CLEARY GOTTLIEB Alert Memo

NEW YORK SEPTEMBER 3, 2009

www.clearygottlieb.com

SEC and FINRA Approve Amendments to NASD Rule 2720 and FINRA Rule 5110

I. Introduction

On June 15, 2009, the Securities and Exchange Commission (the "Commission") published a release (the "Rule 2720 Release") approving changes proposed by The Financial Industry Regulatory Authority, Inc. ("FINRA")[1] to amend and replace NASD Rule 2720, "Distributions of Securities of Members and Affiliates – Conflicts of Interest" ("Rule 2720" or the "Prior Rule"), and to make corresponding changes to FINRA Rule 5110, "Corporate Financing Rule – Underwriting Terms and Arrangements" ("Rule 5110").[2] Rule 2720 governs public offerings of securities in which a participating FINRA member (a "Member") has a conflict of interest. Rule 2720 is intended to address the potential conflicts arising in connection with diligence activities for and the pricing of such offerings, and the amendments are intended to streamline the application of Rule 2720's requirements to such offerings. New Rule 2720, entitled "Public Offerings of Securities with Conflicts of Interest" ("New Rule 2720" or the "New Rule"), will replace existing Rule 2720 in its entirety. On August 14, 2009, FINRA issued Regulatory Notice 09-49 ("Notice 09-49"),[3] announcing the Commission's approval of the amendments to Rules 2720 and 5110. Pursuant to Notice 09-49, the amendments to Rules 2720 and 5110 will become effective on September 14, 2009 (the "Effective Date").[4]

---

1 FINRA was created in July 2007 through the consolidation of the National Association of Securities Dealers, Inc. (the "NASD") and the member regulation, enforcement and arbitration functions of the New York Stock Exchange (the "NYSE"). FINRA is in the process of creating a consolidated rulebook consisting solely of FINRA rules. In the interim, however, the rules governing FINRA members also include certain NASD rules and incorporated NYSE rules.

2 SEC Rel. No. 34-60113 (June 15, 2009), 74 Fed. Reg. 29255 (June 19, 2009) (File No. SR-FINRA-2007-009).

3 FINRA Notice to Members 09-49, "Conflicts of Interest – SEC Approves Amendments to Modernize and Simplify NASD Rule 2720 Relating to Public Offerings in Which a Member Firm With a Conflict of Interest Participates" (Aug. 14, 2009).

4 We understand, based on a conversation between FINRA and members of the American Bar Association's Subcommittee on FINRA Corporate Financing Rules (the "Subcommittee"), that New Rule 2720 will apply to all offerings that commence on or after the Effective Date, even if, for example, an underwriter obtains a no-objections letter for an offering prior to the Effective Date. For example, for takedowns from shelf registration statements that became effective before the Effective Date, the disclosure requirements in New Rule 2720(a) could be satisfied in (and would only apply to)

New Rule 2720 reflects the culmination of a multi-year process undertaken by FINRA (and, before FINRA, the NASD). That process began in September 2006, when the NASD published for comment proposed changes intended to "modernize and simplify" Rule 2720.[5] FINRA received two comments letters, which were generally supportive of the proposal but that also suggested a number of changes and refinements.[6] In response, FINRA revised the original proposal and subsequently filed the text of the proposed rule change with the Commission in September 2007.[7] To address subsequent Commission staff comments, FINRA filed an amended proposal with the Commission in May 2009.[8] The Commission then published a notification of the proposed rule change.[9] The Commission approved the changes to the Prior Rule as proposed on June 15, 2009. FINRA subsequently published Notice 09-49 on August 14, 2009.

II. Summary of Revisions to Rule 2720

New Rule 2720 significantly changes the Prior Rule's requirements. Some of the more noteworthy amendments include the following:

A. Exemptions from the Qualified Independent Underwriter ("QIU") Requirements of NASD Rule 2720 and the Filing Requirements of FINRA Rule 5110

New Rule 2720(a)(1) exempts – from both the QIU requirements of Rule 2720 and the filing requirements of FINRA Rule 5110 – three categories of public offerings, subject to compliance with the New Rule's disclosure requirements (discussed in Section II.B below). The first category is public offerings in which the FINRA member primarily responsible for managing the offering (1) does not have a "conflict of interest," (2) is not an "affiliate" of a member that has a conflict of interest and (3) can meet the disciplinary history requirements for a QIU. In cases where two or more co-lead managers or placement agents have equal responsibilities with regard to due diligence, the New Rule makes clear that each must be free of conflicts of interest and otherwise meet the applicable requirements.[10] Although the New Rule expands the scope of the terms "affiliate" and "conflict of interest" (as discussed

---

a post-effective amendment or prospectus supplement filed after the Effective Date. See Notice 09-49, endnote 3.

5 NASD Notice to Members 06-52, "Proposed Amendments to Rule 2720 – NASD Requests Comment on Proposed Amendments to Rules Governing Conflicts of Interest in Public Offerings of Securities" (Sept. 14, 2006).

6 Letters were received from the Securities Industry and Financial Markets Association and from the American Bar Association. See SEC Rel. No. 34-60113 (June 15, 2009), note 5.

7 SR-2007-009 (Sept. 6, 2007).

8 Amendment No. 1 to SR-FINRA-2007-009 (May 1, 2009).

9 SEC Rel. No. 34-59880 (June 15, 2009), 74 Fed. Reg. 22600 (May 13, 2009).

10 New Rule 2720(a)(1)(A). See Notice 09-49, at 3.

in more detail in Section II.C below), we believe this new exemption likely will decrease the number of offerings required to comply with the QIU requirements.

The second category is public offerings of securities that are "investment grade rated or are in the same series that have equal rights and obligations as investment grade rated securities,"[11] such as unrated securities issued under a medium-term note program where the program or at least one series of notes issued under such a program is investment grade rated.[12] FINRA has informally indicated that differences in maturity, interest rates, and how rates are computed (by referencing different indices, for example) would not constitute different "rights and obligations" for this purpose.[13] However, the interpretation of what constitutes securities "in the same series that have equal rights and obligations as investment grade rated securities" likely will require additional guidance from FINRA. The Prior Rule, on the other hand, only exempted securities that were themselves specifically rated investment grade by a nationally recognized statistical rating organization. The New Rule also differs from the Prior Rule in that the Prior Rule exempted such offerings only from its QIU requirements and not the related filing requirements.

The third category is public offerings of securities that have a "bona fide public market."[14] Although this language is in some respects similar to that in the Prior Rule (which exempted offerings of equity securities that had a "bona fide independent market"), the New Rule is substantially different in several respects. First, the New Rule defines a "bona fide public market" in accordance with the numerical standards of Regulation M under the Securities Exchange Act of 1934 (the "Exchange Act"), which differs substantially from the Prior Rule's definition of a "bona fide independent market."[15] Second, the New Rule is not specifically limited to equity securities.[16] Third, like the exemption for investment grade rated securities, the Prior Rule exempted offerings with a bona fide

---

11 New Rule 2720(a)(1)(C).

12 See Notice 09-49, at 3. "Investment grade" is a new definition in the New Rule, although the concept already existed under the Prior Rule as a prong of the test for QIU exemption. The definition in the New Rule is the same as the concept in the Prior Rule - *i.e.*, it continues to refer to a rating in one of the four highest generic rating categories by a nationally recognized statistical rating organization.

13 Conversation between FINRA and the Subcommittee chair.

14 New Rule 2720(f)(3) defines a "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 (as provided by 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."

15 The definition of "bona fide independent market" required that the issuer be current in its reporting obligations and that the security be registered under the Exchange Act or be issued by a company subject to Section 15(d) of the Exchange Act, trade above $5 prior to the offering and for at least 20 of the last 30 trading days and meet certain trading volume and outstanding volume thresholds.

16 However, this easing of limitation likely will be of limited utility because debt securities are usually issued in distinct classes. Thus, the exemption from the QIU and filing requirements generally would apply only to reopenings of debt.

independent market from only the Prior Rule's QIU requirements and not the related filing requirements.

Under the New Rule, if a Member with a conflict of interest participates in a public offering, a QIU will be required unless the offering falls within one of the QIU exemptions described above. Any offering that requires a QIU must be filed with FINRA for review.[17] Even if one of the QIU exemptions is met and therefore no filing is required, any Member that has a conflict of interest must comply with FINRA's discretionary accounts requirement and,[18] where applicable, the escrow, net capital computation and related disclosure provisions of the Rule.[19]

B. Revised Disclosure Requirements

New Rule 2720 has revised the Prior Rule's existing disclosure requirements to require more prominent disclosure of information relating to participating Member's conflicts of interest in offering documents. The new disclosure requirements apply to all public offerings where a conflict of interest exists for a participating Member, even if a filing under Rule 5110 is not required. If the offering is exempt from QIU participation, New Rule 2720(a)(1) requires "prominent disclosure" of the nature of the conflict of interest. If the offering is not exempt, Rule 2720(a)(2)(B) requires disclosure of the nature of the conflict of interest, the name of the QIU and a brief statement of the QIU's role and responsibilities. "Prominent disclosure" means (1) in the case of an offering subject to Regulation S-K, disclosure in the table of contents, the plan of distribution and any prospectus summary and (2) in the case of an offering not subject to Regulation S-K, disclosure on the cover, with a cross-reference to the discussion in the offering document and in any summary.[20]

C. Key Definitions – Conflict of Interest, Affiliate, Control and Entity

New Rule 2720 includes a set of definitions, many of which are substantially similar to those set forth in Prior Rule 2720. However, the definitions of certain important terms, such as "conflict of interest" and "affiliate," have been revised significantly. The New Rule

---

17 Rule 5110(b)(7) ("…documents and information related to the following public offerings need not be filed with FINRA for review, unless subject to the provisions of NASD Rule 2720(a)(2).")

18 A Member with a conflict of interest may not sell to a discretionary account unless the Member has received specific written approval from the account holder (which can be in the form of an email).

19 These provisions apply only in the context of a Member publicly offering its own securities, and require that all offering proceeds be placed in escrow until the Member has complied with applicable net capital requirements, and that the offering document contain certain disclosure relating to the release of the proceeds from escrow.

20 New Rule 2720(f)(10). FINRA has indicated that these methods of disclosure are non-exclusive, and that it will consider alternative (but equally prominent) disclosures on a case-by-base basis. See Notice 09-49, endnote 2.

also contains terms that are newly defined, including "control" and "entity," that effectively change the Rule's application.

Prior to the amendments, Rule 2720 required that a Member participating in an offering that involved an offering of securities of that Member, an "affiliate" of that Member or an issuer that has a "conflict of interest" with that Member to comply with Rule 2720. New Rule 2720 significantly revises the definitions of "affiliate" and "conflict of interest." Under the Prior Rule, an "affiliate" was any company that controls, is controlled by or is under common control with a Member, and the definition presumed that a control relationship existed if a company beneficially owned 10% of the voting equity of a Member, a Member beneficially owned 10% of the voting equity of a company or another entity beneficially owned 10% of the voting equity of both the Member and the company in question, or had the power to direct or cause the direction of the management or policies of both of them.[21] Similarly, a "conflict of interest" was presumed to exist if the Member and its associated persons, parent or affiliates in the aggregate beneficially owned 10% or more of the issuer's common voting equity or preferred equity or (in the case of an issuer partnership) a general, limited or special partnership interest in the issuer's distributable profits or losses.[22]

New Rule 2720 combines the Prior Rule's tests of what constitutes an "affiliate" and a "conflict of interest" into a single definition of "conflict of interest," and requires any Member with a "conflict of interest" to comply with New Rule 2720.[23] Under the New Rule, a conflict of interest will exist if, at the time the Member participates in a public offering of securities, any of the following four conditions exists:

- The securities will be issued by that Member.
- The issuer of the securities controls, is controlled by or is under common control with the Member or the Member's associated persons.[24]

---

21 Rule 2720(b)(1). The Prior Rule's definition of "affiliate" also included a list of entities that were excluded from that definition, including investment companies, separate accounts, real estate investment trusts, direct participation programs, and investment grade rated entities issuing financing instrument-backed securities.

22 Rule 2720(b)(7). The Prior Rule's definition of "conflict of interest" included a list of entities that were excluded from that definition similar to the exclusions described for the definition of "affiliate" above.

23 New Rule 2720(f)(5).

24 FINRA's By-Laws define a "person associated with a member" to include, in relevant part, any natural person who is registered or has applied for registration under FINRA's rules or a sole proprietor, partner, officer, director, or branch manager of a Member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a Member. See FINRA By-Laws, Article I(rr).

- At least 5% of the net offering proceeds not including underwriting compensation is directed to the Member, together with its associated persons and affiliates ("Related Persons"), including proceeds used to reduce or retire the balance of a loan or credit facility extended by any such entity. This test differs significantly from the analogous test set forth in current Rule 5110(h), which has a higher threshold (10% of net offering proceeds) that applies to the aggregate proceeds directed to all participating Members and their Related Persons.[25] By contrast, the New Rule applies to each individual Member and its Related Persons, without taking into account any offering proceeds that may be directed to another Member and such other Member's Related Persons.[26]

- If, as result of the offering and any transactions contemplated at the time of the offering, the Member will become an affiliate of the issuer or publicly owned, or if the issuer will become a Member or form a broker-dealer subsidiary.

In addition, although the New Rule retains a definition of "affiliate," that definition has been revised to simply read "an entity that controls, is controlled by or is under common control with a member." The New Rule, however, adds new definitions of the terms "control" and "entity" to significantly expand the number of situations where an affiliate relationship exists. Under the New Rule, the 10% beneficial ownership tests that were previously included in the definition of "affiliate" in the Prior Rule have been moved to the definition of "control" and (1) are now mandatory, rather than presumptive, (2) have been expanded to include beneficial ownership of 10% of the tested entity's non-voting equity and subordinated debt, and (3) include any securities the entity in question has the right to acquire within 60 days of the Member's participation in the public offering.[27] Similarly, the definition of the term "entity" under the New Rule sets out a list of entities to be excluded when considering whether a conflict of interest or an affiliate or control relationship exists. Although the list is substantially similar to the exemptions found in the definitions of those

---

25 This change forecloses the ability under the Prior Rule of a Member acting as a QIU in a public offering in which such Member had a "conflict of interest" (including a conflict arising from the receipt of offering proceeds in excess of 10%) but was not an "affiliate" of the issuer of the securities being distributed.

26 By way of example, a public offering in which only one Member participates and receives 9% of the net offering proceeds would be exempt from Prior Rule 2720 because it receives less than 10% of such proceeds, but would not be exempt under New Rule 2720 because it receives more than 5%. By contrast, a public offering in which three Members participate and each receives 4% of the net offering proceeds would not be exempt from Prior Rule 2720 because in aggregate the Members receive 12% of the net offering proceeds; such offering would, however, be exempt under New Rule 2720 because no one Member receives more than 5%.

27 For purposes of this calculation, the Member may not take into account other outstanding warrants, options or other convertible or exchangeable securities held by third parties by assuming the exercise of such securities.

terms in the Prior Rule, it does not include entities issuing financing instrument-backed securities.[28]

D. Changes to QIU Provisions Generally

New Rule 2720 revises the Prior Rule's provisions regarding the use of a QIU to narrow the Rule's scope to focus on the QIU's due diligence and document preparation responsibilities and to eliminate the requirement that the QIU render a pricing opinion. As under the Prior Rule, the New Rule requires the QIU to participate in the preparation of the registration statement and the prospectus, offering circular or similar document and, in doing so, to exercise usual standards of due diligence.[29] The New Rule also amends the QIU qualification requirements to focus on the experience of the firm rather than its board of directors, to 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, to prohibit a QIU from beneficially owning, as of the date of its participation in the public offering, more than 5% of the class of securities that would give rise to a "conflict of interest" and to shorten the required experience of the firm to have underwritten similar offerings from five to three years (but to require the firm to have been engaged in at least three public offerings during such three-year period).[30]

E. Other Amendments and Changes

Other amendments to the Prior Rule eliminated provisions that required an issuer to adopt certain corporate governance policies relating to an audit committee, public directors and issuing periodic reports to shareholders. As discussed in the Rule 2720 Release, these provisions were eliminated as unnecessary in light of the Sarbanes-Oxley Act of 2002 and other recent SEC rule-making and interpretive actions.[31]

In addition, in Notice 09-49, FINRA clarified that while in the New Rule "participation in a public offering" generally has the same meaning as in Rule 5110, New Rule 2720 "continues to apply specifically to a [Member's] participation in the distribution of a public offering as an underwriter, member of the underwriting syndicate or selling group, or otherwise assisting in the distribution of the public offering (*i.e.*, not when a

---

28 New Rule 2720(f)(7). We believe that many offerings of financing instrument-backed securities should already be included in the New Rule's exemption from the QIU and filing requirements for offerings of securities that are "investment grade rated or are in the same series that have equal rights and obligations as investment grade rated securities." However, under the New Rule, a public offering of financing instrument-backed securities will be subject to, among other things, the prohibition against sales to discretionary accounts, which was not applicable under the Prior Rule.

29 New Rule 2720(a)(2)(A).

30 New Rule 2720(f)(12).

31 SEC Rel. No. 34-60113 (June 15, 2009), at 24.

[Member] acts solely as a finder, consultant or advisor, given these capacities generally do not involve managing or distributing a public offering)."[32]

* * * * *

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Capital Markets" in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

[32] Notice 09-49, at 3.

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax