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SEC Approves Amendments to NASD Rule 2720 Which Governs Conflicts of Interest in Public Offerings

The Securities and Exchange Commission ("SEC") has recently approved amendments to NASD Rule 2720 previously proposed by the Financial Industry Regulatory Authority ("FINRA")[1] governing public offerings of securities in which a broker-dealer with a conflict of interest participates.[2] The new rule (the "Rule") entitled "Public Offerings of Securities With Conflicts of Interest," is intended to streamline and modernize the requirements pertaining to public offerings of securities issued by participating members or their affiliates, public offerings in which a member or its affiliates has a conflict of interest, and public offerings that result in a member becoming a public company. The most notable changes from the current rule include: (1) exempting from the filing and qualified independent underwriter ("QIU") requirements public offerings where the lead manager does not have a conflict, there is a "bona fide public market" or involving investment grade securities; (2) changing the definition of "conflict of interest" so that it covers public offerings in which at least five percent of the offering proceeds are directed to a participating broker-dealer or its affiliates and adding a separate definition of "control" to the Rule; (3) requiring more prominent disclosure of conflicts of interest in offering documents; (4) amending the QIU qualification requirements; and (5) eliminating the requirement for QIU pricing opinions from the relevant provisions of the Rule. Corresponding changes to FINRA Rule 5110 ("Corporate Financing Rule")[3] also have been made. It is anticipated that the new Rule will become effective 60 days following publication of FINRA's Regulatory Notice announcing SEC approval.[4]

Discussion

Exemptions From Filing and QIU Requirements

Under new Rule 2720(a)(1), FINRA members participating in public offerings of securities, which would otherwise be subject to the filing requirements and QIU requirements under the Rule,[5] are exempt if:

[1] See NASD Notice to Members 06-52.
[2] See Release 34-60113 http://sec.gov/rules/sro/finra/2009/34-60113.pdf
[3] Formerly NASD Rule 2710.
[4] As part of FINRA's consolidated rulemaking process, Regulatory Notices are published approximately every two months announcing the effective dates for FINRA Rules approved by the SEC in the preceding two months. Generally these effective dates will be 60 days from the publication of the relevant Regulatory Notice, but may be less than 60 days, in FINRA's discretion.
[5] The Corporate Financing Rule requires the filing of the underwriting terms and arrangements for public offerings with FINRA for its review.

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1. The member primarily responsible for managing the offering (book-running lead manager or lead placement agent) does not have a conflict of interest, is not an affiliate of a member with a conflict of interest and can meet all QIU disciplinary history requirements;

2. The public offering has a "bona fide public market"[6]; **or**

3. The public offering is of "investment grade rated securities"[7] or securities in the same series that have equal rights and obligations as investment grade rated securities.[8]

Despite qualifying for an available exemption from the filing and QIU requirements of Rule 2720 and Rule 5110, members would still be subject to the other provisions of the Rule, including provisions governing escrow and net capital requirements,[9] limitations on selling to discretionary accounts and disclosure requirements. The new Rule 2720(c) has been modified to prohibit members with a conflict of interest from selling to a discretionary account any securities to which a conflict exists unless specific written approval for that transaction has been obtained from the account holder.[10] The new Rule also provides independent disclosure requirements for public offerings in which a QIU must participate, and in which a QIU does not participate. The former rule made no such distinction.

Offerings Where QIU Participation Is Required

Under new Rule 2720(a)(2), members with a conflict of interest participating in a public offering of securities that do not qualify for one of the exemptions enumerated in Rule 2720(a)(1) would be required to have a QIU participate in the preparation of registration statements, prospectuses, offering documents, and exercise the usual aspects of due diligence. As noted, the new Rule eliminates the requirement that a QIU provide a pricing opinion for the offering. The new Rule further mandates that any public offering subject to the QIU requirement of 2720(a)(2) is also subject to the Corporate Financing Rule irrespective of whether the offering would otherwise be deemed exempt from the requirements by the provisions of that rule.

Definition of "Control" Under New Rule 2720

All requirements under both the former and new rules hinge on whether a member or its affiliates have a conflict with relation to the securities involved in a public offering in which it is participating. The new Rule's definition of "affiliate" includes "an entity that controls, is controlled by or is under common control with a member." However, the new Rule has added a separate definition of "control" which is an

[6] "Bona fide public market" is defined as a market for a security issued by a company that has been reporting under the Securities Exchange Act of 1934 (the "Exchange Act") for at least 90 days, is current in its reporting requirements, and whose securities are listed on a national exchange with an average daily trading volume of at least $1 million and a public float of at least $150 million.
[7] "Investment grade rated securities" are securities rated by a nationally recognized statistical rating organization in one of its four highest generic ratings.
[8] The former rule already provided for an exemption for this type of offering from QIU requirements, however the new Rule includes an exemption from the filing requirements of Rule 2720 as well.
[9] The provisions governing escrow and net capital requirements under the new Rule 2720, mirror the former rule.

essential element in determining whether a conflict exists.[11] Under the new Rule 2720, "control" is defined as any of the following:

1. Beneficial ownership of 10% or more of outstanding common equity of an entity;

2. The right to receive 10% or more of the distributable profits or losses of an entity that is a partnership;

3. Beneficial ownership of 10% or more of the outstanding subordinated debt of an entity;

4. Beneficial ownership of 10% or more of outstanding preferred equity of an entity; or

5. The power to direct or cause the direction of management or policies of an entity.

Included in provisions 1 through 4 noted above, is the right to receive the relevant interest within 60 days of the member's participation in the public offering. Significantly, the new Rule amended the definition of "beneficial ownership" to include the right to the economic benefits of a security. It should be noted that this standard differs from the widely known definition under Section 13(d) of the Exchange Act, which includes the right to dispose of and vote the securities.

Definition of "Conflict of Interest"

Several substantive portions of the former rule are now contained in the definition of "conflict of interest," which exist where:

1. the securities are issued by the member;

2. the issuer controls, is controlled by or is under common control of the member;

3. at least five percent of the proceeds, excluding underwriting compensation, are to be used to reduce or retire a loan or credit facility extended by the member having the conflict of interest and its affiliates or otherwise directed to that member and its affiliates.

4. as a result of the offering and any related transactions, the member will become an affiliate of the issuer, become publicly owned or the issuer will become a member or form a broker-dealer.

Disclosure

Where no QIU is required pursuant to an exemption under new Rule 2720(a)(1), "prominent disclosure" must be made in offering documents identifying that a conflict exists and the nature of that conflict. Where a QIU is required to participate, the same "prominent disclosure" for exempt offerings must be

[10] This provision differs from the former rule which limited sales by all firms participating in an offering, not just those members with a conflict of interest relating to the securities in question.
[11] Under the former rule, the control standard was incorporated into the definition of “affiliate.”

made; however, additional disclosure must be made in offering documents as to the identity of the QIU and its role and responsibilities in the offering, including its role in pricing the offering and conducting due diligence.

"Qualified Independent Underwriter"

Several changes to the definition of "qualified independent underwriter" have been added in the new Rule. A QIU is now prohibited from receiving more than five percent of the offering proceeds or else it would be disqualified as having a conflict of interest. The minimum experience requirement has been modified so that a QIU must have served as managing underwriter in at least three similar offerings during the prior three years period. In addition, the five year general experience level in investment banking or securities business now applies only to the firm and not its directors. Finally, the period during which the member's supervisory personnel responsible for organizing, structuring or performing due diligence for the offering could not have certain criminal or disciplinary histories has been raised from five to 10 years.

Commentary

The new Rule is intended to reduce the burden on many large industry participants who regularly participate in public offerings of securities. Through expansive industry affiliations, large broker-dealers often have remote or technical conflicts of interest relating to securities being issued that should not give rise to any valid regulatory concern. Through the exemptions provided under the new Rule, the regulatory burden on some large industry participants will be reduced, allowing for more efficient public issuances. Additionally, the elimination of the requirement that a QIU provide a pricing opinion for offerings will further reduce hurdles to efficiently executing public offerings of securities.

Despite increased efficiency for certain industry participants, there exists concern that the amended Rule could require certain FINRA members to make filings who were never previously required to do so. Under the old rule, if a deal (*e.g.* unrated or preferred debt, or equity for which there was no "bona fide independent market") had neither an affiliation nor a conflict of interest, but proceeds were being received by a participating member, a QIU was required, but no filing requirement would arise. Under the new Rule, the receipt of proceeds by a participating FINRA member would trigger both a QIU and filing requirement. This issue is most likely to arise in the case of shelf offerings by non-investment grade issuers. Since the debt of many issuers are not investment grade, the receipt of the proceeds of these common deals by an affiliate to a FINRA member may trigger filing requirements under the new Rule, and potentially slow down deals that formerly were fairly routine.

Concern also exists that the new definition of "control" provided in the Rule could expand the reach of the Rule to the regulation of offerings in which part of the proceeds of the offering are directed to one or more participating members, to offerings where the issuer owns non-voting securities of a participating

member, and to offerings where the affected member does not participate as an underwriter. There also is potential for inadvertent non-compliance stemming from the definitions of "affiliate" and "control" under the Rule, as they are not uniform with commonly applied definitions under other provisions of the securities laws. FINRA member firms should take this into advisement when establishing procedures for participation in public offerings of securities where there is a conflict of interest.

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