

of value that are not disclosed to NASD, and items of value that are received subsequent to the public offering, would be subject to post-offering review to determine whether they were underwriting compensation for the public offering. The proposed rule also contains five exceptions from the general rule that an "item of value" is deemed to be underwriting compensation. The Commission believes that replacing the subjective test with an objective, bright-line test should provide greater clarity and predictability regarding whether equity securities of the issuer and other items of value acquired by the underwriter and related persons constitute underwriting compensation. In addition, it should permit the NASD to better use its resources.

A. Six-Month Pre-Offering Test

As stated above, 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-day period 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. Under the current Rule, the Department examines all items of value acquired by the underwriter and related persons during the 12-month period before the filing date of a proposed public offering. The Commission believes that a bright-line test should provide greater clarity and predictability concerning application of the Rule to specific transactions. Consequently, members and their venture capital and lending affiliates should find it easier to determine at the time of a private placement or other financing whether their investment will be treated as underwriting compensation when the subsequent public offering is filed with the Department for review. The Commission also believes that shortening the time-frame from one year to six months is reasonable and reflects the NASD's experience that a longer time frame has generally been unnecessary to minimize the opportunity for abusive practices by members. The Commission also notes that commenters generally supported shortening the look-back period to 180 days.

Several commenters requested that the Rule be amended to provide that the 180-day review period be measured from the date that the preliminary prospectus is circulated, particularly because certain issuers file early with the SEC. According to NASD, members

typically provide significant underwriting services in connection with the preparation and filing of a registration statement or other offering document. These underwriting activities are likely to have commenced during the 180-day period preceding the filing date. Consequently, the NASD is not going to amend the rule. The Commission believes it is reasonable for the NASD to measure the review period from the required filing date, rather than the date the preliminary prospectus is circulated.

B. Undisclosed and Post-Offering Compensation

The original proposal would have required the staff to examine items of value received by underwriters and related persons during the 90-day period immediately following the effective date of a public offering to determine whether they constitute underwriting compensation. Commenters expressed concern that the provision may subject members to disciplinary actions based upon the unknown activities by unaffiliated entities included in the definition of "underwriter and related person."

In response to the concerns of commenters, NASD narrowed the scope of the rule. As amended, proposed Rule 2710(d)(2) would provide that all items of value received and all arrangements entered into for the future receipt of an item of value by a participating member that are not disclosed to NASD before the date of effectiveness or the commencement of sales of a public offering (including items of value received after the public offering), are subject to post-offering review to determine whether such items of value are additional underwriting compensation for the public offering. In addition, subparagraph (b)(6)(vi)(b) would require the filing of any new arrangement that provides for receipt of an additional item of value subsequent to the issuance of an opinion of no objections to the underwriting arrangements by NASD and during the 90-day period following the date of effectiveness or commencement of the public offering. These provisions will enable NASD staff to consider whether items of value received after the public offering need to be included as underwriting compensation in order to avoid circumvention of the Rule.

C. Items of Value

Current Rule 2710(c)(3)(A) sets forth the items of value that are to be included in the calculation of underwriting compensation. NASD proposed to make non-substantive

amendments to the description of the types of equity securities that are included. In addition, in response to comments, NASD is proposing several changes to Rule 2710(c)(3)(B), which sets forth exclusions from "items of value." The proposal would expand this section by adding: (i) Cash compensation for acting as placement agent for a private placement or for providing a loan, credit facility, or for services in connection with a merger/acquisition; (ii) listed securities purchased in public market transactions; (iii) securities acquired through any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code; (v) securities acquired by an investment company registered under the Investment Company Act of 1940; (vi) non-convertible or non-exchangeable debt securities acquired for a fair price in the ordinary course of business in transactions unrelated to the public offering; and (vii) derivative instruments (and any securities received in settlement thereof) entered into for a fair price in the ordinary course of business in a transaction unrelated to the public offering.

The Commission believes that the proposal codifies exclusions for "items of value" that should not raise concerns about abuse and overreaching. As noted above, securities received in settlement of a derivative entered into at a fair price would not be considered an item of value. The Commission believes that it is reasonable to exempt any securities received in settlement of a derivative entered into at a fair price because the derivative transaction itself is not considered to be an item of value and, thus, the securities received in settlement (like any cash received in settlement in the case of a cash-settled derivative) would not represent any additional value.

Some commenters suggested that the exclusion for listed securities that are purchased in public market transactions is too narrow and should instead extend to securities that are freely trading or acquired in transactions with persons not affiliated with the issuer. Another commenter suggested that the definition of listed securities should be amended to specify the markets and exchanges on which securities may be listed to qualify for the exception. NASD has amended the Rule to specify eligible markets and exchanges. NASD believes that expanding the definition to include all freely trading securities or those acquired from unaffiliated persons would create unacceptable opportunities to evade the Rule. The Commission agrees.