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Update: Changes to NASD Corporate Financing Rule are Effective March 22, 2004

Reflecting the fact that underwriters and their affiliates have expanded the range of services they provide to clients (from venture capital investments, to consulting, lending, investment banking and providing hedging arrangements), the NASD in 2000 proposed amendments to the Corporate Financing Rule (Conduct Rule 2710), the principal rule relating to underwriter compensation. On December 23, 2003, the SEC approved the NASD's proposed changes to the Corporate Financing Rule. The amendments, a number of which had been given informal effect by the NASD, become effective March 22, 2004.

This memorandum summarizes the amended Corporate Financing Rule.

Underwriter Compensation

The Corporate Financing Rule generally prohibits any NASD member or "persons associated with a member" from receiving an amount of underwriting compensation that is deemed to be unfair or unreasonable.[1] Although there are certain exemptions from the NASD filing requirements,[2] the prohibition on unfair or unreasonable compensation applies to underwriters regardless of whether or not an NASD filing is required to be made. [3]

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1 The Corporate Financing Rule does not apply when (i) securities are offered pursuant to Section 4(2) of the Securities Act; (ii) securities are issued by open-end investment companies; or (iii) tender offers are made pursuant to Regulation 14D of the Securities Exchange Act of 1934.

2 Filing exemptions exist for various offerings, including (i) shelf offerings by certain issuers, (ii) offerings of investment grade securities, (iii) offerings by issuers that have certain unsecured investment grade debt outstanding; or (iv) exchange offers where the securities to be issued are listed.

3 In most instances, the NASD reviews filings required to be made by its members during a registered public transaction to ensure that the terms of distribution are fair and reasonable. The SEC will refuse to grant acceleration of effectiveness to any registration statement if the NASD has not issued an opinion that it has "no objection" to the underwriting compensation and other terms and agreements of the public offering. Filings must be made not later than one business day after the registration statement is filed (or submitted confidentially by a non-US issuer) to the SEC or, if not so filed, 15 days prior to the date on which offers are anticipated to commence (the "Required Filing Date").

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Under the Corporate Financing Rule, the term "compensation" is interpreted broadly. In determining the amount of compensation received by an underwriter and related persons, the NASD will take into account if, and when, such persons received "items of value" from the issuer.

All items of value received, and all arrangements entered into for the future receipt of an item of value, by the underwriter and related persons during the period commencing 180 days immediately preceding the required NASD filing date, until the date of effectiveness or commencement of sales of the public offering (the "Review Period"),[4] will be considered to be underwriting compensation in connection with a public offering, unless the securities are received in transactions subject to one of five exclusions. Securities will be considered to be received as of the date of the (i) closing of a private placement, if the securities were purchased or received for arranging a private placement, (ii) execution of a written contract with detailed provisions for the receipt of securities as compensation for a loan, credit facility or put option or (iii) transfer of beneficial ownership of the securities, if the securities were received as compensation for consulting or advisory services, merger or acquisition services, acting as a finder or for any other service.

Items of value. The term "items for value" includes:

- the underwriter's discount or commission;
- securities received for acting as private placement agent for the issuer or for providing or arranging a loan, credit facility, merger or acquisition services or any other service for the issuer;
- reimbursement of expenses to or on behalf of the underwriter and related persons;
- fees and expenses of underwriter's counsel;
- finder's fees, whether in the form of cash, securities or any other item of value;
- wholesaler's fees;
- financial consulting and advisory fees, whether in the form of cash, securities or any other item of value; and
- certain rights of first refusal.

The rules look to economic ownership to determine whether an underwriter or persons associated with such underwriter have received items of value.

- Private funds holding investments by an underwriter or associated persons (including some employee funds) will be considered "persons associated with such underwriter," notwithstanding that there may be no managerial relationship between the entity holding or acquiring the item of value and the underwriter.

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[4] The 180-day test replaces the 12-month look-back and six-month presumption under the old rule.

- If an underwriter or person associated with the underwriter has invested in any private equity or hedge fund and such fund has a passive investment in a company that issues securities in a public offering, the underwriter or associated person may be deemed to own the issuer's securities indirectly.

Certain exclusions from the definition of "item of value." The Corporate Financing Rule identifies various securities, fees and expenses that are excluded from the definition of "item of value." These items, which are not deemed to be underwriting compensation or subject to the lock-up discussed below, include:

- listed securities purchased in public market transactions;
- nonconvertible or non-exchangeable debt securities and derivative instruments if 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;
- securities acquired through a plan that qualifies under Section 401 of the Internal Revenue Code;
- securities acquired by a registered investment company; or
- cash compensation for acting as a placement agent for a private placement or for providing a loan, credit facility or services in connection with mergers and acquisitions.

Exclusions from underwriter compensation. The recent amendments to the Corporate Financing Rule set forth certain items that are excluded from underwriting compensation (but are subject to lock-up as described below). These exclusions are conditioned on the underwriter not conditioning its participation in the public offering on acquiring securities under an exception and any securities purchased are purchased at the same price and on the same terms as other investors.

- *Purchases and loans by certain entities*[5] – This exception applies to securities received as consideration for certain investments and loans by entities that are affiliates of the underwriter. To fall within this exception, these affiliated 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.[6]

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[5] For purposes of these exclusions, the term "entity" includes a group of legal persons that either are contractually obligated to make co-investments and have previously made at least one such investment or have filed a Schedule 13D or 13G; and may make investments through a wholly owned subsidiary.

[6] This exception is available if each entity:

- (i) manages capital contributions or commitments of $100 million or more, at least $75 million of which has been contributed or committed by persons that are not participating in the offering, (ii) manages capital contributions or commitments of $25 million or more, at least 75% of which has been contributed or committed by persons that are not participating in the offering or (iii) is an insurance company or bank;
- is a separate and distinct legal person from the underwriter and is not a registered broker-dealer;

This exception limits the amount of securities of an issuer that may be acquired in transactions during the Review Period to 25%.

- *Investments in and loans to certain issuers* – This exception applies to the acquisition of securities of issuers that have significant institutional investor involvement in their corporate governance. The exception is available for acquisitions by qualifying related entities in a private placement or as compensation for a loan or credit facility. To fall within this exception, the entities also must meet certain capital and other requirements to ensure that the entities have been primarily engaged in the business of making investments in or loans to other companies.[7] The exception limits the amount of securities of an issuer that may be acquired in a transaction to 25%. Unlike the first exception, however, it applies the 25% threshold to each acquisition of securities under the exception.

- *Private placements with institutional investors* – This exception applies to venture capital investments or the receipt of securities as compensation for acting as a placement agent in transactions that include significant institutional investor participation. The exception includes the requirement that an institutional investor that is not affiliated with any underwriter participating in the public offering must have negotiated, established or approved the terms of the investment. In addition, underwriters and related persons, in the aggregate, may not purchase or receive as placement agent compensation securities in an amount that exceeds 20% of the amount of securities sold in the private placement.

- *Acquisitions and conversions to prevent dilution* – This exception applies to acquisitions of securities that are acquired as the result of: (i) a qualifying right of preemption or a stock-split or pro-rata rights or similar offering or (ii) the conversion of securities that have not been deemed by the NASD to be underwriting compensation. The only terms of the purchased securities that could be different from the terms of securities purchased by other investors would be preexisting contractual rights that were granted in connection with a prior purchase. Further, the opportunity to purchase or receive additional securities must have been provided to all similarly situated security holders. Finally, the amount of securities purchased or received must not have increased the recipient's percentage

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- makes investments or loans subject to the evaluation of individuals who have a contractual or fiduciary duty to select investments and loans based on the risks and rewards to the entity and not based on opportunities for the member to earn investment backing revenues;
- does not participate directly in investment banking fees received by any participating member for underwriting public offerings; and
- has been primarily engaged in the business of making investments in or loans to other companies.

[7] This exception is available if each entity:

- (i) manages capital contributions of commitments of at least $50 million; (ii) is a separate and distinct legal person from any underwriter and is not registered as a broker dealer; (iii) does not participate directly in investment banking fees received by the underwriter for underwriting public offerings; and (iv) has been primarily engaged in the business of making investments in or loans to other companies;
- institutional investors beneficially own at least 33% of the issuer's total equity securities, calculated immediately prior to the transaction; and
- the transaction was approved by a majority of the issuer's board of directors and a majority of the institutional investors.

ownership of the same generic class of securities of the issuer, except in the case of conversions and passive increases that result from another investor's failure to exercise its own rights.

- *Securities acquired in an issuer with which the underwriter has a prior investment history* – This exception applies to acquisitions made in private placements during the previous six months in order to prevent dilution of a long-standing equity interest in the issuer. To be eligible for the exception, the investor must have made at least two prior purchases of the issuer's securities: at least one investment must have been made at least 24 calendar months before the Required Filing Date and a second investment must have been made more than 180 days before the Required Filing Date.

Per se prohibitions. The Corporate Financing Rule designates certain categories of compensation as *per se* unfair and unreasonable. These categories include:

- reimbursement of salaries, overhead, supplies or like items;
- reimbursement of expenses other than out-of-pocket expenses;
- any fee tail with a duration of more than 2 years;
- any right of first refusal with a duration of more than three years;
- certain warrants and options with durations of more than five years or warrants and options exercisable at a price below the public offering price; and
- the receipt of indeterminate compensation.

Determinations of fair compensation. In general, the NASD examines the total compensation (as determined above) and compares that compensation to its unpublished maximum permitted compensation amounts. The NASD will consider, among other things, the amount of risk assumed by the underwriter and the amount of the offering. If the amount of compensation is deemed to be unfair or unreasonable, the NASD will prohibit the underwriter from participating in the offering.

Lock-up provisions. Amendments to the Corporate Financing Rule eliminated the general 12-month lock-up and the 90-day venture capital lock-up. The Rule now establishes a six-month lock-up of:

- all unregistered securities acquired by an underwriter and related persons during the 180 days prior to the Required Filing Date and deemed to be underwriting compensation;
- all unregistered securities acquired after the filing of the registration statement and deemed to be underwriting compensation; and
- any security excluded from underwriting compensation under one of the five exceptions described above.

The following would not be prohibited by the lock-up:

- transfers to any members participating in the offering and the officers and partners thereof, if all of the securities so transferred remain subject to the lock-up for the balance of the 180 days;

- transfers of securities beneficially owned on a pro rata basis by all equity members of an investment fund, provided no participating member manages or otherwise directs investments by the fund and participating members in the aggregate do not own more than 10% of the equity in the fund;

- any security excluded from the definition of "item of value";

- transfers of "fair price" derivatives acquired in connection with the offering (though securities acquired by the underwriter or related person upon settlement of the derivative would be subject to the same extent as any other unregistered security);

- transfers of securities where the aggregate amount of securities of the issuer held by the underwriter and persons associated with such underwriter do not exceed 1% of the securities being offered; and

- transfers of securities that are acquired subsequent to the issuer's initial public offering in a transaction exempt from registration pursuant to SEC Rule 144A.

Qualified Independent Underwriter

The Corporate Finance Rule provides that except in certain instances, if more than 10% of the net proceeds of an offering (not including underwriting compensation) will be paid to an underwriter participating in the offering or any associated person of the underwriter, any member of their immediate family or any affiliate of the underwriter, then

- the price at which an equity issue or the yield at which a debt issue is to be distributed is at a price no higher or yield no lower than that recommended by a Qualified Independent Underwriter ("QIU"), which shall also participate in the preparation of the registration statement and the prospectus and which shall exercise the usual standards of due diligence with respect to the offering; and

- the underwriting or plan of distribution section of the registration statement, offering circular or other similar document shall state that the offering is being made pursuant to this rule and, where applicable, the name of the member acting as a QUI.

A QIU will not be required where (i) a bona fide independent market exists or (ii) the offering is of a class of securities rated Baa or better by Moody's rating service or Bbb or better by Standard and Poor's rating service or rated in a comparable category by another rating service acceptable to the NASD.

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