SHEARMAN & STERLING LLP

Client Publication

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SEC Approves Changes to NYSE Rule 312(f) Relating to Recommendation by NYSE Member Firms of Affiliate Securities

I. Introduction and Overview

On August 25, 2006, the Securities and Exchange Commission ("SEC") approved changes to New York Stock Exchange ("NYSE") Rule 312(f) (the "Rule"),[1] which restricts the ability of NYSE member organizations[2] in transactions involving the securities affiliates.

Prior to the rule change, the Rule[3] prohibited a NYSE member organization from soliciting transactions in its own publicly traded securities and from making recommendations in such securities (or the securities issued by any corporation controlling, controlled by or under common control with the member organization). As amended, the Rule:

- Excludes investment grade debt from its restrictions;
- Expands its restrictions to include all non-investment grade debt and equity securities, including nonpublic securities; and
- Permits the recommendation of securities of affiliates (other than parent companies and "material associated persons") with disclosure.

The remainder of this client publication summarizes the Adopting Release and the Rule, as amended. This publication does not purport to be a detailed description or analysis of the issues raised by the Rule. Interested persons should feel free to contact any of the Shearman & Sterling LLP attorneys listed at the end of this client publication.

II. Modifications to NYSE Rule 312(f)

2.1 Full text of NYSE Rules 312(f)(1) and (2), as amended

As amended, Rule 312(f)(1) and (2) will now read as follows:

> (f) (1) After the completion of a distribution of its equity or non-investment grade debt securities or those of any organization controlling the member organization or of any Material Associated Person (as used in Rule 17h-1T of the Securities Exchange Act of 1934, as amended) of the member organization, no member organization shall effect any transaction (except on an unsolicited basis) for the account of any customer in, or make any recommendation with respect to, any such security.
>
> (2) Any member organization that makes any recommendation of any equity or non-investment grade debt security issued by any person controlled by or under common control with such member organization (other than a Material Associated Person) shall promptly disclose to such customer the existence and nature of such control at the time of recommendation and, if this disclosure is not made in writing, shall provide this disclosure in writing prior to the completion of the transaction.

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1 *See* "Self-Regulatory Organizations; New York Stock Exchange, Inc. (n/k/a New York Stock Exchange LLC); Order Approving Proposed Rule Change and Amendment No. 1 Thereto Relating to Exchange Rule 312(f) Regarding Changes Within Member Organizations", SEC Release No. 34-54368 (August 25, 2006) (the "Adopting Release"). The Adopting Release is currently available on the SEC's Internet Website, www.sec.gov, at http://www.sec.gov/rules/sro/nyse/2006/34-54368.pdf.

2 Pursuant to NYSE Rule 2, a "member organization" is defined as a registered broker-dealer that is approved by the Exchange and authorized to designate its associated individuals to effect transactions on the floor of the Exchange (or any facility thereof).

3 The Rule is commonly known as NYSE Rule 312(g), which was its designation prior to modification of NYSE Rule 312 in March 2006.

Prior to amendment, the Rule read as follows:

> After the completion of a distribution of its securities, no member corporation which has any publicly held security outstanding shall effect any transaction (except on an unsolicited basis) for the account of any customer in, or make any recommendation with respect to, any such security issued by such member corporation or make any recommendation of any such security issued by any corporation controlling, controlled by or under common control with such member corporation.

2.2 Relaxation on prohibition against recommendation of securities of companies under common control with the NYSE member, provided disclosure is made

As amended, the Rule prohibits a NYSE member firm from effecting any transaction, or making any recommendation, in the securities of any organization controlling the member firm, or any "material associated person"[4] of the member firm. The Rule will, as amended, permit unsolicited transactions in any such security. This is narrower than the prohibition in the prior Rule in that the prohibition in the prior Rule also extended to any company that was "controlled by or under common control with" the member firm.

NYSE Member firms may therefore recommend and effect transactions in the securities of entities with which they are under common control, but, under the Rule, must "promptly disclose to such customer the existence and nature of such control at the time of recommendation and, if this disclosure is not made in writing, shall provide this disclosure in writing prior to the completion of the transaction." The Adopting Release clarifies that disclosure of the relationship is required "at the time of recommendation."[5]

2.3 Exclusion of investment grade debt from restrictions found under Rule 312(f)

As amended, the Rule excludes investment grade debt from its restrictions. The Adopting Release states that this is a codification of NYSE interpretive policy, noting that, "The [NYSE] has generally interpreted Rule 312(f) restrictions to not apply to investment grade debt and securities that function as investment grade debt."[6]

Prior to the amendment, NYSE would, on the application of member firms, grant relief from the Rule for investment grade securities. In addition, member firms were periodically granted relief from the Rule with respect to preferred securities with "debt-like characteristics". In its Information Memo noting the adoption of the Rule amendment, the NYSE importantly states that; "Exemptive requests regarding such securities will continue to receive interpretive consideration as practical equivalents to investment grade debt for purposes of Rule 312(f) if the securities in question: (1) have either fixed dividends or dividends determined by objective criteria; (2) are non-participatory; (3) have limited voting rights; and (4) are non-convertible."[7]

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[4] The term "material associated person" is used here with reference to the SEC's Risk Assessment Rules, 17h-1T and 17h-2T. Under those rules, broker-dealers must identify to the SEC certain associated persons, the activities of which might have a material impact on the broker-dealer, and must maintain and submit periodic information regarding that "material associated person" to the SEC on prescribed Forms.

[5] *See* the Adopting Release at pages 3 – 4.

[6] *See* the Adopting Release at footnote 7.

[7] *See* "Amendments To Rule 312 Regarding Recommendation Of Affiliate Securities," NYSE Information Memo IM 06-65 (September 11, 2006). NYSE Information Memos are currently available at the NYSE's Internet Website, www.nyse.com. IM 06-65 notes (at footnote 10 thereto) that, "In this context, the term 'debt-like' refers to a security that trades primarily based on the objective factors of credit rating and the stated yield of the security, as opposed to subjective determinations regarding the business prospects and future earnings of the issuer."

2.4 Extension of application of Rule 312(f) to nonpublic securities

Prior to its recent amendment, the Rule applied by its terms only to public securities. However, the Rule as amended has been broadened to restrict all non-investment grade debt and equity securities, including those that were placed in private transactions. The Adopting Release notes the NYSE's assertion that the scope of the Rule was broadened to securities issued privately (in addition to publicly issued securities) because the conflicts intended to be addressed are present equally in public and private transactions.[8]

[8] See the Adopting Release at pages 4 – 5 ("NYSE states that there is a 'need to assure coverage of all post-distribution transactions by member organizations in affiliated securities, and not solely those which are sold pursuant to public offerings.' NYSE also expresses the view that the proposed change will not impose a significant burden on trading in non-publicly traded securities.") (Footnotes omitted.)

III. Conclusion

The amendments to the Rule are generally welcome inasmuch as they broaden the range of transactions in which broker-dealers may recommend securities of their affiliates, and inasmuch as they lift restrictions which previously caused a number of awkward consequences in an era of growing and increasingly international financial institutions. The Rule has been modified in three ways, the consequences of which have yet to be seen. First, the Rule has been broadened to include private placements of securities. Second, the Rule now requires disclosure of control affiliation at the time of recommendation, and, if such disclosure is not in writing, the Rule requires written disclosure of such affiliation prior to the completion of the transaction. Finally, the term "material associated person", as used in SEC Rule 17h-1T, refers to persons that are identified by broker-dealers on the basis of an internal analysis of a number of factors, which by its nature has subjective elements, and which analysis now takes on new importance.

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.

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