

FINRA Announces Implementation of Amendments to NASD Conflicts of Interest Rule: Rule 2720

Effective September 14, 2009, NASD Rule 2720 (Distributions of Securities of Members and Affiliates – Conflicts of Interest) (“Old Rule 2720”) will be replaced in its entirety with a new Rule 2720 entitled “Public Offerings of Securities With Conflicts of Interest” (“New Rule 2720”) and corresponding amendments to FINRA Rule 5110 will take effect (“Revised Rule 5110” and, together with New Rule 2720, the “Amendments”). The approval of the new rule was announced by the Financial Industry Regulatory Authority, Inc. (“FINRA”) on August 14, 2009.¹

Old Rule 2720 governs public offerings of securities issued by participating members or their affiliates, public offerings in which a member or any of its associated persons or affiliates has a conflict of interest (a “Conflicted Member”) and public offerings that result in a member becoming a public company. The Rule imposes requirements with respect to the pricing of such offerings and the conduct of due diligence when a member participates in such offerings. New Rule 2720 will, among other things:

- exempt from filing and qualified independent underwriter (“QIU”) requirements (i) public offerings of investment grade rated securities, (ii) public offerings of securities that have a bona fide public market and (iii) public offerings in which the member primarily responsible for managing the offering does not have a conflict of interest and can meet the disciplinary requirements for 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;
- require more prominent disclosure of conflicts of interest in the offering documents; and
- eliminate Old Rule 2720’s requirement that the QIU render a pricing opinion.

These and the other prominent amendments are discussed in greater detail below.²

¹ See Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice to Members of Implementation of Amendment to NASD Rule 2720 Relating to Public Offerings in Which a Member Firm With a Conflict of Interest Participates, (Regulatory Notice to Members No. 09-49; August 14, 2009), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/pl19784.pdf>. The Amendments were approved by the Securities and Exchange Commission on June 15, 2009. See Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Modernize and Simplify NASD Rule 2720, (Release No. 34-60113; File No. SR-FINRA-2007-009; June 15, 2009), available at <http://www.sec.gov/rules/sro/finra/2009/34-60113.pdf>.

² In addition to the changes to NASD Rule 2720 and FINRA Rule 5110 described herein, the Amendments moved certain definitions in Old Rule 2720 to Rule 5110 and incorporated by reference the relocated definitions into New Rule 2720.

I. CONFLICT OF INTEREST

A. Generally

Like Old Rule 2720, New Rule 2720 prohibits Conflicted Members from participating in public offerings, subject to certain exceptions. New Rule 2720 revises the definition of “conflict of interest” to include situations when:

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

B. Definition of “Control”

New Rule 2720 defines “control” as:

- 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;³
- 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;⁴
- 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 offering;⁵
- 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;⁶ or

³ New Rule 2720(f)(6)(A)(i).

⁴ New Rule 2720(f)(6)(A)(ii).

⁵ New Rule 2720(f)(6)(A)(iii).

⁶ New Rule 2720(f)(6)(A)(iv).

- the power to direct or cause the direction of the management or policies of an entity.⁷

Under New Rule 2720, “control” could derive from the restrictive covenants typically found in debt indentures, preferred rights to dividends given to holders of non-voting common or preferred stock or special voting rights given to certain classes of non-voting stock.⁸ Additionally, the right to receive the relevant securities within 60 days of the Conflicted Member’s participation in the public offering is intended to cause New Rule 2720 to apply to takedowns from an effective shelf registration.⁹

C. Net Proceeds Rule

Under Old Rule 5110, offerings in which ten percent or more of the net offering proceeds (not including the underwriting discount) are intended to be paid to participating members must comply with Old Rule 2720’s QIU requirements, subject to certain exceptions.¹⁰ The Amendments eliminate the ten percent requirement from Old Rule 5110, and instead, incorporate a five percent threshold into New Rule 2720. New Rule 2720’s five percent threshold applies to each participating member individually (including the member’s affiliates and associated persons), and not on an aggregate basis for all participating members, as is the case with Old Rule 5110’s ten percent threshold.¹¹

II. PARTICIPATION BY THE CONFLICTED MEMBER IN A PUBLIC OFFERING

If a conflict of interest exists, a Conflicted Member may still participate in the offering provided certain conditions are met.

A. QIU Requirement

Under New Rule 2720, unless one of the QIU exemptions described herein exists, a Conflicted Member may participate in an offering only if a QIU has participated in the preparation of the registration statement and the offering document and has exercised the usual standards of “due diligence” in respect thereof.¹² New Rule 2720 eliminates the requirement that the QIU render a pricing opinion.

In addition to the QIU requirement, New Rule 2720 also requires “prominent disclosure”¹³ in the offering document of (i) the nature of the conflict of interest, (ii) the name of the member acting as QIU and (iii) a brief statement regarding the role and responsibilities of the QIU.¹⁴

⁷ New Rule 2720(f)(6)(A)(v).

⁸ Release No. 34-60113 at 16.

⁹ *Id.* at 17.

¹⁰ The exceptions to the QIU requirement are discussed herein.

¹¹ Release No. 34-60113 at 14.

¹² New Rule 2720(a)(2)(A).

¹³ The definition of “prominent disclosure” is discussed herein.

¹⁴ New Rule 2720(a)(2)(B).

If a QIU participates in the public offering then the offering is subject to the filing requirements of Revised Rule 5110.¹⁵

B. Definition of QIU

New Rule 2720 defines “qualified independent underwriter” as a member that meets the following conditions:

- the member must not have a conflict of interest and must not be an affiliate of any member that has a conflict of interest;¹⁶
- 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,” including any right to receive any such securities exercisable within 60 days;¹⁷
- the member must have agreed, in acting as a QIU, to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act, specifically including those inherent in Section 11 thereof;¹⁸
- the member must have served as an 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;¹⁹ and
- none of whose associated persons in a supervisory capacity and who are responsible for organizing, structuring or performing due diligence with respect corporate public offerings of securities have been subject to certain disciplinary proceedings.²⁰

New Rule 2720 prohibits a QIU from receiving more than five percent of the offering because the receipt of such proceeds would constitute a conflict of interest, whereas Old Rule 2720 did not disqualify or prohibit a QIU from receiving the proceeds of an offering. The fourth element of the definition of “qualified independent underwriter” would be deemed satisfied if, during the past three years, the member (i) with respect to a proposed public offering of debt securities, has acted as a sole underwriter or book-running lead or co-manager of at least three public offerings of securities each with gross proceeds of not less than 25 percent of the anticipated gross proceeds of the proposed offering²¹ or (ii) with respect to a proposed public offering of equity securities, has acted as sole underwriter or book-running lead or co-manager of at least three public offerings of equity securities (or of

¹⁵ Release No. 34-60113 at 8.

¹⁶ New Rule 2720(f)(12)(A).

¹⁷ New Rule 2720(f)(12)(B).

¹⁸ New Rule 2720(f)(12)(C).

¹⁹ New Rule 2720(f)(12)(D).

²⁰ New Rule 2720(f)(12)(E).

²¹ New Rule 2720(f)(12)(D)(i).

securities convertible into equity securities), each with gross proceeds of not less than 50 percent of the anticipated gross proceeds of the proposed offering.²²

C. Exemptions from the QIU Requirement

New Rule 2720 provides three exemptions from the QIU and filing requirements, provided there is prominent disclosure of the conflict of interest in the offering document.

- The first exemption is where the member(s) primarily responsible for managing the public offering does not have a conflict of interest, is not an affiliate of any member that does have a conflict of interest and meets the QIU disciplinary requirements under New Rule 2720(f)(12)(E).²³ Where there are two or more co-lead managers or co-lead placement agents that have equal responsibilities with regard to due diligence, each must be free of conflicts of interest.²⁴
- The second exemption is where the securities offered have a bona fide public market.²⁵ A “bona fide public market” means a market for a security of an issuer that has been reporting under the Act for at least 90 days and is current in its reporting requirements, and whose securities are traded on a national securities exchange with an Average Daily Trading Volume (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.²⁶
- The last exemption is where the securities offered are investment grade rated or are securities in the same series that have equal rights and obligations as investment grade rated securities.²⁷ “Investment grade rated” securities are securities that are rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories.²⁸ The investment grade rating exemption also applies to public offerings of securities that have not received an individual rating but are of the same class or series and are considered *pari passu* with other investment grade rated securities issued by the same issuer.²⁹

If any one of the QIU exemptions is applicable then the offering is exempt from the filing requirements of Revised Rule 5110.³⁰

²² New Rule 2720(f)(12)(D)(ii).

²³ New Rule 2720(a)(1)(A).

²⁴ Release No. 34-60113 at 4.

²⁵ New Rule 2720(a)(1)(B).

²⁶ New Rule 2720(f)(3).

²⁷ New Rule 2720(a)(1)(C).

²⁸ New Rule 2720(f)(8).

²⁹ Release No. 34-60113 at 5.

³⁰ *Id.* at 6.

D. Definition of “Prominent Disclosure”

A member may make “prominent disclosure” under New Rule 2720 by (i) providing the notation “(Conflicts of Interest)” following the listing of the Plan of Distribution in the Table of Contents section required in Item 502 of SEC Regulation S-K, and by providing such disclosures in the Plan of Distribution section required in Item 508 and any Prospectus Summary section required in Item 503 of SEC Regulation S-K³¹ or (ii) for an offering document not subject to SEC Regulation S-K, by providing disclosure on the front page of the offering document that a conflict exists, with a cross-reference to the discussion within the offering document and in the summary of the offering document if one is included.³² FINRA considers these methods of disclosure as non-exclusive safe harbors for effecting “prominent disclosure” and will consider alternative but equally prominent disclosures on a case-by-case basis.³³

E. Restriction on Sales to Discretionary Accounts

Under New Rule 2720, notwithstanding NASD Rule 2510 (Discretionary Accounts), a Conflicted Member may not sell to a discretionary account any security with respect to which the conflict exists, unless the Conflicted Member has received specific written approval of the transaction from the account holder and retains documentation of the approval in its records.³⁴ The limitation on sales to discretionary accounts under New Rule 2720 applies only to sales by the Conflicted Member, whereas Old 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 can be satisfied by an email from the customer.³⁵

III. PUBLIC OFFERING BY A MEMBER OF ITS SECURITIES

With respect to public offerings by a member of its securities, the escrow of proceeds, net capital computation and disclosure requirements under New Rule 2720 mirror the requirements under Old Rule 2720. One difference, however, is that New Rule 2720 uses the net capital calculation under Exchange Act Rule 15c3-1(a)(1)(ii), whereas Old Rule 2720 uses the net capital calculation under Exchange Act Rule 15c3-1(f).

IV. EXEMPTIONS FROM NEW RULE 2720

New Rule 2720 permits, pursuant to the Rule 9600 Series, FINRA in exceptional and unusual circumstances, taking into consideration all relevant factors, to exempt a member unconditionally or on specified terms from any or all of the provisions of New Rule 2720 that it deems appropriate.

³¹ New Rule 2720(f)(10)(A).

³² New Rule 2720(f)(10)(B).

³³ Release No. 34-60113 at 7.

³⁴ New Rule 2720(c)

³⁵ Release No. 34-60113 at 10.

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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 Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

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80 Pine Street | NY, NY | 10005-1702 | Phone: 212.701.3000 | Fax: 212.269. 5420 | Cahill.com

CAHILL GORDON & REINDEL LLP