resources of the underwriter or restrictions as a result of state blue sky laws, the offering is limited with regard to possible purchasers of the securities. These commenters believe, therefore, that the underwriter should be compensated commensurate with the greater risk of the IPO. One commenter suggested that there is no downside to the issuer to a five-year right of first refusal. The issuer is not obligated to use the services of the original underwriter, but rather is merely prevented from undertaking an offering with another underwriter without compensating the original underwriter. Furthermore, one commenter argued that the issuer and underwriter are free to negotiate a right of first refusal of lesser duration, and to limit expressly duration to three years would hinder the ability of an early stage company to gain access to the public capital markets by reducing the incentive to underwrite such a company's securities.

In response to the above comments, the NASD remains concerned that smaller issuers entering into these agreements may not be in a position to evaluate fully the ramifications of agreeing to a right of first refusal with terms of five years. The NASD also has concluded that such issuers are often not in a position to influence such terms. In support of this belief, the NASD finds that it rarely if ever sees a right of first refusal with a term of less than five years. The five-year maximum term is routinely included in letters of intent and underwriting agreements and appears to be presented to issuers as a usual and customary underwritten arrangement that is non-negotiable.

One commenter suggested that offerings that meet the definition of ''small business issuer'' under Regulation S–B of the Securities Act of 1933 (the ''Securities Act'') and offerings conducted under Regulation A of the Securities Act be permitted to retain a five year right of first refusal while rights in offerings of all other issuers would be limited to three years. The commenter argues that the NASD has historically acknowledged the inherent risk of underwriting small issuers by permitting a greater percentage of underwriting compensation for smaller offerings, and proposes that a comparable analysis be applied to the duration of a right of first refusal.

In response, the NASD believes the commenter's suggestion would exempt from the proposed rule change those smaller issuers who are most unable to evaluate the ramifications of the rights of first refusal and who have the least ability to influence the right's terms. Upon review, the NASD also does not believe the 3-year limitation will reduce the ability of smaller issuers to obtain financing from members.

One commenter agreed that the three-year limitation appeared reasonable but that there should be room for exceptions. For example, the commenter suggests that if an issuer does exceptionally well during this period and issues securities of an affiliated company in a spinoff transaction, the underwriter's three-year time period should begin anew as vis-a-vis the spinoff. The NASD notes that exceptions to the Corporate Financing Rule may be granted by a Hearing Subcommittee of the Corporate Financing Committee in connection with a member's request for review of a staff determination that proposed offering terms and arrangements are unfair and unreasonable. With regard to the commenter's example, the NASD does not believe the contractual obligation of a company to its original underwriter under a right of first refusal should automatically become the obligation of that company's affiliate when it goes public through a spin-off transaction.

Number of Payments for Waiver/Termination

The proposed rule change would permit only one payment to a member for waiving a right of first refusal in connection with a subsequent financing. Upon such payment, the right would be deemed to be terminated.[9]

Commenters argued that such a limitation unfairly penalizes the underwriter and that one payment should not affect subsequent offerings during the term of the right. Despite such arguments, the NASD's concerns remain regarding underwriters receiving a ''stand-aside'' payment for each subsequent offering by an issuer that has established a relationship with a new underwriter when the original underwriter is no longer providing any bona fide services to the issuer. In addition, the NASD believes that multiple payments result in greater difficulty for both the member and the NASD in terms of tracking the amounts received over the term of the right in order to insure compliance with the compensation guideline of the original offering. The NASD also 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.

One commenter argued that the NASD is unnecessarily interfering with the contractual relationship between the issuer and the underwriter, who are free to negotiate a termination of the right if they so desire. In response, the NASD notes that the Corporate Financing Rule is intended to regulate certain contractual provisions between underwriters and issuers to protect the investors in these issues. The NASD believes this provision of the proposed rule change will protect the investors of smaller issuers who are less likely to be able to influence or negotiate the termination of the right of first refusal.

One commenter argued that this provision of the proposed rule change would force members to relinquish their right for very small payment because the secondary offering is not likely to be as large as the example cited in Notice to Members 94–82 and in footnote 3 of this filing (where the original offering was $10 million and the new offering is $150 million). The commenter argues that an underwriter may be willing to accept substantially less to waive its right in order to allow an issuer other financing options if the right of first refusal were to remain intact with respect to future financings. In response, the NASD notes that under the proposed rule change, underwriters may waive their right to an unlimited number of times if they do not receive a payment. Therefore, an underwriter not wishing to terminate its right of first refusal for future offerings may preserve the right by waiving its participation in an offering and by not accepting payment for the waiver.

Limits on Waiver/Termination Compensation

The proposed rule change would limit the amount of any payment or fee to waive or terminate a right of first refusal to the greater of 1 percent (1%) of the original offering proceeds or 5 percent (5%) of the commission paid with respect to the subsequent offering. One commenter argued that there should be no limitation on the amount of the permitted fee for waiving or terminating a right and that any fee should be determined by arms-length negotiation between the issuer and the underwriter, who are uniquely capable of judging the value of the right. The commenter states that in many cases the right of first refusal has no value to the member because many early-stage issuers do not achieve a level of growth sufficient to warrant a subsequent offering of their securities and, therefore, the member has forfeited 1% of the original offering

[9] Three of the four commenters were opposed to limiting the receipt of compensation for waiving or terminating a right of first refusal to one time.