Underwriter Conflicts of Interest

SEC Approves Rule Change Simplifying and Modernizing NASD Rule 2720

SUMMARY

NASD Rule 2720 applies to public offerings of securities when one or more underwriters are affiliated with or have a “conflict of interest” with the issuer. The central requirement of current Rule 2720 is that offerings subject to the rule must be priced by a “qualified independent underwriter” (“QIU”) unless an exemption applies. In addition, Rule 2720 currently requires filing with the Corporate Financing Department of FINRA, even for offerings that otherwise would have had a filing exemption under FINRA Rule 5110 (the Corporate Financing Rule). On June 15, 2009, the SEC approved a proposal of FINRA to modernize and simplify Rule 2720 and to make corresponding changes to Rule 5110. Amended Rule 2720 makes the following changes, among others:

- adds an exception from the requirement to have a QIU for public offerings with a book-running lead manager or dealer-manager that does not have a conflict of interest and that can meet the disciplinary history requirements for a QIU;
- exempts from the filing requirements offerings that would, but for the fact that they are subject to Rule 2720, be exempt under Rule 5110 from filing, if an exception from the QIU requirement is available;
- replaces one of the conflict of interest triggers – more than ten percent of the net proceeds of the offering going to participating members and their affiliates – with a new test – five percent or more of the net proceeds of the offering going to any one member and its affiliates (rather than to all members and their affiliates in the aggregate);
- limits the restriction on sales to discretionary accounts to those member firms having the conflict of interest; and
- eliminates certain provisions of Rule 2720 relating to corporate governance of the issuer.
FINRA has stated that it will issue a regulatory notice announcing the rule changes within 60 days of the publication of the SEC approval order in the Federal Register, and that the effective date of the rule will be 30 days after the date of the notice.

**BACKGROUND**

The conflict of interest provisions applicable to member firms participating in public offerings are currently found in Rule 2720, with an additional conflict of interest provision in Rule 5110(h). Rule 2720 requires that an offering subject to its provisions have a pricing opinion from a QIU who is also responsible for performing independent due diligence, unless an exemption applies. An exemption from the QIU requirement is available for an offering of (1) a class of equity securities for which there exists a “bona fide independent market” as defined in the rule or (2) a class of securities rated investment grade.

Rule 5110(h) provides that, in any offering in which participating FINRA members and their affiliates will receive, in the aggregate, more than ten percent of the net proceeds of the offering, the offering must be priced according to the provisions of Rule 2720, requiring a pricing opinion from a QIU, unless one of the exemptions is available.

Rule 5110 requires that filings be made with the Corporate Financing Department in respect of public offerings, subject to a number of exemptions (e.g., offerings of investment grade debt or Rule 415 shelf offerings satisfying the requirements of Forms S-3 or F-3 as they existed prior to their amendment in 1992). However, the filing exemptions are not available under the current rules for offerings subject to Rule 2720 (other than offerings that are subject to the pricing provisions of Rule 2720 solely because of a Rule 5110(h) conflict of interest.

In September 2006, FINRA (then the NASD) published Notice to Members 06-52 requesting comment on proposed amendments to Rule 2720, which were intended to modernize and simplify the rule. On September 6, 2007, FINRA filed a proposal to amend Rule 2720 and to make corresponding changes to Rule 5110 (at that time, NASD Rule 2710).¹ In response to comments FINRA received from the SEC, FINRA filed Amendment No. 1 replacing and superseding the original filed proposal, except for certain exhibits. Amendment No. 1 was published for comment in the Federal Register on May 13, 2009.² The SEC issued an order approving the proposed rule change on June 15, 2009.³

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¹ SR-FINRA-2007-009. The original filing was never published by the SEC but is available on the FINRA website at: www.finra.org/Industry/Regulation/RuleFilings/2007/P036746. FINRA has not renumbered NASD Rule 2720 as a FINRA rule.


³ Release No. 34-60113 (June 15, 2009), 74 FR 29255 (June 19, 2009).
DISCUSSION

Determination of Conflict of Interest

Under current Rule 2720, the provisions of the rule apply if the company issuing securities in the public offering is the member, a parent of a member or an affiliate of a member participating in the offering, or if there is a conflict of interest between the company and a member participating in the offering. The terms “parent,” “affiliate” and “conflict of interest” are defined in Rule 2720. In addition, a Rule 5110(h) conflict of interest may exist if one or more of the participating members, their associated persons and their affiliates, in the aggregate, are to receive more than ten percent of the net proceeds of the offering. In amended Rule 2720, the conditions giving rise to the application of Rule 2720 have been combined into a single definition of “conflict of interest,” which draws upon a revised definition of “affiliate” and a new definition of “control.”

Under the amended rule definition, a conflict of interest exists if 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 (i) 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 (ii) 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, (i) the member will be an affiliate of the issuer, (ii) the member will become publicly owned or (iii) the issuer will become a member or form a broker-dealer subsidiary.

As amended, Rule 2720 no longer applies to an offering by a “parent” of a member (defined as an entity affiliated with a member that derives 50% or more of its gross revenues from or employs 50% or more of its assets in the member) unless the member participates in the offering or the offering is one that will result in the issuer forming a broker-dealer subsidiary.4

The definition of the term “affiliate” is similar to that in current Rule 2720, except that the exclusions for certain types of issuers have been moved to the definition of “entity,” discussed below.

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4 Including within the definition of conflict of interest offerings by an issuer that plans to form a broker-dealer subsidiary is consistent with the desire of FINRA to review the source of funds used to capitalize new member firms and to regulate offerings intended to provide funds for member firms. For example, new FINRA Rule 5122 regulates certain types of private offerings by members and their control entities, as defined in that rule.
“Control,” which is used in the definitions of “affiliate” and “conflict of interest,” is defined in amended Rule 2720 to mean any of the following:

- beneficial ownership of ten percent or more of the outstanding common equity of an entity;
- the right to ten percent or more of the distributable profits or losses of any entity that is a partnership;
- beneficial ownership of ten percent or more of the outstanding subordinated debt of an entity;
- beneficial ownership of ten percent or more of the outstanding preferred equity of any entity;
- or
- the power to direct or cause the direction of the management or policies of an entity.5

In the amended rule, calculation of ten percent ownership of any of the foregoing interests must include amounts obtainable under a right to receive such interests within 60 days of the member’s participation in the public offering. This is a change from the current rule.

**Definition of “Entity”**

The definition of “entity” in amended Rule 2720 contains the same exclusions for certain categories of issuer (e.g., an investment company or real estate investment trust) which are part of the definitions of “affiliate” and “conflict of interest” in current Rule 2720, with one exception. The new definition does not exclude an entity issuing securities that are backed by financing instruments and are rated investment grade, presumably because investment grade offerings are elsewhere generally excepted from the filing and QIU requirements of Rule 2720. Members having a conflict of interest with issuers of financing instrument-backed securities rated investment grade will not, however, be excepted from the restriction on sales to discretionary accounts imposed by Rule 2720.

**Three Exclusions from QIU and Filing Requirements**

Rule 2720 provides three exclusions from the requirements to employ a QIU and to make a filing with FINRA pursuant to Rule 5110. The first exclusion is available for public offerings if a book-running lead manager or dealer-manager does not have a conflict of interest and can meet the disciplinary history requirements for a QIU (see “Duties and Qualifications of QIUs” below). In cases where there are multiple lead managers or dealer-managers, each lead manager or dealer-manager would need to be free of conflicts of interest in order to qualify for the exclusion. If any lead manager or dealer-manager has a conflict of interest, this exclusion will not apply and filing and employment of a QIU will be required unless another exclusion applies. Current Rule 2720 does not contain an equivalent to this exclusion.

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5 None of these five requirements is new. In the current rule, the first four are included in the definition of “conflict of interest” and the fifth is included in the definition of “affiliate.”
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The second exclusion, which is based on an existing exclusion, is available for public offerings that have a bona fide public market. The term “bona fide public market” replaces the term “bona fide independent market” used in current Rule 2720, and is defined as a market for a security of an issuer:

- that has been reporting under the Securities and Exchange Act of 1934 for at least 90 days and is current in its reporting requirements;
- whose securities are traded on a national securities exchange with an Average Daily Trading Volume (as provided in Regulation M) of at least $1 million; and
- whose common equity securities have a public float of at least $150 million.

Notably, the new definition does not require that the security have had a price of at least $5 for 20 of the past 30 days, as is the case in the definition of “bona fide independent market” in the current rule.

The third exclusion, also based on an existing exclusion, is available for offerings of securities that “are investment grade rated or are securities in the same series that have equal rights and obligations as investment grade rated securities.” The term “investment grade rated,” as applied to securities, is defined in the amended rule to mean securities that are rated by a nationally recognized statistical rating organization in one of the four highest generic rating categories. The adopting release explains that the exception would apply to 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.6

Duties and Qualification of QIUs
If an offering is being conducted pursuant to the provisions of Rule 2720 and there is no exception from the QIU requirement, amended Rule 2720 requires that the QIU participate in the preparation of the registration statement and prospectus, offering circular or similar document, and that the QIU exercise “the usual standards of ‘due diligence’ in respect thereto.” Amended Rule 2720 eliminates the requirement in the current rule that the 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. Amended Rule 2720 defines “qualified independent underwriter” as a member that:

- does not have a conflict of interest and is not an affiliate of any member that has a conflict of interest;
- does not beneficially own as of the date of the member’s participation in the public offering, more than five percent of a class of securities that would give rise to a conflict of interest, including any right to receive any such securities exercisable within 60 days;
- has agreed in acting as qualified independent underwriter to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act of 1933, including those inherent in Section 11;

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- has 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 without a registration statement; and
- has no associated persons in a supervisory capacity responsible for organizing, structuring or performing due diligence with respect to corporate public offerings of securities who have been subject, within the ten-year period prior to filing the registration statement or the preparation of an offering circular for an offering not required to be registered, to certain criminal penalties or disciplinary sanctions listed in the definition.

Other than the second bullet, these requirements are similar to existing ones under the current rule, although some have been modified. For example, the look-back period for disciplinary history was increased from five years to ten years in the amended rule. In addition, the amended rule eliminates the requirement that a majority of the board of directors of the QIU have specified underwriting experience; FINRA staff believes that the experience of the firm itself is more relevant to the determination.

Sales to Discretionary Accounts

Rule 2720 currently prohibits every member participating in an offering subject to the rule from making sales to any account over which the member exercises discretionary authority without the prior specific written approval of the customer. Under the amended rule, this restriction has been narrowed to apply only to discretionary sales by the member that has the conflict of interest. All other participating members may effect sales to discretionary accounts without prior written approval.

Disclosure Requirements

Offering documents will be required prominently to disclose the existence of any conflicts of interest, including the nature of the conflict of interest, the name of the QIU (if used) and a brief statement of the role and responsibilities of the QIU. These provisions codify current FINRA requirements expressed in comments by reviewers on filed offering materials. The amended rule provides a non-exclusive safe harbor with respect to “prominent disclosure” for offerings that disclose conflicts of interest in the plan of distribution section and a prospectus summary section to the extent required by Regulation S-K. For offerings not subject to Regulation S-K, the prominent disclosure may be satisfied by disclosing the existence of a conflict on the front page of the offering documents with a cross-reference in the offering materials. FINRA will consider other methods of prominent disclosure on a case-by-case basis.

Corporate Governance and Suitability Provisions Eliminated

Rule 2720 currently requires that issuers making offerings subject to the rule comply with certain corporate governance provisions. These provisions, relating to audit committees, public directors and

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7 The Rule contains further guidelines for determining whether this requirement is satisfied for particular types of offerings.
8 Release No.34-60113, 74 FR at 29260, text preceding n.52.
periodic reports, have been eliminated in the amended rule. FINRA believes these matters have been addressed by the Sarbanes-Oxley Act of 2002 and no longer need to be addressed by amended Rule 2720.9 Similarly, amended Rule 2720 eliminates the suitability requirements found in current Rule 2720. Those requirements are similar to the customer suitability requirements in NASD Rule 2310, which remains in effect.

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9 Id. at 29261, text at n. 56.
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