to ensure that the underwriting terms and arrangements have received an opinion of "no objections" from the NASD.

Commission Findings

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the NASD and, in particular, the requirements of section 15A of the Act.⁸

Section 15A(b)(2) of the Act requires, in part, that the Association enforce compliance by its members, and persons associated with its members, with the applicable provisions of the Act and the rules of the NASD. The Commission believes that the clarification and codification provided by the Corporate Financing Rule will assist the NASD and its staff in the enforcement of its corporate financing policies.

Specifically, NASD members should find that the codification facilitates their understanding of the compliance with the policies of the Association by more clearly delineating member's responsibilities and obligations in an accessible format.

Similarly, the Commission finds that the Corporate Financing Rule is consistent with section 15A(b)(6) of the Act in that it is designed to prevent fraudulent and manipulative acts and practices, and designed to protect investors and the public interest. By removing certain ambiguities and precisely outlining Association policy with regard to corporate financing

matters, the NASD is providing its membership with a definitive guideline to follow when participating in a public offering of securities. This will allow the NASD to more efficiently detect and prevent unacceptable deviations from the rule, which ultimately furthers investor protection by ensuring that the percentage of investment capital going toward underwriter compensation remains fair and reasonable.

Lastly, the Commission believes that the Corporate Financing Rule is consistent with section 15A(b)(9) of the Act in that it will not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. Further, the Commission agrees with the NASD's decision not to publish the permissible limits of underwriting compensation for NASD members because it would be counterproductive and discourage competition. Specifically, it would tend to encourage members to charge issuers the maximum compensation allowed, which would impede the objectives of sections 15a(b)(9), as well as section 15A(b)(6) which requires also that the rules of the Association be designed to promote just and equitable principles of trade.

It is therefore ordered, pursuant to section 19(b)(2) of the Act, that the above-mentioned proposed rule change, SR-NASD-91-19, be, and hereby is, approved.

For the Commission, by the Division of Market Regulation pursuant to delegated authority.⁹

Margaret H. McFarland,
Deputy Secretary.

⁸ 15 U.S.C. 78a-3 (1968).

⁹ 17 CFR 200.30-3(a)(12).

[In lieu of Exhibit A referenced in this *Federal Register*, the NASD has included typed text of the new Corporate Financing Rule and Code of Procedure.]

**ARTICLE III
RULES OF FAIR PRACTICE**

**THE CORPORATE FINANCING RULE
Underwriting Terms and Arrangements**

Sec. 44

(a) Definitions

For purposes of this Section, the following terms shall have the meanings stated below. The definitions in Schedule E to the By-Laws are incorporated herein by reference.

(1) **gross dollar amount of the offering** — public offering price of all securities offered to the public and securities included in any overallotment option, the registration price of securities to be paid to the underwriter and related persons, and the registration price of any securities underlying other securities;

(2) **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;

(3) **net offering proceeds** — offering proceeds less all expenses of issuance and distribution;

(4) **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;

(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 Rule 13e-3; and

(6) **underwriter and related persons** — includes underwriters, underwriter's counsel, financial consultants and advisors, finders, members of the selling or distribution group, any member participating in the public offering, and any and all

other persons associated with or related to and members of the immediate family of any of the aforementioned persons.

(b) Filing Requirements

(1) General

No member or person associated with a member shall participate in any manner in any public offering of securities subject to this Section, Schedule E to the By-Laws, or Article III, Section 34 of the Rules of Fair Practice unless documents and information as specified herein relating to the offering have been filed with and reviewed by the NASD.

(2) Means of Filing

Documents or information required by this rule to be filed with the NASD shall be considered to be filed only upon receipt by its Corporate Financing Department at the Executive Office located at 1735 K Street, N.W., Washington, D. C. 20006.

(3) Confidential Treatment

The NASD shall accord confidential treatment to all documents and information filed pursuant to this Section and shall utilize such documents and information solely for the purpose of review to determine compliance with the provisions of applicable NASD rules and regulations or for other regulatory purposes deemed appropriate by the NASD.

(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 Section shall file with the NASD the documents and information with respect to the offering specified in paragraphs (5) and (6) below no later than one business day after the filing of any of such documents: (i) with the Securities and Exchange Commission; (ii) with the state securities commission; (iii) with any other regulatory authority; or (iv) if not filed with any regulatory authority, at least fifteen (15) business days prior to the anticipated offering date.

(B) No offering of securities subject to this Section shall commence unless:

(i) the documents and information specified in paragraphs (5) and (6) below have

been filed with and reviewed by the NASD; and

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

(C) Any member acting as a managing underwriter or a similar capacity that has been informed of an opinion by the NASD, or a determination by the appropriate standing committee of the Board of Governors, that the proposed underwriting terms and arrangements of a proposed offering are unfair or unreasonable, and the proposed terms and arrangements have not been modified to conform to the standards of fairness and reasonableness, shall notify all other members proposing to participate in the offering of that opinion or determination at a time sufficiently prior to the effective date of the offering or the commencement of sales so the other members will have an opportunity as a result of specific notice to comply with their obligation not to participate in any way in the distribution of a public offering containing arrangements, terms and conditions which are unfair or unreasonable.

(5) Documents to be Filed

The following documents relating to all proposed public offerings of securities shall be filed for review:

(A) Five (5) copies of the registration statement, offering circular, offering memorandum, notification of filing, notice of intention, application for conversion and/or any other document used to offer securities to the public;

(B) Three (3) copies of any proposed underwriting agreement, agreement among underwriters, selected dealers agreement, agency agreement, purchase agreement, letter of intent, consulting agreement, partnership agreement, underwriter's warrant agreement, escrow agreement, and any other document which describes the underwriting or other arrangements in connection with or related to the

distribution, and the terms and conditions relating thereto; and any other information or documents which may be material to or part of the said arrangements, terms and conditions and which may have a bearing on the NASD's review;

(C) Five (5) copies of each pre- and post-effective amendment to the registration statement or other offering document, one copy marked to show changes; and three (3) copies of any other amended document previously filed pursuant to subparagraphs (A) and (B) above, one copy marked to show changes; and

(D) Three (3) copies of the final registration statement declared effective by the Securities and Exchange Commission or equivalent final offering document and a list of the members of the underwriting syndicate, if not indicated therein, and one (1) copy of the executed form of the final underwriting documents and any other document submitted to the NASD for review.

(6) Information Required to be Filed

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

(A) an estimate of the maximum public offering price;

(B) an estimate of the maximum underwriting discount or commission; maximum reimbursement of underwriter's expenses, and underwriter's counsel's fees (except for reimbursement of "blue sky" fees); maximum financial consulting and/or advisory fees to the underwriter and related persons; maximum finder's fees; and a statement of any other type and amount of compensation which may accrue to the underwriter and related persons;

(C) a statement of the association or affiliation with any member of any officer, director or securityholder 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 securityholder of five percent or more of any class of the issuer's securities, to include:

- (i) the identity of the person,
- (ii) the identity of the member and whether such member is participating in any capacity in the public offering, and
- (iii) 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;

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

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

(F) Any person filing documents pursuant to paragraph (5) above shall file with the NASD written notice that the offering has been declared effective or approved by the Securities and Exchange Commission or other agency no later than one business day following such declaration or approval or that the offering has been withdrawn or abandoned within three business days following the withdrawal or decision to abandon the offering.

(7) Offerings Exempt From Filing

Notwithstanding the provisions of paragraph (1) above, documents and information related to the following public offerings need not be filed with the NASD for review, unless subject to the provisions of Schedule E to the By-Laws. However, it shall be deemed a violation of this Section or Article III, Section 34 of these Rules of Fair Practice, for a member to participate in any way in such public offerings if the underwriting or other arrangements in connection with the offering are not in compliance with this Section or Section 34, as applicable:

(A) securities offered by a corporate, foreign government or foreign government agency issuer which has unsecured non-convertible debt with a term of issue of at least four (4) years, or unsecured non-convertible preferred securities, rated by a nationally recognized statistical rating organization in one of its four (4) highest generic rating categories, except that the initial public offering of the equity of an issuer is required to be filed;

(B) non-convertible debt securities and non-convertible preferred securities rated by a nationally recognized statistical rating organization in one of its four (4) highest generic rating categories;

(C) securities registered with the Securities and Exchange Commission on registration statement Forms S-3 or F-3 and offered pursuant to Rule 415 adopted under the Securities Act of 1933,

as amended, or Form F-10 (only with respect to Canadian issuers) and offered pursuant to the home jurisdiction's shelf prospectus offering procedures;

(D) securities offered pursuant to a redemption standby "firm commitment" underwriting arrangement registered with the Securities and Exchange Commission on Forms S-3, F-3 or F-10 (only with respect to Canadian issuers); and

(E) financing instrument-backed securities which are rated by a nationally recognized statistical rating organization in one of its four (4) highest generic rating categories.

(8) Exempt Offerings

Notwithstanding the provisions of paragraph (1) above, the following offerings are exempt from this Section, Schedule E to the By-Laws, and Article III, Section 34 of the Rules of Fair Practice. Documents and information relating to the following offerings need not be filed for review:

(A) securities exempt from registration with the Securities and Exchange Commission pursuant to the provisions of Sections 4(1), 4(2) or 4(6) of the Securities Act of 1933, as amended, or pursuant to Rule 504 (unless considered a public offering in the states where offered), Rule 505 or Rule 506 adopted under the Securities Act of 1933, as amended;

(B) securities which are defined as "exempt securities" in Section 3(a)(12) of the Securities Exchange Act of 1934, as amended;

(C) securities of investment companies registered under the Investment Company Act of 1940, as amended, except securities of a management company defined as a "closed-end company" in Section 5(a)(2) of that Act;

(D) variable contracts as defined in Article III, Section 29(b)(1) of the Rules of Fair Practice;

(E) offerings of municipal securities as defined in Section 3(a)(29) of the Securities Exchange Act of 1934, as amended;

(F) tender offers made pursuant to Regulation 14D adopted under the Securities Exchange Act of 1934, as amended; and

(G) securities issued pursuant to a competitively bid underwriting arrangement meeting the requirements of the Public Utility Holding Company Act of 1935, as amended.

(9) Offerings Required to be Filed

Documents and information relating to all

other public offerings including, but not limited to, the following must be filed with the NASD for review:

- (A) direct participation programs as defined in Article III, Section 34(d)(2) of the Rules of Fair Practice;
- (B) mortgage and real estate investment trusts;
- (C) rights offerings;
- (D) securities exempt from registration with the Securities and Exchange Commission pursuant to Section 3(a)(11) of the Securities Act of 1933, as amended, which is considered a public offering in the state where offered;
- (E) securities exempt from registration with the Securities and Exchange Commission pursuant to Rule 504 adopted under the Securities Act of 1933, as amended, which is considered a public offering in the states where offered;
- (F) securities offered by a bank, savings and loan association, church or other charitable institution, or common carrier even though such offering may be exempt from registration with the Securities and Exchange Commission;
- (G) securities offered pursuant to Regulation A or Regulation B adopted under the Securities Act of 1933, as amended; and
- (H) any offerings of a similar nature that are not exempt under paragraphs (7) or (8) of this Subsection.

(10) Filing Fees

- (A) The initial documents relating to any offering filed with the NASD pursuant to this Section shall be accompanied by a filing fee equal to \$500 plus .01% of the gross dollar amount of the offering, not to exceed a fee of \$30,500. The amount of filing fee may be rounded to the nearest dollar.
- (B) Amendments to the initially filed documents which increase the number of securities being offered shall be accompanied by an additional amount of filing fee equal to .01% of the increase in the amended gross dollar amount of the offering, not to exceed \$30,500 when aggregated with all fees previously paid.
- (C) Filing fees shall be paid only in the form of check or money order payable to the National Association of Securities Dealers, Inc.
- (D) The provisions of Rule 457 adopted under the Securities Act of 1933, as amended, shall govern the computation of filing fees for all offerings

filed pursuant to this Section, including intrastate offerings, to the extent the terms of Rule 457 are not inconsistent with subparagraphs (10)(A), (B) or (C) above.

(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 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) For purposes of determining the amount of underwriting compensation, all items of value received or to be received from any source by the underwriter and related persons which are deemed to be in connection with or related to the distribution of the public offering as determined pursuant to paragraphs (c)(3) and (c)(4) below shall be included.

(C) All items of underwriting compensation shall be disclosed in the section on underwriting or distribution arrangements in the prospectus or similar document and, if the underwriting compensation includes items of compensation in addition to the commission or discount disclosed on the cover page of the prospectus or similar document, a footnote to the offering proceeds table on the cover page of the prospectus or similar document shall include a cross-reference to the section on underwriting or distribution arrangements.

(D) For purposes of determining the currently effective guideline on the maximum amount of underwriting compensation considered fair and reasonable, the following factors, as well as any other relevant factors and circumstances, shall be taken into consideration:

- (i) the offering proceeds;
- (ii) the amount of risk assumed by the underwriter and related persons, which is determined by (a) whether the offering is being underwritten on a "firm commitment" or "best efforts" basis and (b) whether the offering is an initial or secondary offering; and
- (iii) the type of securities being offered.

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

(3) Items of Compensation

(A) For purposes of determining the amount of underwriting compensation received or to be received by the underwriter and related persons pursuant to paragraph (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 offering, as determined pursuant to paragraph (c)(4) below shall be included:

- (i) discount or commission;
- (ii) reimbursement of expenses to or on behalf of the underwriter and related persons;
- (iii) fees and expenses of underwriter's counsel (except for reimbursement of "blue sky" fees);
- (iv) finder's fees;
- (v) wholesaler's fees;
- (vi) financial consulting and advisory fees, whether in the form of cash, securities, or any other item of value;
- (vii) stock, options, warrants, and other securities, including securities received as underwriting compensation, for example:
 - (a) in connection with a private placement of securities for the issuer;
 - (b) for providing or arranging bridge financing for the issuer;
 - (c) as a finder's fee;
 - (d) for consulting services to the issuer; and
 - (e) securities purchased in a private placement made by the issuer;
- (viii) special sales incentive items in compliance with subparagraph (c)(6)(B)(xi);

- (ix) any right of first refusal provided to the underwriter and related persons to underwrite or participate in future offerings by the issuer, 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 the right of first refusal;
- (x) compensation to be received by the underwriter and related persons or by any person nominated by the underwriter as an advisor to the issuer's board of directors in excess of that received by other members of the board of directors;
- (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 offering;
- (xii) fees of a qualified independent underwriter; and
- (xiii) compensation, including expense reimbursements, paid in the six (6) months prior to the initial or amended filing of the prospectus or similar documents to any member or person associated with a member for a public offering that was not completed.

(B) Expenses customarily borne by an issuer, such as printing costs; SEC, "blue sky" and other registration fees; NASD filing fees; and accountant's fees, shall be excluded from underwriter's compensation whether or not paid through an underwriter.

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

(A) All items of value received or to be received by the underwriter and related persons during the twelve (12) month period immediately preceding the filing of the registration statement or similar document, and at the time of and subsequent to the public offering, will be examined to determine whether such items of value are underwriting compensation in connection with the 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 NASD to support a finding that the receipt of an item is not in connection with the offering and shall not include cash discounts or commissions received in connection with a prior distribution of the issuer's securities.

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

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

- (i) the length of time between the date of filing of the registration statement or similar document and, (a) the date of the receipt of the item of value, (b) the date of any contractual agreement for services for which the item of value was or is to be received, and (c) the date the performance of the service commenced, with a shorter period of time tending to indicate that the item is received in connection with the offering;
- (ii) the details of the services provided or to be provided for which the item of value was or is to be received;
- (iii) the relationship between the services provided or to be provided for which the item of value was or is to be received and (a) the nature of the item of value, (b) the compensation value of the item, and (c) the proposed public offering;
- (iv) the presence or absence of arm's-length bargaining or the existence of any affiliate relationship between the issuer and the recipient of the item of value, with the absence of arm's length bargaining or the presence of any affiliation tend-

ing 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 NASD, 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.

(5) Valuation of Non-Cash Compensation

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

- (A) No underwriter and related person may re-

ceive 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 NASD; 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.

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

(i) the difference between the per security cost and either the market price per security on the date of acquisition, where a bona fide independent market exists for the security, or the proposed (and actual) public offering price per security;

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

(iii) divided by the offering proceeds; and

(iv) multiplied by one hundred (100).

(C) options, warrants or convertible securities shall be valued on the basis of the following formula:

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

(ii) minus the difference between the exercise or conversion price per security and either the market price per security on the date of acquisition, where a bona fide independent market exists for the security, or the proposed (and actual) public offering price per security;

(iii) divided by two (2);

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

(v) less the total price paid for the securities;

(vi) divided by the offering proceeds; and

(vii) multiplied by one hundred (100).

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

(6) Unreasonable Terms and Arrangements

(A) 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 Section or inconsistent with any By-Law or any Rule of Fair Practice, or other rule or regulation, of the NASD.

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

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

(ii) any non-accountable expense allowance in excess of three (3) percent;

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

(iv) the payment of any compensation by an issuer to a member or person associated with a member in connection with an offering of securities which 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) any right of first refusal regarding future public offerings, private placements or other financings which has a duration of more than five (5) years from the effective date of the offering;

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

- (1) is exercisable or convertible more than five (5) years from the effective date of the offering;
- (2) is exercisable 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;
- (3) is not in compliance with subparagraph (c)(5)(A) above;
- (4) has more than one demand registration right at the issuer's expense;
- (5) has a demand registration right with a duration of more than five (5) years from the effective date of the offering;
- (6) has a piggyback registration right with a duration of more than seven (7) years from the effective date of the offering; or
- (7) is convertible or exercisable or otherwise is on terms more favorable than the terms of the securities being offered to the public;

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

(viii) when proposed in connection with the distribution of a public offering of securities on a "firm commitment" basis, any overallotment option providing for the overallotment of more than fifteen

(15) percent of the amount of securities being offered, computed excluding any securities offered pursuant to the overallotment option;

(ix) 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:

- (1) any securities deemed to constitute underwriting compensation;
 - (2) any securities issued or to be issued pursuant to an overallotment option;
 - (3) in the case of a "best efforts" offering, any securities not actually sold; and
 - (4) any securities underlying warrants, options, or convertible securities which are part of the proposed offering, except where acquired as part of a unit;
- (x) the receipt by a member or person associated with a member, pursuant to an agreement entered into at any time before or after the effective date of a public offering of warrants, options, convertible securities or units containing such securities, of any compensation or expense reimbursement in connection with the exercise or conversion of any such warrant, option, or convertible security in any of the following circumstances:

- (1) 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;
- (2) 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;
- (3) the arrangements whereby compensation is to be paid are not disclosed (a) in the prospectus or offering circular by which the warrants, options, or convertible securities are offered to the public, if such arrangements are contemplated or any agreement exists as to

such arrangements at that time, and (b) in the prospectus or offering circular provided to securityholders at the time of exercise or conversion; or

(4) 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;

(xi) for a member or person associated with a member to accept, directly or indirectly, any non-cash sales incentive item including, but not limited to, travel bonuses, prizes and awards, from an issuer or an affiliate thereof in excess of \$50 per person per issuer annually. Notwithstanding the foregoing, a member may provide non-cash sales incentive items to its associated persons provided that no issuer, or an affiliate thereof, including specifically an affiliate of the member, directly or indirectly participates in or contributes to providing such non-cash sales incentive; or

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

(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 in exceptional and unusual circumstances, upon good cause shown, a different arrangement may be permitted.

(7) Restrictions on Securities

(A) No member or person associated with a member shall participate in 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 one year following the effective date of the offering for which the securities were received. However, securities deemed to be underwriting compensation may be transferred to any member participating in the offering and the bona fide officers or partners thereof and securities which are convertible into other types of securities or which may be exercised for the purchase of other securities may be so transferred, converted or exercised if all securities so transferred or received remain subject to the restrictions specified herein for the remainder of the initially applicable time period;

(ii) certificates or similar instruments representing securities restricted pursuant to subparagraph (A)(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.

(B) The provisions of subparagraph (A) notwithstanding, the transfer of any security by operation of law or by reason of reorganization of the issuer shall not be prohibited.

(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 effec-

tive 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) the aggregate amount of such securities held by such member and its related persons enumerated above would not exceed 1% of the securities being offered.

(8) Conflicts of Interest

Proceeds Directed to a Member — no member shall participate in a public offering of an issuer's securities where more than ten (10) percent 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, 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 Subsection 3(c) of Schedule E to the By-Laws.

(A) All offerings included within the scope of this paragraph (8) 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 paragraph 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) The provisions of this paragraph (8) shall not apply to:

- (i) an offering otherwise subject to the provisions of Schedule E to the By-Laws;
- (ii) an offering of securities exempt from registration with the Securities and Exchange Commission under Section 3(a)(4)

- of the Securities Act of 1933;
- (iii) an offering of a real estate investment trust as defined in Section 856 of the Internal Revenue Code; or
- (iv) an offering of securities subject to Section 34 of the Rules of Fair Practice, 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) Power of the Board of Governors

The Board of Governors shall have the power to alter, amend, supplement or modify the provisions of Subsection (b) of this Section from time to time without recourse to the membership for approval as would otherwise be required by Article III of the By-Laws.

CODE OF PROCEDURE

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ARTICLE XII

CODE OF PROCEDURE FOR CORPORATE FINANCING AND DIRECT PARTICIPATION PROGRAM MATTERS

(1) Purpose

The purpose of this Code of Procedure is to provide a procedure for review of determinations by the NASD's staff regarding compliance with NASD rules relating to corporate financing and direct participation program matters by which any member is aggrieved.

(2) Application by Aggrieved Member

Any member aggrieved by a determination rendered pursuant to any rule or regulation of the NASD relating to underwriting terms or arrangements may make application for review of such determination. In exceptional or unusual circumstances, a member may request conditionally or unconditionally an exemption from such rules or regulations. Applications for review will be accepted only with respect to offerings for which a registration statement or similar document has been filed with the appropriate federal or state regulatory agency; provided, however, that a hearing committee may waive the requirement for filing

prior to review upon a finding that such review is appropriate under the circumstances.

(3) Application for Review

Any member making application for review pursuant to paragraph (2) above (hereinafter referred to as "applicant") shall request such review in writing and shall specify in reasonable detail the source and nature of the aggrievement and the relief requested. The applicant shall state whether a hearing is requested and shall sign the written application.

(4) Notice of Hearing

Any applicant shall have a right to a hearing before a hearing committee constituted as provided in paragraph (5) below. The hearing committee may request a hearing on its own motion. A hearing shall be scheduled as soon as practicable, at a location determined by the hearing committee. Written notice of the hearing shall be sent to the applicant stating the date, time, and location of the hearing.

(5) Hearing Committee and Procedure

(A) Any hearing shall be before an individual or individuals designated by the NASD, who shall be current or past members of the appropriate standing committee of the Board of Governors, i.e. the "hearing committee." Any applicant shall be entitled to appear at, and participate in, the hearing, to be represented by counsel, and to submit any relevant testimony or evidence. Representatives of the NASD shall be entitled to appear at, and participate in, the hearing, to be represented by counsel, and to submit any relevant testimony or evidence. Upon agreement of the applicant, representatives of the NASD, and the hearing committee, a hearing may be conducted by means of a telephonic or other linkage which permits all parties to participate simultaneously in the proceeding.

(B) In the event that the applicant waives a hearing before the appropriate hearing committee, the hearing committee shall review the matter on the record before it. Any applicant and the NASD shall be entitled to submit any relevant written testimony or evidence to the hearing committee.

(6) Requirement for Written Determination

The hearing committee shall render a determination as to all issues which the committee finds to

be relevant as soon as practicable following conclusion of the hearing or, in cases in which a hearing is not requested, completion of the committee's review of the record. The hearing committee may determine whether the proposed underwriting or other terms and arrangements in connection with or relating to the distribution of the securities, or the terms and conditions related thereto, taking into consideration all elements of compensation and all of the relevant surrounding factors and circumstances, are fair and reasonable and in compliance with applicable rules and regulations. The determination of the hearing committee shall be issued in writing, and a copy shall be sent to each applicant.

(7) Review by Committee of Board

(A) Any member aggrieved by a determination of a hearing committee shall have a right to have that determination reviewed by the appropriate standing committee of the Board of Governors.

(B) Any member seeking a review of a determination of a hearing committee shall submit a written request for such review to the NASD within fifteen (15) business days following issuance of the hearing committee's written determination. Any such member shall submit with the written request for review a written statement specifying the portion of the hearing committee's determination for which review is requested and the relief sought. Any such member may submit written testimony or evidence for consideration by the committee. Representatives of the NASD may also submit written testimony or evidence to the committee.

(C) Pursuant to a request duly made, the appropriate standing committee of the Board of Governors will review the determination of a hearing committee, giving consideration to all parts of the record which the Board committee finds relevant. The Board committee shall render a determination as to all issues which the committee finds to be relevant. The determination of the Board committee shall be issued in writing, and a copy shall be sent to each member requesting review.

(8) Nature of Determination

Any determination by a hearing committee or standing committee rendered shall constitute the opinion of that committee as to compliance with applicable NASD rules, interpretations or policies and shall be advisory in nature only. Such determi-

nation shall not be subject to review by the Board of Governors. No such determination shall constitute a finding of a violation of any rule, interpreta-

tion or policy. A finding of a violation shall be made only by a District Business Conduct Committee.