

percent of the offering proceeds and currently limits the duration of the right to 5 years.² To the extent that an underwriting agreement includes a provision specifying a dollar amount for the waiver or termination of a right of first refusal, it has been the policy of the NASD Corporate Financing Department ("Department") under the Corporate Financing Rule to value the right of first refusal on the basis of the specified dollar amount in place of the one percent valuation.

The NASD believes that members should be permitted to negotiate to waive or terminate a right of first refusal in the event that the issuer wishes to use a different underwriter to subsequently raise additional capital through a public or private offering of its securities, provided that amounts negotiated are limited to an amount that has some relation to the size of the subsequent offering in which the member is not participating. Because use of right of first refusal are primarily confined to certain underwriters of companies that are generally small and without significant operating history, the NASD has found that issuers negotiating with an underwriter for the first time in connection with an initial public offering often may not fully comprehend that they have agreed to extend their relationship with the underwriter for as many as five years, nor be in a position to influence the terms of the right. In addition, the NASD has observed that certain underwriters routinely negotiate to receive rights of first refusal at the time of an initial public offering and later negotiate to waive or terminate their rights, apparently without any original intent to actually underwrite any subsequent offering of securities by the issuer.

The NASD is concerned that underwriters not be permitted to avoid underwriting compensation limits by negotiating to waive or terminate a right of first refusal with no limitation whatsoever on the amount of compensation they might negotiate to receive. The NASD is also concerned that an issuer may find it difficult to negotiate appropriate underwriting compensation with a new underwriter, where the issuer has determined to sever its relationship with its former underwriter and the former underwriter requires a substantial payment to waive or terminate its right of first refusal. Finally, the NASD believes that the policy on rights of first refusal should

also protect investors, who ultimately incur the cost when an issuer compensates an underwriter for waiving or terminating a right of first refusal.

Description of Proposed Rule Change

Three-Year Duration

Currently, the NASD Corporate Financing Rule at section 44(c)(6)(B)(v) to Article III of the Rules of Fair Practice prohibits, as unreasonable, any "right of first refusal" regarding future public offerings, private placements or other financings that has a duration of more than five (5) years from the effective date of the offering. The NASD is concerned that smaller issuers entering into these agreements may not be in a position to fully evaluate the ramifications of agreeing to a right of first refusal with a term of five years. In addition since the NASD staff rarely, if ever, sees a right of first refusal with a term less than five years, the duration of rights may not be freely negotiated by the issuer and the underwriter. The NASD has determined that a right of first refusal with a duration of five years is overreaching and that a three-year period is more appropriate. The NASD is proposing to modify section 44(c)(6)(B)(v) to Article III of the Rules of Fair Practice to reduce the duration of the right of first refusal from five years to three years. That portion of subparagraph (v) referring to the proposed three-year limitation is proposed to be separated and numbered as new subparagraph (v)(1).

Number of Payments for Waiver/Termination

The NASD finds that certain underwriters routinely negotiate to receive rights of first refusal at the time of an initial public offering and later negotiate, repeatedly, to waive or terminate their rights, apparently without any original intent to actually underwrite any subsequent offerings of securities by the issuer. The NASD is concerned over underwriters receiving a "stand-aside" payment for each subsequent offering by an issuer that has established a relationship with a new underwriter, where the original underwriter is no longer providing any bona fide services to the issuer.

The NASD also is concerned that multiple stand-aside payments by the issuer to a member result in difficulty for both the member and the NASD in tracking the payments received over the term of the right. Such tracking is important in order to insure compliance with the Corporate Financing Rule's

compensation guidelines for the original offering.³

The NASD, therefore, proposes to add a new subparagraph (v)(2) to section 44(c)(6)(B) to Article III of the Rules of Fair Practice to limit a member to one opportunity to waive or terminate a right of first refusal in consideration of any payment or fee. The NASD notes that an underwriter not wishing to terminate its right of first refusal for future offerings may preserve its right by waiving its participation in a particular offering without accepting payment for such waiver.

Limitation on Waiver/Termination Compensation

The NASD believes that members should be permitted to negotiate to waive or terminate a right of first refusal in the event that the issuer wishes to use a different underwriter to subsequently raise additional capital through a public or private offering of its securities. However, the NASD believes that the amounts negotiated for the waiver or termination of the right should be limited to an amount that has some relation either to the original offering or to the subsequent offering in which the member is not participating.

The NASD is concerned that the cost to the issuer of raising additional capital may become excessive where the issuer's former underwriter requires an excessive payment to waive or terminate its right of first refusal. The NASD, therefore, proposes to limit the amount of such waiver/termination payments by adding a new subparagraph (vi) to section 44(c)(6)(B) to Article III of the Rules of Fair Practice. New subparagraph (vi)(1) would prohibit any payment to waive or terminate a right of first refusal that has a value in excess of the greater of 1% of the original offering (or a higher amount if additional compensation is available under the compensation guideline applicable to the original offering) or 5% of the underwriting discount or commission paid in connection with the future offering (including any over-allotment 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.

The proposed provision is intended to balance the interests of former underwriters and issuers by prescribing

² See, Corporate Financing Rule at Article III, Section 44 of the Rules of Fair Practice (Corporate Financing Rule), section (c)(3)(A)(ix) and section (c)(6)(B)(v). NASD Manual, paragraph 2200D at pages 2206 and 2209.

³ The NASD anticipates that the former underwriter will contact the NASD Corporate Financing Department when it is negotiating a waiver or termination of a right of first refusal to obtain information on whether additional compensation is available under the compensation guideline applicable to the original offering.