



A Guide to FINRA's New Conflict of Interest Rule for Public Offerings

On June 15, 2009 the Securities and Exchange Commission (the "SEC") approved a proposal from The Financial Industry Regulatory Authority, Inc. ("FINRA") to "modernize and simplify" Rule 2720, the FINRA rule that addresses public offerings of securities in which a member with a conflict of interest participates.¹ FINRA originally proposed to amend Rule 2720 in 2007, and amended its proposal in May 2009. New Rule 2720, entitled simply "Public Offerings of Securities with Conflicts of Interest," replaces existing Rule 2720 in its entirety. New Rule 2720 effects the following primary changes:²

- Exempts from the filing and qualified independent underwriter ("QIU") requirements,
 - 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 a QIU;
 - public offerings of investment grade rated securities; and
 - public offerings of securities that have a bona fide public market;
- Amends 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;
- Requires more prominent disclosure of conflicts of interest in offering documents;
- Streamlines the qualifications for a QIU; and
- Eliminates the obligation of a QIU, if required, to render a pricing opinion.

This alert provides practical guidance for compliance with its requirements. This guidance should be particularly helpful for large investment banks that regularly offer securities of their affiliates.

¹ The SEC's approval is contained in Exchange Act Release No. 34-60113; File No. SR-FINRA-2007-009, available at: <http://www.sec.gov/rules/sro/finra/2009/34-60113.pdf>. The revised rule should become effective 60 days following publication of FINRA's Regulatory Notice announcing SEC approval, which, as of July 13, 2009, has not occurred. FINRA was created through the consolidation of the National Association of Securities Dealers ("NASD") and the member regulation, enforcement and arbitration functions of the New York Stock Exchange ("NYSE"). Rule 2720 was originally an NASD rule. FINRA is in the process of consolidating the NASD and NYSE rules but has not set a timetable for conversion of Rule 2720 to a FINRA rule number.

² In addition, the SEC approved conforming changes to FINRA Rule 5110, the Corporate Financing Rule, which included moving certain definitions from existing Rule 2720 to Rule 5110, clarifying that if a QIU is required, the offering must be filed with FINRA under Rule 5110 irrespective of whether the securities to be offered or the offering itself would otherwise be exempt, and moving the requirements regarding proceeds directed to a member from Rule 5110 to new Rule 2720.

What is a Conflict of Interest?

Rule 2720(f)(5) provides that a “conflict of interest” exists if, at the time of a member’s participation in an issuer’s public offering, any of the following four conditions apply:

- 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;³
- at least five percent⁴ of the net offering proceeds, net of underwriting compensation, is intended to be used either 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 be 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.

Rule 2720 provides that no member that has a conflict of interest may participate in a public offering unless the offering complies with either Rule 2720(a)(1) or 2720(a)(2), each of which requires disclosure of the conflict of interest.

Affiliate, Control and Beneficial Interest

Three key concepts in determining whether new Rule 2720 applies are the entwined definitions of “affiliate,” “control” and “beneficial interest.”

Consistent with other SEC and FINRA usage, new Rule 2720 defines “affiliate” to mean “an entity that controls, is controlled by or is under common control with a member.”⁵ New Rule 2720(f)(6) then adds a new definition of “control,” which means

- Beneficial ownership of ten percent or more of an entity’s outstanding
 - common equity,
 - subordinated debt,⁶ or
 - preferred equity,

including, in each case, any right to receive such securities within 60 days of the member’s participation in the public offering;⁷

- 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; or

³ See discussion of “control” elsewhere in this memorandum.

⁴ Five percent is less than the percentage set forth in current Rule 5110(h), in which ten percent or more will be paid to participating members in the aggregate. New Rule 2720 applies the five percent test to each member separately (including its affiliates and associated persons). This potentially allows for substantially more of the aggregate proceeds of an offering to be directed to members.

⁵ New Rule 2720(f)(1).

⁶ The definition of “subordinated debt” in new Rule 2720(f)(14) excludes short-term debt with maturity at issuance of less than one year and secured debt and bank debt not specified as subordinated debt at the time of issuance.

⁷ FINRA’s proposal noted that “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 (generally) non-voting stock. See Exchange Act Release No. 34-60113; File No. SR-FINRA-2007-009, available at: <http://www.sec.gov/rules/sro/finra/2009/34-60113.pdf>.

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

As approved, the timing of the right to receive the specified securities within 60 days commences from the time of the member's participation in the public offering and not the effective date of the registration statement for the offering (as originally proposed) in order to ensure that takedowns from shelf registration statements are included in the determinations.⁸

Rule 2720 continues to define "beneficial ownership" to mean only "the right to the economic benefits of a security."⁹ This is in contrast to the definition of the SEC that focuses on the right, shared or otherwise, to vote or dispose of a security.¹⁰

Rule 2720 also incorporates definitions from FINRA Rule 5110.

Rule 2720(a)(1) – Exemption from QIU and Filing Requirements

An offering in which it is determined that a member has a conflict of interest will be exempt from the filing requirements of FINRA Rule 5110 and the obligation to retain a QIU, but not other requirements otherwise applicable with respect to escrows and discretionary accounts, if one of the following conditions is satisfied:¹¹

- the member(s) primarily responsible for managing the public offering does (do) not have a conflict of interest, is not an affiliate of any member that does have a conflict of interest, and meets the requirements for being a QIU;
- the securities offered have a "bona fide public market"; or
- the securities offered are investment grade rated¹² or are securities in the same series that have equal rights and obligations as investment grade rated securities.¹³

A common stock initial public offering of an affiliate of the lead, book-running underwriter would, therefore, require the use of a QIU. However, many other kinds of offerings generally will be able to satisfy at least one of the above conditions and be able to avoid the filing requirements of FINRA Rule 5110.

Bona Fide Public Market

Rule 2720 defines "bona fide public market" as a market for a security of an issuer that has been reporting under the Exchange 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 (calculated in accordance with Regulation M under the Exchange Act) of at least \$1 million, provided that the issuer's common equity securities have a public float value of at least \$150 million.

Prominent Disclosure

If the public offering satisfies at least one of the conditions described above, even if the lead underwriter does not have a conflict of interest, the prospectus or other offering document must contain "prominent disclosure of the nature of the conflict of interest." The Rule requires this disclosure to be included in one of the following ways:

⁸ In calculating whether an entity has the right to receive securities, only such entity's rights are included and not all such rights held by other entities or investors.

⁹ New Rule 2720(f)(2).

¹⁰ See Exchange Act Rule 13d-3.

¹¹ New Rule 2720(a)(1).

¹² Similar to usage elsewhere in the federal securities laws, New Rule 2720(f)(8) defines "investment grade rated" to refer to securities that are rated by a nationally recognized statistical rating organization in one of its four highest generic categories.

¹³ This provision allows offerings of securities that are not rated but are otherwise *pari passu* with investment-grade rated securities to take advantage of the exemption, and is particularly important for issuers that are continuously in the market with such securities.

- 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 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-K; *or*
- 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.

Despite the apparent specificity of these requirements, some common offering practices will need to be adjusted, and FINRA has noted that the methods described above are non-exclusive safe harbors. Many large issuers, particularly financial institutions whose securities are offered by their broker-dealer affiliates, do not have tables of content in their offering documents or provide only short, term sheet style prospectus supplements. These issuers may not be prepared to file a new or amend an existing shelf registration statement in order to satisfy this disclosure requirement. However, we believe that the intention of the prominent disclosure requirement is satisfied¹⁴ if:

- the front cover of a prospectus supplement discloses the location of the conflict of interest disclosure (or if the prospectus supplement is only one page, the full disclosure is set forth on that one page), and
- the disclosure of the conflict of interest is clearly identified within the body of the prospectus supplement.

In addition, when a new shelf registration statement is filed, issuers whose securities will likely be offered by their broker-dealer affiliates should include the required language in their new base prospectuses.

Rule 2720(a)(2) – Obligation to File and Retain a QIU

If the offering does not meet at least one of the conditions set forth in new Rule 2720(a)(1), then a QIU must participate in the preparation of the registration statement and the offering document and must exercise the usual standards of “due diligence” in respect of the offering. There must also be “prominent disclosure” of the nature of the conflict of interest as well as disclosure of the name of the member acting as QIU, and a brief general statement regarding the role and responsibilities of a QIU.¹⁵ Further, even if the offering might otherwise be exempt from filing under FINRA Rule 5110, the offering must be filed and subject to FINRA’s review of the fairness and reasonableness of the underwriter compensation.

Escrow for Offerings of Member’s Securities; Net Capital Computation

New Rule 2720(b)(1) mirrors existing Rule 2720(e). All proceeds from a public offering by a member of its securities must be placed in an escrow account and may not be released from escrow or used by the member in any manner until the member has (1) immediately notified FINRA when the public offering has been terminated and settlement effected, and (2) filed with FINRA a computation of its net capital computed pursuant to the provisions of SEC Rule 15c3-1 under the Exchange Act (the net capital rule) as of the settlement date. If the net capital ratio does not meet certain targets,¹⁶ after giving effect to the proceeds of the offering, all monies received

¹⁴ Under new Rule 2720(d), FINRA may exempt a member from one or more provisions of the Rule under “exceptional and unusual circumstances, taking into consideration all relevant factors.” While FINRA could be asked for an exemption from the specific prominent disclosure requirements of the Rule in accordance with our suggested approach, we believe that it is not necessary in this instance to require a formal answer from FINRA.

¹⁵ This new disclosure is in contrast to the requirements of existing Rule 2720(d), which requires that, among other things, the offering document expressly state that the member acting as a QIU is assuming its responsibilities in pricing the offering and conducting due diligence. FINRA made the change in response to commenters’ concerns that such a statement could potentially result in liability for the QIU. See Exchange Act Release No. 34-60113; File No. SR-FINRA-2007-009, available at: <http://www.sec.gov/rules/sro/finra/2009/34-60113.pdf>.

¹⁶ All funds must be returned if at such time its net capital ratio as so computed is more than 10:1 or, net capital fails to equal 120 percent of the minimum dollar amount required by Rule 15c3-1 or, in the event the member calculates its net capital requirement using the alternative standard (set forth in Rule 15c3-1(a)(1)(ii)), its net capital is less than seven percent of aggregate debit items as computed in accordance with

from sales of securities of the public offering must be returned in full to the purchasers and the offering withdrawn, unless the SEC has granted the member a specific exemption from the net capital rule. In addition, the offering document must also disclose the date by which the offering is reasonably expected to be completed and the terms upon which the proceeds will be released from the escrow account.¹⁷

Discretionary Accounts

Notwithstanding FINRA Rule 2510, which is the general rule regarding discretionary accounts, no member that has a conflict of interest may 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 (which may be by email) from the account holder and retains documentation of the approval in its records.¹⁸ This provision is different from current Rule 2720(l), which limits discretionary sales by all firms participating in the offering, not just those with the conflict of interest.

The QIU

QIU Qualifications

New Rule 2720(f)(12) revises the current definition of QIU and sets forth five specified conditions. The term “qualified independent underwriter” means a member:

- that does not have a conflict of interest and is not an affiliate of any member participating in the public offering that has a conflict of interest;
- that does not beneficially own as of the date of the member’s participation in the public 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;
- that has agreed in acting as a QIU to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act of 1933, specifically including those inherent in Section 11 thereof;
- that 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;¹⁹ and
- whose associated persons in a supervisory capacity who are responsible for organizing, structuring, or performing due diligence with respect to corporate public offerings of securities do not have certain criminal or disciplinary histories.²⁰

Rule 15c3-3a. Note that the reference in existing Rule 2720(e) to Exchange Act Rule 15c3-1(f) has been changed to Exchange Act Rule 15c3-1(a)(1)(ii).

¹⁷ New Rule 2720(b).

¹⁸ New Rule 2720(c).

¹⁹ This requirement will be deemed satisfied if, during the preceding three years, the member: (i) with respect to a proposed public offering of debt securities, has 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; and (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 securities convertible into equity securities), each with gross proceeds of not less than 50% of the anticipated gross proceeds of the proposed offering.

²⁰ In the ten years (five years under existing Rule 2720) prior to the filing of the registration statement or the preparation of an offering circular in an offering without a registration statement, none of such persons (i) has been convicted of a violation of the anti-fraud provisions of the federal or state securities laws, in connection with a registered or unregistered offering of securities; (ii) is subject to any order, judgment, or decree of any court of competent jurisdiction permanently enjoining or restraining such person from engaging in or continuing any conduct or practice in violation of the anti-fraud provisions of the federal or state securities laws, in connection with a registered or unregistered offering of securities; or (iii) has been suspended or barred from association with any member by an order or decision of the SEC, any state, FINRA or

In addition, the definition of “conflict of interest” would also prohibit the QIU from receiving more than five percent of the offering proceeds. It should be noted that new Rule 2720 requires firm level experience and does not contain the current rule’s requirement that directors or partners of the underwriter have offering experience

Role of the QIU

As noted earlier, the QIU must participate in the preparation of the registration statement and the offering document and must exercise the usual standards of “due diligence” in respect of the offering. However, new Rule 2720, unlike existing Rule 2720, eliminates the requirement 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. In its rule request to the SEC, FINRA staff stated that they were unaware of instances where QIUs have made recommendations that were inconsistent with pricing decisions by the book-running lead manager or lead placement agent. In addition, FINRA staff stated that they believe QIU pricing opinions in at-the-market offerings are of little to no value.²¹

Entities Not Subject to Rule 2720

New Rule 2720 has added a definition of entity and, then, for purposes of determining affiliate, conflict of interest and control definitions, the following entities are not considered to be an “entity,” thereby excluding them from compliance with new Rule 2720:²²

- an investment company registered under the Investment Company Act of 1940;
- a “separate account” as defined in Section 2(a)(37) of the Investment Company Act of 1940;
- a “real estate investment trust” as defined in Section 856 of the Internal Revenue Code; or
- a “direct participation program” as defined in Rule 2810.

These exceptions are consistent with the exclusions in current Rule 2720.

Offerings that are not “Public Offerings”

New Rule 2720 broadly defines “public offering” to mean any primary or secondary offering of securities made pursuant to a registration statement or offering circular, including exchange offers, rights offerings, offerings made pursuant to a merger or acquisition and all other securities offerings of any kind whatsoever. However, “public offering does not include any offering of exempted securities (as defined in Section 3(a)(12) of the Exchange Act) or any offering made pursuant to:

- an exemption from registration under Sections 4(1), 4(2), or 4(6) of the Securities Act of 1933;
- Rule 504, if the securities are “restricted securities” under SEC Rule 144(a)(3), SEC Rules 505 or 506; or
- SEC Rule 144A or Regulation S.

The specific exclusion of Rule 144A and Regulation S offerings clarifies the current uncertainty of the applicability of existing Rule 2720 to such offerings. In the filing proposal, FINRA also noted that such offerings are not considered “public offerings” for purposes of existing Rule 2720.

any other self-regulatory organization for any conduct or practice in violation of the anti-fraud provisions of the federal or state securities laws, or of any self regulatory organization in connection with a registered or unregistered offering of securities.

²¹ See Exchange Act Release No. 34-60113; File No. SR-FINRA-2007-009, available at: <http://www.sec.gov/rules/sro/finra/2009/34-60113.pdf>.

²² New Rule 2720(f)(7).

Some Commentary

New Rule 2720 is an improvement over the more complicated provisions of current Rule 2720 and eliminates the burdensome and outdated requirement that QIUs deliver pricing opinions. However, it will require issuers and investment banks to put in place revised procedures to ensure that a conflict of interest does not arise unexpectedly, as well as to ensure that every affected offering document contains the required disclosure regarding the conflict even if no QIU is required, which is a change from the past. More importantly, FINRA has now linked the requirement to have a QIU with a FINRA Rule 5110 filing, unlike under the current Rule where those determinations were separate. FINRA's filing review could potentially affect the timing of the issuance of non-investment grade securities by issuers that are affiliates of FINRA members. Lastly, in working with new Rule 2720, participants should pay careful attention to the non-customary definitions of "control" and "beneficial interest," as offerings that in the past would not have raised a conflict of interest concern might be swept in by the new definitions.

Contacts

Nilene R. Evans
(212) 468- 8088
nevans@mofo.com

About Morrison & Foerster

With more than 1000 lawyers in 16 offices around the world, Morrison & Foerster offers clients comprehensive, global legal services in business and litigation. The firm is distinguished by its unsurpassed expertise in finance, life sciences, and technology, its legendary litigation skills, and an unrivaled reach across the Pacific Rim, particularly in Japan and China. For more information, visit www.mofo.com.

© 2009 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.