FINRA Proposes Amended Rule Change to Modernize and Simplify NASD Rule 2720

In an amended proposal dated May 1, 2009, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission (the "SEC") a proposed rule change to modernize and simplify NASD Rule 2720 (Distributions of Securities of Members and Affiliates – Conflicts of Interest) and make corresponding changes to FINRA Rule 5110 (Corporate Financing Rule).[1]

The proposed rule change would replace the current Rule 2720 ("Current Rule 2720") in its entirety with proposed Rule 2720 entitled "Public Offerings of Securities With Conflicts of Interest" ("Proposed Rule 2720"). Some of the more significant amendments that FINRA is proposing are to:

- exempt from the filing and qualified independent underwriter ("QIU") requirements public offerings of investment grade rated securities, public offerings of securities that have a bona fide public market, and public offerings in which the member primarily responsible for managing the offering does not have a conflict of interest and can meet the disciplinary history requirements for acting as a QIU;
- amend the definition of "conflict of interest" to include public offerings in which at least five percent of the offering proceeds are directed to a participating member or its affiliates;
- modify disclosure requirements to provide more prominent disclosure of conflicts of interest in the offering documents; and
- eliminate the requirements that the QIU render a pricing opinion.

In addition, Proposed Rule 2720 would amend the QIU qualification requirements to focus on the experience of the firm rather than its board of directors, prohibit a member from acting as a QIU if it would receive more than five percent of the proceeds of an offering, and lengthen from five to ten years the amount of time that a person involved in due diligence in a supervisory capacity must have a clean disciplinary history.

The significant amendments contained in Proposed Rule 2720 are discussed in greater detail below.[2]

I. Offering Exemptions

Proposed Rule 2720 provides for exemptions from QIU and filing requirements for three categories of public offerings. The first exemption is for public offerings in which the member primarily responsible for managing the offering (e.g., the book-running lead manager or lead placement agent) does not have a conflict of interest, is not an affiliate of a member that has a conflict of interest and can meet the disciplinary history requirements for a QIU. Where there are two or more co-lead managers or co-lead placement agents that have equal responsibilities with regard to due diligence, each would need to be free of conflicts of interest.

---

[1] Self -Regulatory Organization; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto to Modernize and Simplify NASD Rule 2720, (Release No. 34-59880; File No. SR-FINRA- 2009- 009; May 7, 2009), available at http://www.sec.gove/rules/sro/finra/2009/34-59880.pdf (the "Proposing Release").

[2] The amended proposal replaces and supersedes the original proposed rule filing submitted in September 2007. The text of the amended proposed rule is available on FINRA's Web site at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p118624.pdf.

The second exemption is for public offerings of securities that have a bona fide public market. Current Rule 2720 exempts public offerings of securities for which there is a "bona fide independent market" from the QIU requirement, but not the filing requirements. The proposed rule change would replace the term "bona fide independent market" with "bona fide public market," defined in accordance with the numerical standards set forth in SEC's Regulation M. Specifically, "bona fide public market" is defined in Proposed Rule 2720 as a market for a security issued by a company that has been reporting under the Securities Exchange Act of 1934, as amended, for at least 90 days, is current in its reporting requirements and whose securities are listed on a national securities exchange with an average daily trading volume of at least $1 million; *provided* that the issuer's common equity securities have a public float value of at least $150 million.

The third exemption is for public offerings of investment grade securities and securities in the same series that have equal rights and obligations as such investment grade rated securities. "Investment grade rated" is defined as securities that are rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories.[3]

II. Offerings in Which a QIU Must Participate

If a member with a conflict of interest participates in a public offering that does not meet the conditions of an offering exemption described above, then a QIU would need to participate in the preparation of the registration statement and the prospectus, offering circular or similar document and exercise the usual standards of "due diligence" with respect thereto. A public offering in which a QIU participates would continue to be subject to the filing requirements of Rule 5110 and Proposed Rule 2720's discretionary account requirements (and, in the case of offerings by members of their securities, offering proceeds escrow requirements), if applicable. In addition, Proposed Rule 2720 would require prominent disclosure of the nature of the conflict of interest in the prospectus, offering circular of similar document for the public offering.

Current Rule 2720 requires that a QIU provide an opinion that the price at which equity securities are offered to the public is no higher, or the yield for debt securities is no lower, than that recommended by the QIU. Proposed Rule 2720 would eliminate the requirement that a QIU provide a pricing opinion.

III. Discretionary Accounts

Proposed Rule 2720 provides that no member that has a conflict of interest would be permitted to sell to a discretionary account any security with respect to which the conflict exists, unless the member has received specific written approval of the transaction from the account holder and retains documentation of the approval in its records. This provision differs from Current Rule 2720 in that Proposed Rule 2720 would only apply to the sale of securities by the member with the conflict of interest. Current Rule 2720 limits discretionary sales by all firms participating in the offering, even those that do not have a conflict of interest. The "specific written approval" requirement in Proposed Rule 2720 can be satisfied by an email from the customer.

---

[3] In proposing the revised rule, FINRA rejected commenters suggestions to expand the categories of offerings eligible for automatic exemption from filing. In particular, FINRA did not agree add "well-known seasoned issuers" or "WKSIs" to the list. "FINRA believes that if a participating member has a conflict of interest, the offering should be subject to the QIU and filing requirements, irrespective of whether the issuer involved is a WKSI." Proposing Release at 29.

IV. Definition of "Conflict of Interest"

Proposed Rule 2720 would define "conflict of interest" to mean if, at the time of a member's participation in a public offering, any of the following applies:

- the securities are to be issued by the member;
- the issuer controls, is controlled by or is under common control with the member or the member's associated persons;
- at least five percent of the net offering proceeds, not including underwriting compensation, are intended to be either used to reduce or retire the balance of a loan or credit facility extended by the member, its affiliates, and its associated persons (in the aggregate) or otherwise directed to the member, its affiliates, and associated persons (in the aggregate); or
- as a result of the public offering and any transactions contemplated at the time of the public offering, the member will be an affiliate of the issuer, the member will become publicly owned, or the issuer will become a member or form a broker-dealer subsidiary.

Currently, Rule 5110 requires offerings in which ten percent or more of the offering proceeds (not including the underwriting discount) will be paid to participating members to comply with Current Rule 2720's QIU requirements. Although the threshold for proceeds directed to a member is being lowered from ten percent to five percent, the new threshold would apply to each participating member individually (including the member's affiliates and its associated persons), not on an aggregate basis for all participating members, as is currently the case.

V. Definition of "Control"

Proposed Rule 2720 would define "control" as any of:

- beneficial ownership of ten percent or more of the outstanding common equity of an entity, including any right to receive such securities within 60 days of the member's participation in the public offering;
- the right to ten percent or more of the distributable profits or losses of an entity that is a partnership, including any right to receive an interest in such distributable profits or losses within 60 days of the member's participation in the public offering;
- beneficial ownership of ten percent or more of the outstanding subordinated debt of an entity, including any right to receive such subordinated debt within 60 days of the member's participation in the public offering;
- beneficial ownership of ten percent or more of the outstanding preferred equity of an entity, including any right to receive such preferred equity within 60 days of the member's participation in the public offering; or
- the power to direct or cause the direction of the management or policies of an entity.

Under Proposed Rule 2720, warrants or rights for voting securities that are exercisable within 60 days of the member's participation in the public offering would be included in the calculation of voting securities when determining whether control exists, including the potential ownership of shares in both the numerator and

denominator. The calculation would be limited to warrants or rights that are exercisable within 60 days and received, or which could be received, by the participating member only and would not include warrants or rights held by other investors. In its original filing of September 6, 2007, FINRA proposed that for purposes of this provision, the 60 day period would be calculated from the effective date of the offering. However, Proposed Rule 2720 provides that the relevant time frame is within 60 days of the member's participation in the public offering. This would ensure that the rule properly applies to takedowns from an effective shelf registration.

VI. Definition of "Qualified Independent Underwriter"

Proposed Rule 2720 defines the term "qualified independent underwriter" as a member that meets five conditions.

- First, the member must not have a conflict of interest and must not be an affiliate of any member that has a conflict of interest. Current Rule 2720 does not disqualify or prohibit a QIU from receiving proceeds from an offering. Proposed Rule 2720 would prohibit a QIU from receiving more than five percent of the offering proceeds because the receipt of such proceeds would disqualify a member from acting as a QIU by causing it to come within the proposed definition of "conflict of interest."
- Second, the member cannot beneficially own, as of the date of the member's participation in the public offering, more than five percent of the interests referred to in the first four elements of the definition of "control" summarized above, including any right to receive any such securities exercisable within 60 days.
- Third, the member must have agreed, in acting as a QIU, to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act of 1933, amended.
- Fourth, the member 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 or the date of first sale in an offering for which there is no registration statement.[4] While similar to the requirements set forth in Current Rule 2720, Proposed Rule 2720 would shorten the relevant period from five to three years. This requirement will be deemed satisfied if, during the relevant period, the member, with respect to a proposed public offering of debt securities, acted as sole underwriter or book-running lead or co-manager of at least three public offerings of debt securities, each with gross proceeds of not less than 25% of the anticipated gross proceeds of the proposed offering. With respect to a proposed public offering of equity securities, this requirement will be deemed satisfied if, during the relevant period, the member acted as sole underwriter or book-running lead or co-manager of at least three public offerings of equity securities (or securities convertible into equity securities), each with gross proceeds of not less than 50% of the anticipated gross proceeds of the proposed offering. In addition, Proposed Rule 2720 would eliminate Current Rule 2720's requirement regarding board or partner experience.
- Fifth, the member's associated persons in a supervisory capacity who are responsible for organizing, structuring or performing due diligence with respect to corporate public offerings of securities cannot have been subject to a statutory disqualification within the ten-year period prior

[4] Because the Rule defines "public offering" to include exchange offers, an exchange offer made pursuant to the exemption from registration afforded by Section 3(a)(9) of the Securities Act of 1933, if made by a member or an affiliate of a member, would be subject to the Rule.

to the filing of the registration statement or the preparation of an offering circular in an offering without a registration statement.[5] Current Rule 2720 prohibits an associated person's involvement in the due diligence process in a supervisory capacity if that person has been subject to a statutory disqualification within five years prior to the filing of the registration statement.

Within 35 days of the date of publication of Proposing Release in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which FINRA consents and, if so approved, the SEC will either approve the proposed rule change or will institute proceedings to determine if it should be disapproved. The SEC has invited interested parties to submit comments on the proposal.

* * *

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Richard E. Farley at 212.701.3434 or rfarley@cahill.com; or Jon Mark at 212.701.3100 or jmark@cahill.com.

[5] Statutory disqualifications are those matters which would disqualify an individual from association with a registered broker-dealer and generally include such events as being convicted of violations of federal and state securities laws, being the subject of a consent decree arising from such violations and having been subject to other regulatory sanctions imposed by the SEC, FINRA or other self-regulatory organizations.