



## SEC Adopts Major Changes to NASD Corporate Financing Rule\*

### Purpose of the NASD's Corporate Financing Rule

#### History and objectives

The National Association of Securities Dealers, Inc. (the "NASD"), pursuant to its Conduct Rule 2710 (the "Corporate Financing Rule" or the "Rule"), substantively reviews many public offerings of securities and all initial public offerings to determine whether the underwriting terms and conditions are "fair and reasonable".

Generally, the Corporate Financing Rule prohibits NASD members, including persons associated with NASD members, from receiving an amount of underwriting compensation in connection with a public offering that is deemed to be unfair or unreasonable by the NASD. The NASD will assess the fairness of underwriting terms and arrangements by considering, among other things, the amount of risk assumed by participating NASD members and the dollar amount of the offering proceeds. If the amount of compensation is deemed to be unfair or unreasonable, the NASD will withhold its "no objections" opinion until alternate arrangements are made.

In an attempt to accommodate the changing pace of corporate financing activities by NASD members, and the increasing breadth of services provided by NASD members in addition to underwriting and related services, the NASD commenced an amendment process in January 2000. From January 2000 until December 2003, the NASD filed ten drafts of the proposed changes to the Corporate Financing Rule with the Securities and Exchange Commission ("SEC"). On December 23, 2003, the SEC adopted the proposed rule change (as adopted, the "Adopted Rules").<sup>1</sup> The NASD has now released a substantial

\* This memorandum is an abridged version of our client publication analyzing the adopted changes to NASD Conduct Rule 2710. For more information regarding this subject, or to obtain a copy of the unabridged memorandum and analysis, please contact any of the Shearman & Sterling LLP attorneys named on the last page of this memorandum.

<sup>1</sup> See Release No. 34-48989 (SR-NASD-2000-04) (December 23, 2003), 68 FR 75684 (December 31, 2003) ("Approval Order").

Notice to Members describing the Adopted Rules, and has announced that the Corporate Financing Rule became fully effective as of March 22, 2004.<sup>2</sup>

This memorandum describes in detail the NASD's Adopted Rules and provides a broad overview of the NASD corporate financing review process.

### Underwriting Compensation

#### Compensation and items of value received by an underwriter or a related person<sup>3</sup>

##### *Underwriting compensation*

The Corporate Financing Rule prohibits NASD members from participating in a public offering if the compensation to be received by the underwriters is unfair or unreasonable. Compensation in connection with a public offering, however, is a broader term than underwriting discount or commission. When reviewing the terms and conditions of an underwriting agreement, the NASD will take into account if and when an underwriter received "items of value" from the issuer.

##### *What are items of value?*

Under the Adopted Rules, the following items of value and all other items of value that are received by an underwriter and related persons during a specified time period and in connection with or related to the distribution

<sup>2</sup> See NASD Notice to Members 04-13, "Amendments to the Corporate Financing Rule" (February, 2004) ("NTM 04-13") currently available at <<http://www.nasdr.com/pdf-text/0413ntm.pdf>>. The Corporate Financing Rule as it existed prior to the effectiveness of the Adopted Rules is referred to in this memorandum as the "Prior Rule". As of the time of this memorandum, the NASD has proposed further changes to the Corporate Financing Rule. Those changes are described by the Shearman & Sterling LLP client publication, "NASD Reissues Proposals to Amend the Corporate Financing Rule With Respect to Regulation of Shelf Offerings", currently available at <[www.shearman.com](http://www.shearman.com)>.

<sup>3</sup> *Underwriter and Related Persons*, as defined in the Adopted Rules, "consists of underwriter's counsel, financial consultants and advisors, finders, any participating member, and any other persons related to any participating member."

of securities in a public offering would be included in the calculation of underwriting compensation:

- the underwriters' discount or commission;
- reimbursement of expenses to or on behalf of the underwriter and related persons;
- fees and expenses of underwriter's counsel (except for reimbursement of "blue sky" fees);
- finder's fees, whether in the form of cash, securities or any other item of value;
- common or preferred stock, options, warrants, and other equity securities, including debt securities convertible to or exchangeable for equity securities, received: (a) for acting as private placement agent for the issuer; (b) for providing or arranging a loan, credit facility, merger or acquisition services, or any other service for the issuer; (c) as an investment in a private placement made by the issuer; or (d) at the time of the public offering;
- special sales incentive items;
- any right of first refusal to underwrite or participate in future public offerings, private placements or other financings, which will have a compensation value of 1% of the offering proceeds, or alternatively, the dollar amount the issuer is contractually obligated to pay the underwriter in order to cancel the right of first refusal;
- compensation to be received by the underwriter and related persons or by any person nominated by the underwriter as an advisor to the issuer's board of directors in excess of that received by other members of the board of directors;
- commissions, expense reimbursements, or other compensation to be received by the underwriter and related persons as a result of the exercise or conversion within twelve months following the effective date of the offering of warrants, options, convertible securities, or similar securities distributed as part of the public offering;
- fees of a qualified independent underwriter; and
- compensation, including expense reimbursements, paid in the six months prior to the initial or amended filing of the prospectus or to any member in connection with a proposed public offering that was not completed, unless the member does not participate in the revised public offering.

*Exclusion of certain items of value (including certain securities) without further analysis*

In addition to the safe harbor provided by the five "exceptions" described below, the Adopted Rules identify six items of value that would not be deemed compensation in connection with a public offering:

- 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 or acquisition;<sup>4</sup>
- underwriters' expenses that are customarily borne by issuers, such as printing costs, SEC, NASD and "blue sky" registration fees, and accountant's fees;
- compensation (including reimbursement of expenses) previously paid to any member in connection with a proposed public offering that was not completed, if the member does not participate in the revised public offering;
- listed securities<sup>5</sup> purchased in public market transactions;
- securities acquired through any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code; and
- securities acquired by an investment company registered under the Investment Company Act of 1940, as amended (the "40 Act").

*Items of value received by an underwriter or related person within six months of filing a registration statement will be deemed to be underwriting compensation*

Under the Adopted Rules, the NASD employs a bright-line, objective test to determine whether an underwriter's receipt of an item of value should be considered compensation in connection with a public offering. Specifically, the Adopted Rules state that all items of value received within the 180-day period preceding the first submission of a registration statement will be considered compensation in connection with the public offering.

In addition, if items of value or arrangements to receive items of value are not disclosed to the NASD prior to the date of the registration statement's effectiveness or prior to commencement of selling (including compensation received close in time after the effectiveness of the offering), the Adopted Rules provide that the NASD may conduct a post-offering review to determine whether such items of value or arrangements to receive items of value by any participating NASD member are, in fact, underwriting compensation in connection with the public offering.

<sup>4</sup> Note that the NASD has continued to analyze receipt of both cash and securities in connection with financial, consulting and advisory services based on the particular facts and circumstances of the arrangement under review.

<sup>5</sup> The phrase "listed securities" is defined in the Adopted Rules to mean (a) securities meeting the listing standards to trade on the national securities exchanges identified in SEC Rule 146, (b) markets registered with the SEC under Sections 6 or 11A of the Exchange Act, and (c) any offshore market that is a "designated offshore securities market" under Rule 902(b) of SEC Regulation S.

*Securities received in connection with private placements or lending activities*

Under the Adopted Rules, underwriters or related persons that acquire an issuer's securities in connection with a private placement or as compensation for arranging loans or credit facilities will be considered to have received such securities when (a) the private placement in which securities are purchased or otherwise received closes, (b) when the contract providing for the receipt of securities as compensation for a loan, credit facility or put option is executed, or (c) on the transfer of beneficial ownership of securities received as compensation for consulting or advisory services, merger or acquisition services, acting as a finder, or for any other service.

**The Adopted Rules contain five "exceptions" to the designation of recently acquired securities as underwriting compensation.**

*Technical description of the exceptions*

The Adopted Rules contain five "exceptions" that will allow underwriters and related persons to exclude certain items of value from the NASD's definition of underwriting compensation. The following is a brief summary of the five exceptions detailed in the Proposed Rule:

- (a) Purchaser and loans by certain entities.<sup>6</sup> Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility (before the issuer's first submission to the SEC) by certain enumerated entities will, if other criteria relating generally to the independence of such entities from the underwriting function of the underwriters are met, be excluded from the definition of underwriting compensation.
- (b) Investments in and loans to certain issuers. Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility (before the issuer's first submission to the SEC) if received by certain entities from issuers that are substantially owned by institutional in-

<sup>6</sup> The Adopted Rules define "entity" to include a "group of legal persons" who (i) (a) are contractually obligated to make co-investments and have previously made at least one such investment, or (b) have filed a Schedule 13D with the SEC that identifies the legal persons as members of a group that have agreed to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer in connection with a previous investment; and (ii) may make its investment or loan through a wholly-owned subsidiary (except when the entity is a group of legal persons.)

vestors<sup>7</sup> will, if other criteria relating generally to the independence of such issuers and entities from the underwriting function of the NASD member under review, be excluded from the definition of underwriting compensation if:

- (c) Private Placements with Institutional Investors. Securities of the issuer before the issuer's first submission to the SEC will be excluded from the definition of underwriting compensation if those securities were purchased in an "institutional round" of financing in which, among other things, (i) institutional investors purchased 51% or more of the total round, and (ii) an institutional investor were the lead negotiator in setting the terms of the round with the issuer.
- (d) Acquisitions and Conversions to Prevent Dilution. Securities of the issuer will be excluded from the definition of underwriting compensation if, among other criteria designed to ensure that the anti-dilution rights are *bona fide*, those securities were acquired as the result of a right of preemption granted in connection with a private placement (other than a private placement that itself is deemed to be compensation), a stock-split or the conversion of securities that have not been deemed by the NASD to be underwriting compensation.
- (e) Securities acquired in a company with which the member has a prior investment history. Securities of the issuer will be excluded from the definition of underwriting compensation if, the receipt of those securities did not increase the purchaser's percentage ownership of the same generic class of securities of the issuer, and an initial purchase of securities of the issuer was made at least two years and a second purchase was made 180 days the required filing date of the public offering.<sup>8</sup> Since the first three exceptions will require the securities to be acquired *before* the first submission of the registration statement, these exceptions will *not be available for private placements or loans conducted during the registration period.*

<sup>7</sup> An institutional investor is a defined term generally referring to an institution that has over \$50 million under management, of which NASD members participating in the offering under review do not direct or otherwise manage the institutional investor's investments and do not hold an equity interest of more than 1% (for a private entity) or 5% (for a publicly-owned entity).

<sup>8</sup> The acquisition in question must be the third acquisition by the NASD member or its related person, the first being more than two years prior to the first submission of a registration statement to the SEC and the second being more than 180 days prior to the first submission of a registration statement to the SEC.

## Lock-up Restrictions

### The Adopted Rules significantly change the lock-up restrictions

*The new lock-up is shorter but broader*

The Prior Rules imposed a one-year lock-up on securities deemed to be underwriting compensation. Securities of an issuer that were not deemed to be underwriting compensation, but were held by members of the underwriting syndicate in an IPO, however, were subject to a 90-day “venture capital” lock-up.

Under the Adopted Rules, securities subject to the NASD’s lock-up restrictions will be locked up for a shorter period of time. However, the Adopted Rules also expand the breadth of the lock-up restrictions. The Adopted Rules require a 180-day lock-up on: (a) all of the issuer’s unregistered equity securities or debt securities convertible to or exchangeable for equity securities that are acquired by an underwriter or its related person within 180 days prior to the filing of the registration statement and deemed to be compensation in connection with the offering; (b) all unregistered securities of the issuer acquired after the filing of the registration statement and deemed to be compensation in connection with the offering; or (c) any security excluded from compensation under one of the five exceptions, as described above.<sup>9</sup> However, the Adopted Rules states that a lock-up is required in any public equity offering, “other than a public equity offering by an issuer that can meet the requirements [of the “shelf offering” filing exemption contained] in subparagraphs (b)(7)(C)(i) or (ii)” of the Adopted Rules. An important exception to the lock-up restrictions therefore appears to have been created by the NASD for shelf offerings of mature and sizeable issuers.<sup>10</sup>

<sup>9</sup> The text of the proposed change reads as follows: “Any common or preferred stock, options, warrants, and other equity securities of the issuer, including debt securities convertible to or exchangeable for equity securities of the issuer, that are unregistered and acquired by an underwriter and related person within 180 days prior to the filing of the registration statement, or acquired after the filing of the registration statement and deemed to be compensation by NASD, and securities excluded from underwriting compensation pursuant to subparagraph (d)(5) above, shall not be sold during the offering, or sold, transferred, assigned, pledged, or hypothecated, or be the subject of any hedging, short sale, derivative, put, or call transaction that would result in the effective economic disposition of the securities by any person for a period of 180 days immediately following the date of effectiveness or commencement of sales of the public offering, except as provided in subparagraph (g)(2) below.”

<sup>10</sup> For more information regarding the shelf offering exemption, please see the Shearman & Sterling LLP client publication, “NASD Reissues Proposals to Amend the Corporate Financing Rule With Respect to Regulation of Shelf Offerings”, currently available at <www.shearman.com>.

The Adopted Rules also clarify that NASD members and related persons may offer their own securities or act as selling security holders of another issuer without being subject to the lock-up restrictions.

The exceptions to the lock-up restrictions have also been broadened somewhat. The NASD’s lock-up restrictions will not apply to any transfer of any security:

- (i) by operation of law or by reason of reorganization of the issuer;
- (ii) to any member participating in the offering and the officers or partners thereof, if all securities so transferred remain subject to the lock-up restriction for the remainder of the time period;
- (iii) if the aggregate amount of securities of the issuer held by the underwriter or related person do not exceed 1% of the securities being offered;
- (iv) that is beneficially owned on a pro-rata basis by all equity owners of an investment fund, provided that 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;
- (v) that is not an “item of value” under the Adopted Rules, because such security is either (i) a listed security purchased on the open market, (ii) a security acquired through a plan that qualifies under Section 401 of the Internal Revenue Code, or (iii) a security acquired by an investment company that is so registered under the ’40 Act;
- (vi) that is eligible for the limited filing relating to derivative transactions (described below) and has not been deemed to be underwriting compensation;
- (vii) that was previously but is no longer subject to the lock-up restriction in connection with a prior public offering (or a lock-up restriction in the Prior Rules), provided that if the prior restricted period has not been completed, the security will continue to be subject to such prior restriction until it is completed; or
- (viii) that was acquired subsequent to the issuer’s initial public offering in a transaction exempt from registration pursuant to SEC Rule 144A.

Furthermore, the lock-up restrictions permit the exercise or conversion of any security, provided that all securities received from such exercise or conversion remain subject to the lock-up restriction, as described above, for the remainder of the time period.

### *Extended lock-up yields discounts on compensation*

Under the Adopted Rules, the imputed value of securities that are voluntarily locked up beyond the 180-day period will be discounted to reflect the additional restrictions on sale or disposition. The Adopted Rules state that a lower value equal to 10% of the calculated compensation value shall be deducted for each 180-day period that the securities or underlying securities

are restricted from sale or other disposition beyond the 180-day period of lock-up restriction that is otherwise required. However, certain transfers will not be permitted during a voluntary, extended lock-up.<sup>11</sup>

## Issues Relating to Derivatives

**The Adopted Rules significantly change the valuation of warrants that are deemed to be compensation in connection with an offering.**

### *Description of changes to warrant valuation*

An underwriter or related person may not receive a security (including securities in a unit), a warrant for a security, or a convertible security as underwriting compensation in connection with a public offering unless:

- the security received or the security underlying the warrant or convertible security is identical to the security offered to the public or to a security with a bona fide independent market;<sup>12</sup> or
- the security can be accurately valued by the warrant formula set out in the Adopted Rules.

Despite eliminating the prohibition found in the Prior Rules on so-called “in the money” warrants, the Adopted Rules have modified the warrant valuation procedures in order to provide a disincentive to the receipt of warrants as items of compensation.

The warrant formula set out in the Adopted Rules is the same formula set forth and enforced by the NASD in connection with the Prior Rules.<sup>13</sup> In addition to the requirement that the security be capable of valuation under one of the NASD’s formulas, there is an additional barrier to the receipt of warrants created in the Adopted Rules. Specifically, under the Adopted Rules, such warrants are deemed to have a compensation value of no less than 0.2% of the offering proceeds for each amount of securities that is up to 1% of the securities being offered to the public (excluding securities subject to an over-allotment option).

<sup>11</sup> Specifically, the transfers permitted by subparagraphs (g)(2)(A)(iii) and (iv) of the proposed rules (items (iii) and (iv) immediately above) are not available for the sale of such securities.

<sup>12</sup> “Bona fide independent market” is a term defined in NASD Rule 2720.

<sup>13</sup> The “warrant” formula for options, warrants or convertible securities price in the Adopted Rules is as follows: (A) the public offering price per security multiplied by 0.65; (B) minus the result of the exercise or conversion price per warrant less either: (i) the market price per security on the date of acquisition, where a bona fide independent market exists for the security, or (ii) the public offering price per security; (C) divided by two; (D) multiplied by the number of securities underlying the warrants; (E) less the total price paid for the warrants; (F) divided by the offering proceeds; and (G) multiplied by one hundred. A similar formula exists for instruments that have an exercise or conversion price.

**The acquisition of nonconvertible or non-exchangeable debt securities and derivative instruments may be deemed underwriting compensation in connection with a public offering**

### *Purpose of the Derivative Amendments*

Recognizing that NASD members or related persons may enter into certain derivatives and other instruments in the ordinary course of business, the NASD has adopted special provisions (the “Derivative Amendments”) as part of the rule proposals adopted by the SEC. The NASD acknowledges that the definition of “items of value”, as defined, might include derivative instruments<sup>14</sup> and certain other transactions that were not intended to be included in the NASD’s compensation provisions.<sup>15</sup> The NASD, therefore, adopted the Derivative Amendments, which are intended to address the unintended possibility that the entry into derivatives or other instruments by NASD members in the ordinary course of business will be counted as underwriting compensation in connection with a public offering.

### *Overview of the Derivative Amendments*

Under subparagraphs (c)(3)(B)(vi) and (vii) to Rule 2710, nonconvertible or non-exchangeable debt securities and derivative instruments acquired or entered into:

- for a fair price;
- in the ordinary course of business; and
- in transactions unrelated to the public offering;

will not be considered items of value, and will therefore be excluded from the NASD’s determination of compensation and lock-up requirements.

### *The term “fair price” defined*

The Derivative Amendments require underwriters and related persons to acquire nonconvertible or non-exchangeable debt securities or derivative instruments at a fair price. The NASD will consider debt securities or derivative instruments to have been acquired or entered into at a “fair price” if the underwriters and related persons priced such securities (i) in good faith; (ii) on an arm’s length, commercially reasonable basis; and (iii) in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions.

A derivative instrument or other security entered into or acquired for acting as a private placement agent for the issuer, for providing or arranging a loan,

<sup>14</sup> A “derivative instrument” is any “eligible OTC derivative instrument”, as defined in SEC Rule 3b-13(a)(1), (2) and (3).

<sup>15</sup> See File No. SR-NASD-2000-04, Amendment No. 8: Amendments to the Corporate Financing Rule (April 11, 2003).

credit facility, merger, acquisition or any other service, including underwriting services, is explicitly not included within the “fair price” definition. Therefore, if a NASD member is participating in a public offering and such NASD member also receives a derivative instrument or other security in consideration for the performance of any of the aforementioned services, the NASD will consider the receipt of such instruments to be an item of value and may deem such instruments to be compensation in connection with the public offering under review.

To determine whether a NASD member has acquired a debt security or entered into a 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”, the NASD will compare the level of risk assumed by the underwriter or related person to the relative benefit gained by the underwriter and the customer. If a transaction “is structured so that the risk to the underwriter or related person and the benefit to the customer is expected to be minimal, in comparison to the benefit received by the underwriter or related person,” the NASD will not consider such debt security or derivative instrument to have been acquired at a “fair price”. However, the NASD will not apply “twenty-twenty hindsight” when considering risks versus benefits; rather, the NASD will determine whether the “fair price” requirement was satisfied at the time the parties entered into the transaction.<sup>16</sup>

*“In the ordinary course of business” is not a defined term*

The Derivative Amendments require underwriters and related persons to acquire non-convertible or non-exchangeable debt securities or derivative instruments “in the ordinary course of business”. This term is not defined. The NASD will consider the “facts and circumstances” of each case when determining whether a debt security or derivative instrument has been acquired in the ordinary course of business or, alternatively, in a transaction related to an issuer’s public offering.

*Derivative transactions must be unrelated to the public offering*

The Derivative Amendments require underwriters and related persons to acquire nonconvertible or non-exchangeable debt securities or derivative instruments in transactions unrelated to a public offering. In general,

the NASD will not consider transactions to be unrelated to a public offering, if (i) the transaction occurs during the NASD’s review period; and (ii) the transaction was negotiated by persons employed by the NASD member’s investment banking department. However, if an underwriter enters into a transaction related to a publicly-disclosed share repurchase program, the preceding analysis will not apply, because “[t]he 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.”

In NTM 04-13, the NASD notes that information regarding debt and derivative transactions that are related to the public offering must be filed if the related public offering is subject to the filing requirements of the Rule. However, if a NASD member participating in a public offering has entered into a derivative transaction in connection with an offering that is exempt from the Rule’s filing requirements, members and their counsel must evaluate the facts and circumstances and reasonably determine that the transaction was executed at a fair price and, therefore, has no compensation value.

*Valuation of Derivative or Debt Transactions entered into at other than “fair price” for purposes of the Corporate Financing Rule*

The Derivative Amendments provide that any debt or derivative transaction acquired or entered into at a “fair price” and any item of value received in or receivable in the settlement, exercise or other terms of such debt or derivative transaction do not have a compensation value for purposes of determining underwriting compensation. If the actual price for the debt or derivative security is not a fair price, however, compensation should be calculated pursuant to subsection (e) of the Adopted Rules (the “warrant formula” discussed above) or based on the difference between the fair price and the actual price.

*Information that should be filed relating to derivatives transactions*

The Adopted Rules require NASD members participating in a public offering to disclose whether they or their related persons have entered into an arrangement, during the 180-day period immediately preceding the required filing date of the public offering, that provides for the receipt of any item of value or the transfer of any warrants, options, or other securities.

The Derivative Amendments, however, provide that a NASD member does not need to file information regarding debt securities and derivative instruments if such securities are not considered to be items of value. Conversely, if debt securities and derivative instruments are items of value, but were nevertheless acquired “for a

<sup>16</sup> The NASD provides the following assurance: “NASD recognizes ... that the fact that a debt security or derivative instrument turns out to be more or less favorable to a party as the result of market movements or events subsequent to entry into the transaction would not affect whether the transaction was entered into at ‘fair price’ under the definition.”

fair price”, information required to be filed may be limited to a brief description of the transaction and a representation by the NASD member that the transaction was or will be entered into at a fair price (hereinafter, the “Limited Filing Requirement”).<sup>17</sup> Any required information would only have to be submitted with respect to a particular public offering.

The Adopted Rules also require NASD members that have participated in a public offering to disclose, subsequent to the issuance of the NASD’s “no objections” opinion, if it or a related person has entered into any new arrangement that provides for the receipt of any additional item of value within 90 days immediately following the date of effectiveness or commencement of sales of the public offering. The Derivative Amendments, however, provide that any such information filed in connection with debt securities and derivative instruments acquired or entered into for a “fair price” may be submitted in accordance with the Limited Filing Requirement.

*Lock-up requirements for debt securities and derivative instruments*

If a debt security or derivative instrument is an item of value and is thus deemed by the NASD to be compensation in connection with a public offering, such derivative instruments and securities may be subject to the lock-up restrictions, as described above. However, the Derivative Amendments do allow for an exception: if a NASD member can take advantage of the Limited Filing Requirement and if the NASD has not deemed such securities to be underwriting compensation, then the derivative instruments and debt securities acquired by the NASD member will not be subject to any of the NASD’s lock-up restrictions.<sup>18</sup>

<sup>17</sup> The NASD may require the NASD member to submit additional information during the review process.

<sup>18</sup> During the pendency of the Adopted Rules, the NASD explained the rationale for excluding derivative instruments and securities that are eligible for the Limited Filing Requirement: “NASD staff understand that interest rate swaps entered into in connection with a bond offering may be designed to reduce the issuer’s net cost of funding for the offering or to exchange a fixed rate obligation for a floating rate obligation. If the transaction were entered into at a ‘fair price’... the Department would not determine that the interest rate swap constituted underwriting compensation and the lock-up provision would not apply. If the interest rate swap were entered into in connection with a bond offering subject to the filing requirements of the [Adopted] Rule[s], however, information regarding the swap arrangement would be required to be filed and reviewed so that the Department could reach this conclusion.”

## Receipt of Proceeds by Underwriters

**The receipt of more than 10% of the proceeds of a public offering by an underwriter or related person may require a “QIU” to be appointed.**

*Technical description of Rule 2710(c)(8)*

Under the Prior Rules and the Adopted Rules, if more than 10% of the net proceeds of an offering (not including underwriting compensation) will be paid to members participating in the offering, compliance with Rule 2720(c)(3) is required. Rule 2720(c)(3) requires the imposition of a qualified independent underwriter (“QIU”) to establish the fairness of the offering price of the securities to be issued, unless (i) a bona fide independent market exists (for equity securities); or (ii) the securities are investment grade (for debt securities).

## Conclusion

This memorandum is an abridged version of our client publication analyzing the adopted changes to NASD Conduct Rule 2710. For more information regarding this subject, or to obtain a copy of the unabridged memorandum and analysis, please contact any of the Shearman & Sterling LLP attorneys named on the last page of this memorandum.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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