

a formula for waiver/termination payments that allows former underwriters to participate in the success of issuers, while at the same time not jeopardizing that success with a payment so large that it harms an issuer's ability to conduct and realize the benefits of a secondary offering.⁴ The proposed one percent limitation reflects the NASD's belief that it is appropriate that the former underwriter be permitted to negotiate a fee that is at least equal to the valuation of the right of first refusal in connection with the NASD's review of the original offering in the event that the issuer wishes to sever its relationship with the former underwriter.⁵ The five percent alternative limitation reflects the NASD's belief that the former underwriter that assumed the risk of distributing the issuer's IPO should be allowed to participate or equitably benefit in the issuer's subsequent offering of securities, including any overallotment option that may be exercised, regardless of whether the payment or fee is negotiated at the time of or subsequent to the original public offering.

Cash Payment Requirement

The NASD also proposes adding provision (2) to the new subparagraph (vi) of section 44(c)(6)(B) to Article III of the Rules of Fair Practice to specify that compensation to members for waiving or terminating a right of first refusal must be in the form of cash. The NASD believes this provision will limit the waiver/termination payment to a percentage of the capital raised in the secondary offering and protect the company's shareholders from dilution resulting from the issuance of shares to a former underwriter.

Additional Clarifications

The proposed rule change would revise subparagraph (ix) to section 44(3)(A) and subparagraph (v) to section 44(6)(B) to Article III of the Rules of Fair Practice to make the rule language consistent. The rule change to subparagraph (ix) to section 44(c)(A) would clarify policy that any right of first refusal provided to the underwriter

and related persons to underwrite or participate is applicable to all future "public" offerings and "private placements or other financings."

The proposed rule change would also revise subparagraph (v) to section 44(6)(B) to Article III of the Rules of Fair Practice to clarify current policy that all unreasonable terms and arrangements cited under subparagraph (v) to section 44(6)(B) shall apply to any right of first refusal "provided to the underwriter and related persons to underwrite and participate in" future public offerings, private placements or other financings.

Implementation of Rule

The NASD is proposing to make the proposed rule change applicable to filings made with the Corporate Financing Department of the NASD that are not yet effective with the SEC on the date of implementation of the rule change announced by the NASD in a Notice to Members following SEC approval. The implementation date announced by the NASD will not be more than 90 days following SEC approval of the rule change. Thus, offerings filed with the Corporate Financing Department that have not become effective with the SEC on the date of implementation announced by the NASD will be required to comply with the proposed rule change, regardless of whether the Corporate Financing Department has previously issued an opinion that it has no objections to the terms and arrangements. It is the intention of the Corporate Financing Department after the proposed rule change has been published for comment to include a notification with all correspondence with counsel to members regarding this proposed amendment to the Corporate Financing Rule.

The NASD believes that the proposed rule change is consistent with the provisions of section 15A(b)(6) of the Act which provides that the proposed rule change be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest in that the proposed rule change will preserve "rights of first refusal" as a valuable item of compensation to an underwriter, while protecting issuers and investors from excessive payments to waive or terminate a right of first refusal granted to a former underwriter.

(B) Self-Regulatory Organization's Statement on Burden on Competition

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

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

The proposed rule change was published for comment in Notice to Members 94-82 (Oct. 1994). Four comments were received in response thereto and were generally opposed to the proposed rule.⁶

The major issues raised by the commenters can be generally categorized as follows: (1) The duration of a right of first refusal, (2) the number of payments permitted for waiver or termination of a right, (3) limits on waiver/termination compensation, (4) the cash payment requirement, and (5) the valuation of rights of first refusal.⁷

Duration of the Right of First Refusal

The proposed rule change would limit the term of a right of first refusal to a maximum of three years.⁸ Two commenters argued that early stage companies operate unprofitably for more than three years after an IPO and, as a result, limiting a right of first refusal to three years could prevent the underwriter from realizing the benefits of underwriting an offering for a financially stable issuer. Two commenters also argued that securities offerings of smaller issuers are inherently riskier for the underwriter than securities offerings of more financially-stable companies. Typically, small early-stage companies are not well known to the public market and, because of the size and limited

⁶ Comment letters were submitted by Lew Lieberbaum and Co., Inc.; Spelman & Co., Inc.; Kelley Drye and Warren; and Bachner, Tally, Polevoy and Misher.

⁷ Notice to Member 94-82 incorrectly stated that the NASD is proposing to amend the methodology employed by the NASD for valuing a right of first refusal, which as currently valued for compensation purposes is 1% of the gross proceeds of the offering, or the amount specified in the underwriting contract to waive or terminate the right. The incorrect rule language would have limited the compensation value of a right of first refusal to the "lesser of" 1% of the gross offering proceeds on the contracted amount. The NASD is not considering such a proposed rule change and the comments opposing this proposal, therefore, are not discussed in this filing.

⁸ Two commenters expressed concern with the proposed reduction in the maximum permissible duration of a right of first refusal from five years to three years and one commenter generally agreed that the 3-year limit was reasonable, and one commenter expressed no view.

⁴ The NASD does not include the payment to waive or terminate a right of first refusal as compensation in connection with its review of the subsequent offering of securities. The proposed rule change does not modify this practice.

⁵ For example, where the offering proceeds of the original offering were \$10 million and the new offering is to be \$150 million, with a discount of 6 percent or \$9 million, the member could negotiate a fee for waiver or termination of the right of first refusal of up to \$450,000 (5 percent of \$9 million), which is greater than 1 percent of \$10 million, or \$100,000.