

to obtain a right for which it derives no related benefit.

As discussed above, the NASD remains concerned about the initial capacity of smaller issuers to understand the ramifications of the right of first refusal in an IPO and its ability to influence the terms of the right. Moreover, to protect the investors in the issuer, the NASD has concluded that its concerns necessitate the restrictions contained in the proposed rule change.

The commenter also argues that it is the issuer that has the upper hand in setting the terms of the secondary offering and if the member does not agree to these terms, the issuer is free to arrange for the secondary offering to be underwritten by another member. In response, the NASD considers it unlikely that issuers intentionally set the terms of their secondary offerings to discourage the initial underwriter. The NASD believes the normal priority for issuers when setting the terms of their secondary offerings is optimum capital formation. In particular, the typical secondary offering of a small business issuer is considerably larger than the issuer's initial public offering.

The above commenter, while opposing a payment limitation, suggested in lieu of the proposed limitation that the NASD adopt a range of permissible cash payments as a percentage of the subsequent offerings depending on the size and stage of development of the issuer and the dollar amount of the offering. The commenter considers the 5 percent limitation arbitrary and suggested that payments up to 20% of the underwriting compensation of the subsequent offering be permitted to be received by underwriters of small business issuers or of offerings of less than \$25 million in order to allow a fair compensation to the member. In response, the NASD believes that a payment equal to 20% of the underwriting compensation of a subsequent offering would create a hardship for smaller issuers, and consequently their investors, in terms of reduced net proceeds and/or the ability to attract a new underwriter. The NASD's determination to base the percentage at 5% was not arbitrary but determined after considerable deliberation to balance the interests of the former underwriter and the issuer and arrive at a percentage that allowed the former underwriter to participate in the success of the issuer, while not jeopardizing the success with a payment so large that it affects the issuer's ability to conduct and realize the benefits of a secondary offering.

One commenter stated that this is an ideal proposal that serves both parties.

It ensures that the original underwriter is justly rewarded if the issuer becomes highly successful by preventing the issuer from severing all ties with the original underwriter without compensating it in a manner that is consistent with the underwriter's previously provided services and interests. At the same time, the proposed provision would permit the issuer to ascertain the actual cost of terminating or waiving the right at the time of the original and subsequent offering. The commenter also supported this proposal on the basis that it is appropriate to base the amount of payment to the original underwriter on the amount of the new underwriter's compensation.

Cash Payment Requirement

The proposed rule change specifies that compensation to members for waiving or terminating a right of first refusal must be in the form of cash. One commenter argued that the proposal to require only cash payments in consideration of the waiver or termination of a right would work to the detriment of both underwriters and issuers since early-stage companies often lack the liquidity to make substantial cash payments. The commenter believes that requiring issuers to make payments in cash could reduce working capital and damage a small company's ability to meet payment obligations, thus jeopardizing the company's ability to function as a going concern. In response, the NASD believes that a company should have sufficient cash available from the proceeds of the subsequent offering to make any necessary payment to a former underwriter holding a right of first refusal. The NASD also believes this provision of the proposed rule change is appropriate to protect the company's shareholders from the dilution resulting from the issuance of securities to a former underwriter.¹⁰

Other Comments

Two commenters addressed the NASD's statements that issuers negotiating with an underwriter often may not be in a position to influence the terms of the right of first refusal or fully comprehend that they have agreed to extend their relationship with the underwriter for five years. One commenter noted, specifically, that issuers are represented by counsel and that most issuers have knowledgeable,

competent officers who are aware of the terms of their agreement with the underwriter. This commenter argued that the proposed rule change imposes undue restrictions on the ability of underwriters and issuers to negotiate a mutually acceptable arrangement. In spite of such arguments, the NASD's concerns remain that small issuers, even with counsel, may not understand the ramifications of the right of first refusal, nor be able to influence the terms of these agreements. The NASD has often found that issuer's counsel is generally experienced in corporate law and inexperienced in securities law matters. The NASD reiterates the regulatory purposes of the Corporate Financing Rule is to protect investors in such issuers. One commenter stated that it appears that the committees of the NASD are representative of major sized firms putting forth recommendations for rule changes that will eventually give the major underwriters and wire houses more and more control of the industry. In response, the NASD notes that the standing Committees of the NASD Board of Governors consist of members from both large and small firms. The Corporate Financing Committee was the review committee for the proposed rule change and, at the time this matter was considered, was chaired by an individual representing a very small NASD member.

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the

¹⁰ Any such securities would, moreover, be in addition to securities that the former underwriter previously acquired in connection with the original public offering.