

The amended proposal eliminates the 90-day *per se* requirement and adds the following:

- A 10% limitation on acquisitions of securities that meet the exception for “purchases and loans by certain entities” in paragraph (d)(5)(A) of Rule 2710 (“Exception 1”) and the exception for “investments in and loans to certain issuers” in paragraph (d)(5)(B) of Rule 2710 (“Exception 2”);

- A provision that excludes listed securities from being deemed an “item of value;”

- The addition of insurance companies and banks as qualifying entities in Exception 1;

- An exception for securities received in connection with financial consulting and advisory arrangements, if the arrangement is detailed in a written agreement executed at least 12 months before filing; and,

- Tightened lock-up restrictions that prohibit derivative transactions that result in the effective economic disposition of locked-up shares.

The following is a description of proposed amendments to the amended proposal to which the Commission is granting accelerated approval. As noted previously, the Commission has published the filing for comment on two prior occasions.<sup>22</sup> All of the proposed changes from the amended proposal are in response to the comments on Amendment No. 5, except as indicated for non-substantive and conforming changes to the Rule. NASD also describes several suggestions made by the commenters that it does not support because they would not improve the Rule or would be inconsistent with its purposes.

#### 1. Lock-Up Restrictions

The current Corporate Financing Rule imposes a one-year lock-up on securities deemed to be underwriting compensation. Securities of an issuer that are not deemed to be underwriting compensation, but are held by members of the underwriting syndicate in an IPO, are subject to a 90-day “venture capital” lock-up. The lock-up provisions in the Rule are intended primarily to protect the aftermarket in a new security from the potential for manipulation. The lock-up provisions as proposed to be amended also should ensure that securities acquired during the Review Period by an underwriter or related person that are not deemed to be compensation because they were acquired in transactions that meet one of the five proposed exceptions, were

acquired and held as an investment in the issuer.

The original proposal replaced the one-year and 90-day lock-up provisions with a single 180-day lock-up. According to NASD, the 180-day lock-up is consistent with the industry practice to impose a 180-day lock-up on securities of the issuer held by its officers, directors and other insiders. The amended proposal further tightens the lock-up provision by prohibiting certain derivative transactions. NASD believes that this change should ensure that securities subject to the lock-up are held as an investment and minimize the opportunity for underwriters and related persons to realize a quick profit from cheap stock and warrants acquired from the issuer or its nominees during the Review Period.

Commenters (Goldman, Fried Frank, SIA and Testa) suggested changing language in the amended proposal that could be read to prevent members from participating in public offerings in which their affiliates or associated persons are selling security-holders. They also commented that the lock-up restrictions are too broad and recommended that the restrictions apply only to securities deemed to be underwriter compensation related to initial public offerings.

In response to these comments, NASD proposes to revise the language in the proposed amendments to clarify that members may participate in public offerings in which the members, their affiliates or associated persons are offering their shares or are selling security-holders of another issuer. NASD intended for the Rule to permit such participation, but the draft rule language was not clear on this point. The proposed amendments also would limit the 180-day lock-up to equity or convertible-to-equity securities and certain derivatives (“unregistered equity securities”) held by underwriters and related persons and acquired during the Review Period. NASD also proposes additional exceptions from the lock-up requirements in NASD Rule 2710(g)(2) to provide that debt securities and derivative instruments (1) that are not items of value, or (2) that are eligible for the limited filing requirement in NASD Rule 2710(b)(6)(A)(iv) and have not been deemed to be underwriting compensation by the Department under the Rule will not be locked up.

The proposed amendments retain the lock-up provision in connection with secondary offerings. Nevertheless, NASD believes that it is unusual for members and their affiliates to acquire privately placed, unregistered securities of issuers conducting secondary

offerings, except pursuant to Rule 144A transactions. The proposed amendments would provide an exception from the lock-up restrictions for Rule 144A securities acquired after the completion of an issuer’s IPO.

#### 2. 10% Limitation

The original and amended proposals contained an objective standard that members and the Department would use to determine whether any “item of value,” such as fees and securities, received by underwriters and their affiliates must be included in the calculation of underwriting compensation under the Rule. Under this standard, all items of value received by a participating member during the Review Period would be included, unless the items were received in a transaction that met one of the enumerated exceptions contained in the proposal.

Exceptions 1 and 2 except from underwriting compensation, securities received as consideration for certain investments and loans by entities that are affiliates of members. These entities must meet certain capital and other requirements that are designed to ensure that they are engaged in bona fide businesses providing loans to, or venture capital investments in, other companies. The amended proposal also provided that the total amount of securities received by all entities related to a member in transactions meeting the requirements in Exceptions 1 and 2 may not exceed 10% of the issuer’s total equity securities, calculated immediately following the transaction.

Some commenters (Fried Frank, Goldman, Kirkland, SIA and Testa) asserted that the 10% limitation undermined the usefulness of the exceptions and was unnecessary because the other requirements in the exceptions ensure that the transactions are bona fide investments or loans. NASD proposed to retain the limitation in Exceptions 1 and 2, but raise the threshold to 25%. NASD states that other conditions of the exceptions help to ensure that the transaction is a bona fide investment or loan, but a 25% limitation is a reasonable additional protection against the potential for overreaching and unfair arrangements. The 25% limitation would apply only to transactions that qualify for the particular exception. If, for example, a member receives unregistered equity securities as placement agent compensation in a transaction that qualifies under the third exception, those securities would not count toward the 25% limitation on the amount of securities that could be acquired by an

<sup>22</sup> See *supra* notes 6 and 10.