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SEC Approves FINRA Amendments to Conflict of Interest Rules for Securities Offerings

Headlines:

Changes adopted by the SEC:

- Revised definition of "conflict of interest" that includes the payment of 5% or more of the offering proceeds to an underwriter and/or its affiliates (in the aggregate).
- Some offerings for which a FINRA filing (and approval) is not required at present will now require filing.
- Easing of FINRA filing and approval requirements for offerings of investment grade rated debt or securities with a "bona fide public market".
- "Prominent" prospectus disclosure required for conflicts of interest.

I. Introduction and Overview

On September 14, 2006, the National Association of Securities Dealers, Inc. ("NASD") published for comment proposed amendments to NASD Conduct Rule 2720 ("Current Rule") relating to conflicts of interest that occur in the context of securities distributions.[1] Rule 2720, together with Financial Industry Regulatory Authority ("FINRA") Rule 5110, the Corporate Financing Rule,[2] and NASD Conduct Rule 2810 ("Direct Participation Program Rule")[3] form the principal means by which FINRA[4] regulates the securities offering process.

On May 1, 2009, FINRA published for comment a revised proposed amendment to the Current Rule ("Adopted Rule"). On June 15, 2009, the Securities and Exchange Commission ("SEC") approved the proposed rule.[5]

The Adopted Rule will be implemented within 30 days after the issuance of a Regulatory Notice by FINRA; FINRA has indicated that the applicable Regulatory Notice will be issued within 60 days of the SEC approval.

[1] *See* NASD Notice to Members 06-52, "Proposed Amendments to Rule 2720" (September 2006) ("Notice to Members 06-52"). NASD Notices to Members are currently available at FINRA's Internet website, www.finra.org. For more information about the initial proposal, see "NASD Proposes Major Changes to Rule 2720 Governing Conflicts of Interest Between Underwriters and Issuers" (October 2006), currently *available at* http://www.shearman.com/cm_100406/.

[2] FINRA Rule 5110 superseded former NASD Conduct Rule 2710.

[3] Recently, FINRA adopted NASD Conduct Rule 2810 as FINRA Rule 2310. As part of the merger of the regulatory operations of the New York Stock Exchange ("NYSE") and the NASD ("Merger"), FINRA is consolidating the rules of NASD and NYSE Regulation. For more information regarding the rulebook consolidation process, please see "Report from SIFMA's 40th Annual Compliance and Legal Division Seminar: FINRA Officials Provide an Update on the NASD – NYSE Merger" (April 2008), currently *available at* http://www.shearman.com/cm_041408/. As of August 17, 2009, the Direct Participation Program Rule will be found at FINRA Rule 2310. *See* SR–FINRA-2009-016 *available at* www.finra.org.

[4] On July 26, 2007, the SEC approved the Merger of the regulatory operations of the NYSE and the NASD. *See* "*Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc.*", SEC Release 34-56145 (July 26, 2007), currently *available at* http://sec.gov/rules/sro/nasd/2007/34-56145.pdf. FINRA commenced operations on July 30, 2007. Information regarding the Merger is *available at* the FINRA Internet website: www.finra.org.

[5] *See* SEC Release 34-60113, "Order Approving Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Modernize and Simplify NASD Rule 2720" (June 15, 2009) ("Adopting Release").

Description of the Current Rule and the Adopted Rule follows, together with some conclusory thoughts. This publication does not purport to be a detailed description or analysis of the issues raised by the Adopted Rule. Interested persons should feel free to contact any of the Shearman & Sterling LLP attorneys listed at the end of this client publication or any others with whom you have regular contact.

II. Executive Summary of the Adopted Rule

The Current Rule creates a series of requirements in respect of offerings of securities by FINRA members where the securities being offered are those of:

(a) The member itself (i.e., self-underwriting);

(b) An "affiliate" of the member, as defined; or,

(c) A person with whom the member has a "conflict of interest", as defined.

Generally, the Current Rule requires that the pricing of offerings conducted under these circumstances must be supported by the pricing opinion of a qualified independent underwriter ("QIU"),[6] unless, in the case of an equity security, a "bona fide independent market" exists;[7] or, in the case of fixed income, the security has an investment-grade rating. The Current Rule also creates certain filing and disclosure requirements for offerings that are subject to its ambit.

The Adopted Rule sets forth a series of changes to the Current Rule that were in some instances broad and in other instances highly detailed. The Adopted Rule can be summarized as follows:

(a) Changes to what constitutes a "conflict of interest" for purposes of Rule 2720, including:

- The elimination of affiliation as a separate category implicating Rule 2720, and the inclusion of affiliation within the definition of "conflict of interest";
- Express inclusion in the definition of "conflict of interest" of a member participating in an offering in which the member, its affiliates, or its associated persons in the aggregate receive 5% or more of the offering proceeds;
- Express inclusion in the definition of "conflict of interest" of any issuer that is controlled or under common control with the FINRA member participating in the offering; and
- Expansion of the definition of "control" to mean the ownership of 10% or more of the equity securities of an issuer, including the right to receive securities within 60 days of the effective date of the public offering to which the analysis relates (including non-voting securities).

(b) Exemption from the filing and QIU requirements of Rule 2720 for:

- Offerings of securities for which the book-running lead manager has no conflict of interest, is not an affiliate of any member that has a conflict of interest, and meets the disciplinary history requirements to act as QIU; or
- Offerings of investment grade securities, or securities for which a "bona fide public market" exists.[8]

(c) Requirement of prominent prospectus disclosure (a defined term) of:

[6] The term "qualified independent underwriter" is defined at Current Rule 2720 (b)(15).

[7] The term "bona fide independent market" is defined in Current Rule 2720(b)(3) as a market in a security that is listed on a national securities exchange or NASDAQ with a market price of $5 per share, aggregate trading volume of 500,000 shares over 90 days and a public float of 5 million shares.

[8] This definition is changed from the Current Rule's term, "bona fide independent market." *See* footnote 7. Under the Proposal, a "bona fide public market" is defined as "[a] market for a security issued by a company that has been reporting under the Exchange Act for at least 90 days, is current in its reporting requirements, and whose securities are traded on a national securities exchange with an ADTV (as provided by Regulation M under the Securities Exchange Act of 1934) of at least $1 million, provided that the issuer's common equity securities have a public float value of at least $150 million." *See* Adopting Release at page 4.

- The nature of the conflict of interest in an offering that does not require a QIU; or
- The nature of the conflict of interest, the name of the QIU, and the fact that the QIU will participate in the due diligence examination in an offering that does require a QIU.

(d) Changes to the QIU requirement such that:

- No pricing opinion will be required of any QIU, though the standards for independent pricing by the QIU remain in the Adopted Rule.

(e) Changes to QIU qualifications including:

- Disqualification from acting as QIU for any underwriter, or affiliate thereof that is receiving 5% or more of the proceeds of the offering;
- Elimination of the requirement that a majority of the board of directors or general partners of a broker-dealer must have specified experience in the investment banking business;
- Shortening from five to three years the period of comparable underwriting experience required of the QIU; and
- Lengthening from five to 10 years the period during which certain criminal or disciplinary actions of certain associated persons disqualify a broker or dealer from acting as QIU.

A more detailed description of the Adopted Rule follows:

III. Description of the Adopted Rule

3.1 Amendments to the definition of "conflict of interest"

The Current Rule generally requires FINRA member broker-dealers to file securities offerings for review where the offering is by (a) the member itself, (b) an "affiliate" of the member, as defined, or (c) an issuer with which the FINRA member broker-dealer has a "conflict of interest", as that term is defined for purposes of the Adopted Rule.[9]

Under the Adopted Rule, the definition of "conflict of interest" will be modified in three substantial ways. First, the Adopted Rule deems a conflict of interest to exist if at least 5% of the proceeds are intended to be directed to the member, its affiliates or its associated persons in the aggregate[10]. This important aspect of the Adopted Rule will replace current Rule 5110(h), which requires compliance with the QIU requirements of Rule 2720 for any offering in which 10% or more of the net offering proceeds are intended to be paid to participating FINRA members.

Of importance to FINRA members that (themselves, or, together with affiliates) regularly engage in both underwriting and lending is that the new 5% "trigger" for a conflict of interest will apply to each participating member, rather than the current 10% trigger that applies in the aggregate to all of the participating members.

Second, the Adopted Rule modifies the definition of "conflict of interest" to include situations where the issuer is controlled by, or under common control with, the member, or any of its affiliated or associated persons.

[9] The Current Rule's definition of "conflict of interest" presumes a conflict of interest to exist where: (a) a member and/or its associated persons, parent or affiliates in the aggregate beneficially own 10% or more of the outstanding subordinated debt of a company; (b) a member and/or its associated persons, parent or affiliates in the aggregate beneficially own 10% or more of the common equity of a company which is a corporation, or beneficially own a general limited or special partnership interest in 10% or more of the distributable profits or losses of a company; or (c) a member and/or its associated persons, parent or affiliates in the aggregate beneficially own 10% or more of the preferred equity of a company. *See* Current Rule 2720(b)(7).

[10] Under the Adopted Rule, an affiliate would be defined as "any entity that controls, is controlled by, or is under common control with another entity or member. The term "person associated with a member" is defined in the By-Laws of FINRA to mean, in relevant part: "(1) a natural person who is registered or has applied for registration under the Rules of the Association; (2) a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with FINRA under these By-Laws or the Rules of the Association [...]"

The Adopted Rule brings about this change by defining conflict of interest to include circumstances where issuer and underwriter are affiliated.

Third, the Adopted Rule expands the definition of "control" from its current definition—which presumes control on the basis of 10% beneficial economic ownership of voting securities (or 10% interest in a partnership's profits and losses), or the ability to direct the entity's management—to include: (i) non-voting as well as voting securities and (ii) the right to receive within 60 days such voting or non-voting securities or distributable profits and losses.

3.2 Exemptions from the filing and QIU requirements for certain offerings

Under the Current Rule, a QIU is required for all offerings subject to Rule 2720, unless the offering is (a) of a security for which a "bona fide independent market", as defined, exists, or (b) of investment grade securities.[11]

The Adopted Rule maintains the QIU requirements for offerings that are subject to Rule 2720, but exempts from both the QIU and filing requirements any offering for which the offering document "prominently" discloses[12] the nature of the conflict of interest and either:

(a) the book-running lead manager or dealer manager[13] does not have a conflict of interest, is not an affiliate of any member that does have a conflict of interest, and meets the disciplinary history requirements of the Adopted Rule;

(b) the securities offered have a "bona fide public market"; or

(c) the securities offered are debt or preferred securities that have been rated investment grade (Baa or better by Moody's rating service or BBB or better by Standard & Poor's rating service or rated in a comparable category by another rating service acceptable to FINRA) or debt or preferred securities that rank *pari passu* with such rated securities.[14]

3.3 Criteria for meeting prominent disclosure requirements

The Adopted Rule delineates the criteria for prominently disclosing the nature of the conflict of interest in the prospectus or other offering documents.

(a) For offering documents that are subject to SEC Regulation S-K, "prominent disclosure" requires including a separate notation (to be called "Conflict of Interest") that is placed following the listing of the "Plan of Distribution" section in the Table of Contents of the Registration Statement and including such disclosure in the "Plan of Distribution" section itself.

(b) For other offering documents that are not subject to SEC Regulation S-K, such as is the case for sovereign issuers or issuers relying on an exemption from registration under Section 3(a)(2) of the Securities Act of 1933, as amended, "prominent disclosure" requires providing disclosure on the front page of the offering document that a conflict exists, in addition to a cross-reference to the discussion within the offering document and in the summary of the offering document if one is included.

3.4 Changes to the responsibilities of the QIU

Under the Current Rule, a QIU must render a pricing opinion that the price (or yield) at which an equity (or debt) offering is distributed to the public should be no higher (or lower) than that recommended by the QIU.

[11] *See* Current Rule 2720(c).

[12] Under the Adopted Rule, offering documents will require disclosure of (a) the nature of the conflict of interest, in an offering that does not require a QIU; or (b) the nature of the conflict of interest, the name of the QIU, and the fact that the QIU will participate in offering diligence, in an offering that does require a QIU.

[13] Neither the term "book-running lead manager" nor the term "dealer-manager" is defined in the Adopted Rule.

[14] *See* Adopting Release at page 5.

The Adopted Rule eliminates the requirement that the QIU render a pricing opinion.[15] Instead, a QIU is required to participate in the preparation of the offering documents and perform due diligence.

3.5 Changes to the qualification requirements for acting as QIU

Under the Adopted Rule, the criteria for acting as QIU include requirements that a member firm:

- Must have served as underwriter in at least three public offerings of a similar size and type during the three-year period immediately preceding the filing of the registration statement.
- Cannot have a person who structures or supervises public offerings that has been convicted within 10 years prior to the filing of the registration statement of any violation of the antifraud provisions of any securities law or regulation.
- Cannot have a conflict of interest and cannot be an affiliate of any member that does have a conflict of interest.[16]
- Cannot beneficially own, as of the date of filing of the registration statement and the effective date of the offering, more than 5% of the class of securities that would give rise to a conflict of interest, including any right to receive any such securities exercisable within 60 days.
- Cannot be an affiliate of the issuer or does not beneficially own at least 5% of the equity, subordinated debt or partnership interest of the issuer.

The Current Rule's requirement that a majority of the QIU's board of directors be persons who have been actively engaged in the investment banking or securities business for at least five years has been eliminated.

3.6 Changes involving sales to discretionary accounts

The Adopted Rule prohibits FINRA members that have a conflict of interest from selling to a discretionary account any security with respect to which the conflict exists, unless the member has received specific written approval[17] of the transaction from the account holder and retains documentation of the approval in its records. The Adopted Rule limits the prohibition to the individual member with the conflict of interest, allowing other firms participating in the offering that are not subject to a conflict of interest to sell to discretionary accounts without being subject to this restriction. In contrast, the Current Rule subjects all firms participating in an offering to this limitation regardless of whether the participating firm is subject to a conflict of interest.

IV. Conclusions

The Adopted Rule represents a major revision to Rule 2720. Though many of the concepts underlying the Current Rule are retained by the Adopted Rule, the principal operative aspects of the Current Rule are changed by the Adopted Rule in ways that are both large and small. FINRA member broker-dealers will need to consider the provisions of the Adopted Rule carefully in order to ensure that firm policies and procedures are consistent with the Adopted Rule—and to FINRA thinking in respect of conflicts of interest as they exist among FINRA members.

In particular, several of the modifications in the Adopted Rule will require changes to underwriting practices in respect of offerings that are subject to a "conflict of interest", as that term is now defined. For example,

[15] *See* Adopting Release at page 8.

[16] Note that the Current Rule does not disqualify a prospective QIU on the basis of that QIU receiving proceeds from an offering. The Proposal would prohibit a QIU from receiving more than 5% of the offering proceeds, because no FINRA member with a "conflict of interest", as defined by the Proposal, is permitted to act as QIU.

[17] *See* Adopting Release at page 10. ("FINRA has clarified that the specific written approval requirement in this provision could be satisfied by an e-mail from the customer.")

under the Adopted Rule, if more than 5% of the offering proceeds (not including underwriting compensation) are intended to be directed to the FINRA member(s) primarily responsible for managing the public offering (or an affiliate of such an underwriter), and no "bona fide public market" or "investment grade rated debt" exemption from the QIU requirement is available, then FINRA approval will be required for the offering notwithstanding the availability of a filing exemption under Rule 5110(b)(7). This is a significant change from current practice, as the intention to direct proceeds to an underwriter (or its affiliate) does not currently create a FINRA filing and approval requirement if an exemption from filing is available under Rule 5110(b)(7).

Conversely, the Adopted Rule will also eliminate the filing requirement for offerings subject to Rule 2720 where a bona fide public market or investment grade rating exists.

Additionally, the definition of "prominent disclosure" now suggests a notation in the Table of Contents of a SEC-filed registration statement, which is a significant change from current practice.

In this regard, the SEC's approval of the Adopted Rule exhibits continuing interest by FINRA and the SEC regarding the way that conflicts of interest are regulated in the securities industry, requiring additional disclosure and conflict of interest mitigation practices.

Charles S. Gittleman
New York
+1.212.848.7317
cgittleman@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Robert Evans III
New York
+1.212.848.8830
revans@shearman.com

Michael J. Schiavone
New York
+1.212.848.4813
mschiavone@shearman.com

Lona S. Nallengara
New York
+1.212.848.8414
lnallengara@shearman.com

Jennifer D. Morton
New York
+1.212.848.5187
jennifer.morton@shearman.com