

14. Non-Cash Compensation

One commenter (Winston) suggested that the Rule be amended so that its treatment of non-cash compensation conforms to the requirements in the rules regulating investment company sales charges and variable annuities. The proposed amendments do not address this issue. NASD currently is working on rule amendments that would address the issue comprehensively under both the Corporate Financing Rule and NASD Conduct Rule 2810 (Direct Participation Programs).

15. Certain Derivative Securities

NASD also proposes additional amendments to the definition of "item of value" so that it does not have the unintended effect of capturing within "underwriting compensation" certain derivative and other instruments that are entered into by members or related persons in the ordinary course of business. As proposed, the definition of "items of value" would include derivative instruments and certain other transactions that were not intended to be included in the compensation provisions. Accordingly, NASD proposes to add subsections (c)(3)(B)(vi) and (vii) to NASD Rule 2710, which provide that nonconvertible or non-exchangeable debt securities and derivative instruments acquired or entered into: (i) for a fair price; (ii) in the ordinary course of business; and (iii) in transactions unrelated to the public offering; are not "items of value" under the Rule. Because they are not items of value, they would also be excluded from the lock-up requirements in the Rule, as discussed above. In addition, any securities received in settlement of the derivative entered into at a fair price would not have any compensation value.

The term "fair price" would be defined in NASD Rule 2710(a)(9) to require that the underwriters and related persons have priced the non-convertible or non-exchangeable debt security or derivative instrument in good faith, on an arm's length basis, in a commercially reasonable manner, and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions. This "fair price" definition is intended to distinguish covered debt and derivative transactions from a transaction in which the benefit to the underwriter or related person is related to the underwriting or similar services provided to the issuer. The proposed definition would exclude a derivative instrument or other security

received for acting as a private placement agent for the issuer, for providing or arranging a loan, credit facility, merger, acquisition or any other service, including underwriting services.

As stated above, proposed NASD Rule 2710(c)(3)(B)(vi) and (vii) would require that the non-convertible or non-exchangeable debt securities and derivative instruments be acquired or entered into "in transactions unrelated to the public offering." Generally, if a transaction occurring within the review period is negotiated by personnel in a member's investment banking department, it would not be considered to be "unrelated to the public offering." An exception to this general principle would be a put option or other derivative instrument that is entered into by an issuer with an underwriter or related person, in connection with a publicly disclosed share repurchase program. The public disclosure and transparent nature of the repurchase program distinguish the derivative transaction in support of the program from other privately negotiated transactions between the investment bankers and the issuer during the review period.

NASD determined not to define the term "in the ordinary course of business" for purposes of Rule 2710(c)(3)(B)(vi) and (vii). Whether a debt or derivative transaction between an issuer and an underwriter or related person is part of regular business services provided by the member to its clients or whether it is a customized transaction that is being offered in connection with a public offering depends on the particular facts and circumstances.

Under the proposed Rule, information regarding debt and derivative transactions that do not meet the "in the ordinary course of business in transactions unrelated to the public offering" requirement of Rule 2710(c)(3)(B)(vi) and (vii) would be required to be filed if the related public offering is subject to the filing requirements of the Rule. NASD proposes to amend the filing requirement in NASD Rule 2710(b)(6)(A)(iv), such that information initially filed in connection with debt securities and derivative instruments acquired or entered into for a "fair price" as defined in NASD Rule 2710(a)(9), but not excluded from items of value, may be limited to a brief description of the transaction and a representation that the transaction was (or if the pricing terms have not been set) will be entered into at a fair price as defined in NASD Rule 2710(a)(9).

The required information would have to be submitted only with respect to the particular public offering to which a particular non-convertible or non-exchangeable debt security or derivative instrument relates. The Department would evaluate the information submitted in the same case-by-case manner that it will review financial consulting and advisory arrangements under the Rule.

IV. Commission Findings and Order Granting Accelerated Approval to Proposed Rule Change

The Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities association. In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,²³ which requires that an Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest.²⁴ The Commission believes that the proposed rule change should permit members to provide legitimate capital-raising services to issuers, while adopting restrictions that are designed to minimize the opportunity for abusive practices by members.

Current NASD Rule 2710 requires the terms of an underwriting to be fair and reasonable. Under the current Rule, any item of value, including certain securities of the issuer, acquired by the underwriter and related persons during the 12-month period before the filing date of a proposed public offering is examined by the Department to determine whether it was acquired "in connection with the public offering" and, therefore, is deemed to be underwriting compensation. The Rule presumes that any such item of value acquired during the six-month period before filing is underwriting compensation, but this presumption may be rebutted by the member based on information satisfactory to the Department. The proposed rule change replaces the current subjective standard with an objective standard under which all items of value received by an underwriter or related person during the 180 days before the required filing date of the registration statement or similar document will be considered to be underwriting compensation in connection with a public offering. Items

²³ 15 U.S.C. 78o-3(b)(6).

²⁴ In approving this rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).