

The NASDAQ Stock Market Solicits Comments on a Method for Valuing Warrants in Applying the Shareholder Approval Listing Requirements

NASDAQ is considering a change in the method for valuing warrants in applying the shareholder approval listing requirements. As with all initiatives, your feedback is imperative to us in ensuring we maintain our high quality service. With that we welcome and encourage you to tell us what you think. Comments should be submitted by January 15, 2007.

Please review the details of the proposed change included below. While NASDAQ welcomes all comments, in particular NASDAQ is seeking comment on the following questions:

- Should NASDAQ adopt the methodology described in this request for comment?
- If NASDAQ were to adopt the changes described, would you prefer the use of a formula or a table to determine the value of warrants?
- Does the NASD Rule fail to adequately consider any factors which may result in the valuation being inaccurate?
- Are there other changes to the shareholder approval requirements that NASDAQ should consider?

Comments may be provided electronically via email to: warrantvaluation@nasdaq.com or may be submitted in writing to:

David Compton
Director, Listing Qualifications
The NASDAQ Stock Market
9600 Blackwell Road
Rockville, MD 20850

It is important to note that any changes NASDAQ makes will require approval of the Securities and Exchange Commission. NASDAQ will share any comments received in response to this request with the SEC, and such responses may become public in that process.

We hope that you will take this opportunity to give your opinion and thank you in advance for your feedback.

Background

Pursuant to Marketplace Rule 4350(i)(1)(D), a company is required to obtain shareholder approval if a transaction could result in an issuance of 20% or more of the company's pre-transaction shares outstanding at a price less than the greater of the book or market value of the common stock. The application of this rule generally is straightforward when a transaction involves only a single security. However, it is not uncommon for a listed company to sell common stock and warrants together in a transaction where the common stock portion alone represents more than 20% of the pre-transaction outstanding shares. NASDAQ has long taken the position that a value should be attributed to warrants issued in such a transaction and has historically attributed a value to the warrants of \$1/8 for each share that could be purchased.¹ The remainder of the consideration received by the company is allocated to the common stock and is compared to the book value and closing bid price at the time of the transaction to determine if shareholder approval is required.

A simple example can illustrate NASDAQ's historical treatment of these transactions. Assume that a company sells 2,200,000 units (representing more than 20% of the outstanding shares) for \$2.00 per unit, the closing bid price of the common stock on the date of the transaction, and that the stock's closing bid price is higher than its book value. Each unit consists of one share of common stock and one warrant, exercisable at \$2.46. To avoid the need for shareholder approval under NASDAQ's historic approach, these units would have had to be priced at \$2 1/8 (\$2.125) or more.

Recognizing the historic \$1/8 valuation is an outgrowth of a pre-decimal trading environment, and that warrants now can be valued under a variety of sophisticated models, NASDAQ is considering whether it would be appropriate to adopt a different model for valuing warrants in connection with the shareholder approval rules. NASDAQ is soliciting your comments on the merits of this approach, including in particular, the proposal which is outlined below.

Discussion

As part of its analysis, NASDAQ researched and tested a variety of models that value warrants and other derivative securities, including the Black-Scholes Option Pricing Model, the Binomial Option Pricing Model, and the formula used by the NASD in valuing warrants to determine underwriter's compensation (NASD Rule 2710(e)(3) (the "NASD Rule")). The NASD Rule utilizes a seven-step process which takes into account the offering price, the intrinsic value of the warrant, the number of warrants, the price paid for the warrants, and the offering proceeds, to determine the share equivalent for each warrant in question, which is multiplied by the closing bid price of the common stock to find the dollar value of each warrant. NASDAQ believes that the NASD Rule may offer certain advantages over the other models because it is simpler to apply and is generally familiar to the market participants that advise companies in structuring private financing transactions.

¹ In cases where the warrant exercise price is less than the closing bid price at the time of the transaction, the amount that the warrant is in the money (the intrinsic value of the warrant) is added to this 1/8th of a dollar.

As a substitute for going through all of the steps required by the NASD Rule, NASDAQ has derived a simple formula that produces a comparable share equivalent value for each warrant. The resulting share equivalent would then be multiplied by the closing bid price of the underlying common stock to determine the dollar value of one warrant. The formula is:

$$\text{Share Equivalent} = .825 - \frac{X}{2 \times S}$$

Where:

X = Warrant Exercise Price

S = Closing Bid Price of Common Stock

If this formula was applied to the example above, the resulting share equivalent for the warrant would be:

$$.825 - \frac{\$2.46}{2 \times \$2.00} = .21$$

Therefore, the dollar value of each warrant would be:

$$.21 \times \$2.00 = \$0.42$$

Thus, the issuer would have to sell the unit at a minimum of \$2.42 for the common shares to be considered sold at "market value" for purposes of the shareholder approval rules. Adding \$0.42 instead of \$0.125 to the unit price would change the situations where shareholder approval would be required. However, companies would still have the choice of structuring the transaction at market value or, if investors were unwilling to pay this amount, the company could instead submit the transaction for shareholder approval. Of course, NASDAQ recognizes that the process of seeking shareholder approval adds costs and complexities in terms of timing and potential outcome.

To potentially simplify the valuation process even further, NASDAQ has developed tables (see Exhibit A) which could be used instead of the formula. The tables list the share equivalents based on the percentage² of premium or discount of the warrant exercise price to the closing bid price. Due to the use of ranges for the premium or discount to the market price, the share equivalent derived from the tables may vary from the share equivalent derived from the formula. NASDAQ also requests comments on whether it would be preferable to rely upon the formula or use the tables instead.

While it is difficult to forecast the impact of this proposed change in warrant valuations, NASDAQ has analyzed several hundred financing transactions by issuers which occurred in 2005 and 2006 and determined that less than 5% of those transactions would have required shareholder approval had the proposed warrant valuation model been in place. However, 85% of the transactions that did not require shareholder because the pricing satisfied the \$1/8 test would require shareholder approval under the proposal.

² Rounded to the nearest 1/10%

It should also be noted that the proposed valuation model for warrants could potentially affect the listing eligibility of companies going public through unit offerings since NASDAQ would need to ensure that the underlying common stock itself satisfies the minimum price for inclusion on NASDAQ. Based upon a review of historic unit offerings, NASDAQ does not believe that this change would have affected many companies.

REQUEST FOR COMMENT

NASDAQ is seeking public comment on the proposed change described above. While NASDAQ welcomes all comments, in particular NASDAQ is seeking comment on the following questions:

- Should NASDAQ adopt the methodology described in this request for comment?
- If NASDAQ were to adopt the changes described, would you prefer the use of a formula or a table to determine the value of warrants?
- Does the NASD Rule fail to adequately consider any factors which may result in the valuation being inaccurate?
- Are there other changes to the shareholder approval requirements that NASDAQ should consider?

NASDAQ encourages issuers, market participants, investors and other interested parties to comment on this proposal. Comments should be submitted by January 15, 2007.

Comments may be provided electronically via email to:

warrantvaluation@nasdaq.com or may be submitted in writing to: David Compton, Director, Listing Qualifications, The NASDAQ Stock Market, 9600 Blackwell Road, Rockville MD 20850

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EXHIBIT A

If the warrant exercise price is at a premium to the closing bid price, the share equivalent can be determined using the table below:

Premium to Bid Price	Share Equivalent
0 to 10%	0.30
10.1% to 20%	0.25
20.1% to 30%	0.20
30.1% to 40%	0.15
40.1% to 50%	0.10
50.1% to 60%	0.05
more than 60%	0

If the warrants are exercisable at a discount to the closing bid price (or “in the money”), the following table applies:

(Discount) to Bid Price	Share Equivalent
(0.1%) to (10%)	0.35
(10.1%) to (20%)	0.40
(20.1%) to (30%)	0.45
(30.1%) to (40%)	0.50
(40.1%) to (50%)	0.55
(50.1%) to (60%)	0.60
(60.1%) to (65%)	0.65
more than (65.1%)	Intrinsic Value

As evidenced in the charts, the share equivalent decreases as the premium increases until the premium reaches 60% when the resulting share equivalent becomes zero. Conversely, as the discount increases, the share equivalent increases up to a maximum of 65%. After the discount becomes greater than 65%, the intrinsic value is used to determine the value of the warrant.