

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications

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Exhibit Sent As Paper Document

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

Exhibit 3 - Form, Report, or Questionnaire

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Exhibit Sent As Paper Document

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

Exhibit 4 - Marked Copies

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

Partial Amendment

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to modernize and simplify NASD Rule 2720 (Distributions of Securities of Members and Affiliates – Conflicts of Interest), which governs public offerings of securities in which a member with a conflict of interest participates.

The text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on April 19, 2006, which authorized the filing of the rule change with the SEC. The Board of Governors of FINRA (then known as NASD) had an opportunity to review the proposed rule change at its meeting on April 20, 2006. No other action by FINRA is necessary for the filing of the proposed rule change.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Regulatory Notice announcing Commission approval.

¹ 15 U.S.C. 78s(b)(1).

3. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

NASD 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 and public offerings that result in a member becoming a public company. The Rule regulates the potential conflicts of interest that exist with respect to the pricing of such offerings and the conduct of due diligence when a member participates in such offerings.

In September 2006, FINRA published NASD Notice to Members 06-52 requesting comment on proposed amendments to Rule 2720. FINRA received two comment letters that generally supported the proposal and recognized the need to modernize the Rule.² However, in response to the comments received, FINRA staff made certain revisions to the proposal.

The proposed rule change would replace the current Rule in its entirety with proposed Rule 2720 entitled “Public Offerings of Securities With Conflicts of Interest.” Some of the more significant amendments that FINRA is proposing in this proposed rule change are to: (1) exempt from the filing and qualified independent underwriter (“QIU”) requirements public offerings of investment grade rated debt, public offerings of securities that have a bona fide public market, and public offerings in which the member principally responsible for managing the offering does not have a conflict of interest and

² Letter from the Securities Industry and Financial Markets Association, dated November 1, 2006 (the “SIFMA Letter”); and Letter from the American Bar Association, dated December 4, 2006 (the “ABA Letter”).

can meet the disciplinary history requirements for a QIU; (2) 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; (3) modify the Rule’s disclosure requirements to provide more prominent disclosure of conflicts of interest in the offering documents; and (4) amend the Rule’s provisions regarding the use of a QIU to focus on the QIU’s due diligence responsibilities and eliminate the requirement that the QIU render a pricing opinion. In addition, the proposed rule change would amend the QIU qualification requirements to: (1) focus on the experience of the firm rather than its board of directors; (2) prohibit a member from acting as a QIU if it would receive more than five percent of the proceeds of an offering; and (3) 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. These and the other proposed amendments are discussed in greater detail below.

Proposed Rule 2720(a) provides that no member that has a conflict of interest may participate in a public offering unless the offering meets one of the exemptions set forth in paragraph (a)(1) or a QIU participates in the offering pursuant to paragraph (a)(2).

1. Offerings exempt from the QIU and filing requirements under paragraph (a)(1)

First, FINRA is proposing an exemption from the QIU and filing requirements for public offerings in which the member principally responsible for managing the offering (e.g., the book-running lead manager or lead placement agent) does not have a conflict of interest, is not an affiliate of a member that has a conflict of interest, and can meet the disciplinary history requirements for a QIU under proposed paragraph (f)(9)(E). See

proposed Rule 2720(a)(1)(A). FINRA staff believes that a QIU should not be required for such offerings because the book-running lead manager or lead placement agent (or member acting in a similar capacity), which does not have conflict of interest, would be expected to perform the necessary due diligence that would otherwise be required of a QIU.³

In response to comments on the original proposal,⁴ FINRA has amended this provision to clarify that it applies to public offerings in which there are joint books or that are best efforts offerings. However, 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. Due to the important role a book-runner or dealer-manager can be expected to play in the due diligence process in an offering, even if that responsibility is shared equally with other members, the Rule's QIU provisions would apply, and the offering would have to be filed for review if any book-runner or dealer-manager has a conflict.

Second, FINRA is proposing an exemption from the QIU and filing requirements for public offerings of securities that have a bona fide public market. See proposed Rule 2720(a)(1)(B). The current Rule exempts public offerings of securities for which there is a "bona fide independent market"⁵ from Rule 2720's QIU requirement, but not the filing

³ All syndicate members have due diligence responsibility, but the book-runner(s) in a firm commitment offering or the lead placement agent(s) in a best efforts offering typically hire outside counsel to help members meet their due diligence obligations.

⁴ SIFMA Letter.

⁵ "Bona fide independent market" is defined as a market in a security that is listed on a national securities exchange or Nasdaq with a market price of \$5 per share,

requirement. The proposed rule change would replace the term “bona fide independent market” with “bona fide public market,” which is defined in proposed Rule 2720(f)(3) in accordance with the numerical standards set forth in SEC’s Regulation M under the Act.⁶ Specifically, “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 for at least 90 days, is current in its reporting requirements and whose securities are listed on a national securities exchange with an average daily trading volume of at least \$1 million, provided that the issuer’s common equity securities have a public float value of at least \$150 million. One commenter expressed strong support for the proposed definition of “bona fide public market.”⁷

Third, FINRA is proposing to exempt from the filing requirement, and to retain the existing exemption from the QIU requirement for, public offerings of debt and preferred securities that are investment grade rated, and debt and preferred securities in the same series that have equal rights and obligations as investment grade rated securities. See proposed Rule 2720(a)(1)(C). In response to comments on the original proposal,⁸ FINRA has proposed to define “investment grade rated” in proposed Rule 2720(f)(7) to refer to securities that are rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories. This definition is consistent with the definition proposed by FINRA in SR-NASD-2004-022 relating to the

aggregate trading volume of 500,000 shares over 90 days and a public float of 5 million shares.

⁶ 17 CFR 242.

⁷ ABA Letter.

filing requirements and the regulation of public offerings of securities registered with the Commission and offered by members pursuant to SEC Rule 415 (the “proposed shelf amendments”).⁹

The three types of public offerings enumerated in paragraphs (a)(1)(A) through (a)(1)(C) of proposed Rule 2720 are not subject to the QIU requirements of the Rule and, by operation of proposed Rule 2720(d), are not subject to the filing requirements of Rule 2710. They are, however, subject to the other provisions of Rule 2720, e.g., the escrow and discretionary account requirements in paragraphs (b) and (c) respectively, if applicable. Additionally, these public offerings are subject to certain disclosure requirements. As set forth in proposed Rule 2720(a)(1), the prospectus, offering circular or similar document for the public offering must prominently disclose the nature of the conflict of interest.

2. Offerings in which a QIU must participate under paragraph (a)(2)

If a member with a conflict of interest participates in a public offering that does not meet the conditions of proposed Rule 2720(a)(1), then pursuant to proposed Rule 2720(a)(2)(A), a QIU must participate in the preparation of the registration statement and the prospectus, offering circular or similar document and exercise the usual standards of

⁸ ABA Letter.

⁹ See Securities Exchange Act Release No. 50749 (November 29, 2004), 69 FR 70735 (December 7, 2004) (notice of filing of SR-NASD-2004-022) and Amendment No. 5 (filed on August 31, 2007), available at http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p036671.pdf

“due diligence” with respect thereto.¹⁰

Pursuant to proposed Rule 2720(a)(2)(B), the prospectus, offering circular or similar document must prominently disclose the nature of the conflict of interest, the name of the member acting as QIU and a brief statement regarding the role and responsibilities of the QIU. The disclosure requirements contained in current Rule 2720(d) require that, among other things, the offering documents expressly state that the member acting as QIU (if one is required for the offering) is assuming its responsibilities in pricing the offering and conducting due diligence. In response to commenters’ concerns that such a statement potentially could give rise to liability on the part of the QIU,¹¹ FINRA is proposing to replace this disclosure requirement with a more general statement about the role and responsibilities of a QIU.

A public offering in which a QIU participates pursuant to paragraph (a)(2) is subject to the filing requirements of Rule 2710. See proposed Rule 2720(d). Additionally, a public offering in which a QIU participates must meet Rule 2720’s escrow and discretionary account requirements, if applicable.

Current Rule 2720 requires that a 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. The proposed rule change would eliminate the requirement that a QIU provide a pricing opinion. Both commenters

¹⁰ The requisite qualifications of a QIU are set forth in the definition of “qualified independent underwriter” in proposed Rule 2720(f)(9), which is discussed in greater detail below.

¹¹ ABA Letter; SIFMA Letter.

expressed strong support for eliminating the QIU pricing requirement.¹²

3. Disclosure

Current Rule 2720(d) requires disclosure in the registration statement or offering circular regarding the date the offering will be completed and the terms upon which proceeds will be released from the escrow account. The current Rule also requires disclosure: (1) that the offering is being made pursuant to Rule 2720; (2) relating to the member's status in the offering; and (3) relating to the QIU (if one is required).

The proposed rule change would eliminate the disclosure requirements set forth in Rule 2720(d) and, as discussed above, establish separate disclosure requirements for public offerings in which a QIU participates (see proposed Rule 2720(a)(2)(B)) and public offerings in which a QIU does not participate (see proposed Rule 2720(a)(1)(A)). In response to the original proposal, one commenter requested clarification regarding the "prominent disclosure" requirement in the proposed Rule.¹³ FINRA requests comment on whether this requirement should be deemed satisfied by: (1) a separate paragraph in the underwriting section of the prospectus or offering circular; (2) a separate paragraph on or close to the front page of the prospectus or offering circular; or (3) a sentence on or close to the front page of the prospectus or offering circular directing investors to a more detailed disclosure in the underwriting section.

4. Escrow of Proceeds; Net Capital Computation

Proposed Rule 2720(b)(1) requires that all proceeds from a public offering by a member of its securities shall be placed in a duly established escrow account and shall

¹² SIFMA Letter; ABA Letter.

¹³ ABA Letter.

not be released therefrom or used by the member in any manner until the member has complied with the net capital requirements set forth in paragraph (b)(2). This proposed provision mirrors current Rule 2720(e).

5. Discretionary Accounts

Proposed Rule 2720(c) provides that, notwithstanding Rule 2510, 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 from the account holder and retains documentation of the approval in its records. This provision differs from current Rule 2720 in that FINRA has narrowed the proposed rule to apply only to the sale of securities by the member with the conflict of interest, rather than limit discretionary sales by all firms participating in the offering, even those that do not have a conflict of interest. One commenter expressed support for limiting this provision to the member that has a conflict.¹⁴ Additionally, FINRA notes that the “specific written approval” requirement in this provision can be satisfied by an email from the customer.

6. Application of Rule 2710

As noted above, proposed Rule 2720(d) provides that any public offering subject to the QIU requirements of paragraph (a)(2) is subject to Rule 2710, whether or not the offering would otherwise be exempted from that Rule’s filing or other requirements. Rule 2710 generally requires members to file with FINRA public offerings for review of the proposed underwriting terms and arrangements. Rule 2710 contains certain exemptions from the filing requirements for, among others, public offerings of the

¹⁴ ABA Letter.

securities of seasoned issuers¹⁵ and offerings of investment grade debt. However, pursuant to current Rule 2720(m), these exemptions are inapplicable to public offerings that fall within the scope of Rule 2720. Thus, for example, while a public offering of the securities of a seasoned issuer is normally exempt from filing under Rule 2710, if a member participating in the offering has a conflict of interest with the seasoned issuer, it must be filed and comply with Rule 2710. The proposed rule change narrows this filing requirement to apply only to those public offerings that fall within the scope of proposed Rule 2720(a)(2).

In response to comments on the original proposal,¹⁶ FINRA is proposing to amend current Rule 2710(b)(7), which lists offerings that are exempt from the Rule 2710 filing requirements, to specify that documents and information related to the public offerings listed in Rule 2710(b)(7) are not required to be filed with FINRA for review, unless the public offering is subject to the QIU requirements of Rule 2720(a)(2). This would clarify that if a public offering listed in Rule 2710(b)(7) is subject to Rule 2720(a)(1), such offering would not be subject to the filing requirements of Rule 2710.

7. Requests for Exemption from Rule 2720

Proposed Rule 2720(e) provides that pursuant to the Rule 9600 Series, FINRA may in exceptional and unusual circumstances, taking into consideration all relevant factors, exempt a member unconditionally or on specified terms from any or all of the provisions of this Rule that it deems appropriate. This provision mirrors existing Rule

¹⁵ A “seasoned issuer” is eligible for an exemption from filing under Rule 2710(b)(7) if it has a three-year reporting history and either a \$150 million float or a \$100 million float plus annual trading volume of three million shares.

¹⁶ SIFMA Letter.

2720(o).

8. Definition of “Affiliate”

Proposed Rule 2720(f)(1) defines the term “affiliate” as an entity that controls, is controlled by or is under common control with a member. While current Rule 2720(b)(1) incorporates the “control” standard in the definition of affiliate, FINRA is proposing instead to adopt a separate definition of “control,” which is discussed below.

In response to comments on the original proposal,¹⁷ FINRA has narrowed the proposed definition of “affiliate” to apply only where an entity controls, is controlled by or is under common control with *a member*. As originally proposed, the definition would have applied where an entity was under common control with *another entity* that controls, was controlled by or was under common control with a member.

9. Definition of “Beneficial Ownership”

Proposed Rule 2720(f)(2) defines “beneficial ownership” as the right to the economic benefits of a security. This provision mirrors the definition contained in current Rule 2720(b)(3). In NASD Notice to Members 06-52, FINRA requested comment on whether Rule 2720 should incorporate the definition of “beneficial ownership” found in SEC Rule 13d-3. That definition includes the right to dispose and vote the securities, which would apply to many investment funds. In response to comments suggesting that the definition should be confined to economic interests in which the member can profit directly,¹⁸ FINRA is proposing to retain the current definition of “beneficial ownership.”

¹⁷ ABA Letter.

¹⁸ ABA Letter.

10. Definition of “Conflict of Interest”

Proposed Rule 2720(f)(4) would define “conflict of interest” as a member’s participation in an entity’s public offering if any of four conditions applies. The Rule would operate much as it does today; however, the proposed rule change would relocate many of the current Rule’s substantive concepts to the definition of “conflict of interest.”

First, pursuant to proposed Rule 2720(f)(4)(A), a conflict of interest would exist if the securities are to be issued by the member or its affiliate.

Second, pursuant to proposed Rule 2720(f)(4)(B), a conflict of interest would exist if the issuer controls, is controlled by or is under common control with the member or the member’s associated persons. “Control” is defined in proposed Rule 2720(f)(5) and is discussed below.

Third, pursuant to proposed Rule 2720(f)(4)(C), a conflict of interest would exist where at least five percent of the net offering proceeds, not including underwriting compensation, as of the effective date of the registration statement or the date of first sale in an offering without a registration statement, will 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. In response to comments on the original proposal,¹⁹ FINRA has amended the proposed definition to clarify that the proceeds are net of underwriting compensation.

¹⁹ SIFMA Letter.

Currently, Rule 2710(h) requires public offerings in which ten percent or more of the offering proceeds (not including the underwriting discount) will be paid to participating members to comply with Rule 2720's QIU requirements. Pursuant to this proposed rule change, FINRA is proposing to delete Rule 2710(h) and move the proceeds requirement to Rule 2720 by defining "conflict of interest" to include a member's participation in a public offering where proceeds are directed to the member. Although the threshold for proceeds directed to a member is being lowered from ten percent to five percent, the new threshold would apply to each participating member individually (including the member's affiliates and its associated persons), not on an aggregate basis for all participating members, as is currently the case. Thus, for example, a conflict of interest would exist where a member received five percent of the proceeds, but not where two unaffiliated members each received three percent of the proceeds.

Fourth, pursuant to proposed Rule 2720(f)(4)(D), a conflict of interest would exist if, 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.

In response to comments on the original proposal,²⁰ FINRA is clarifying that for purposes of Rule 2720, "participation in a public offering" will have the same meaning as in Rule 2710. Specifically, as amended by the proposed shelf amendments,²¹ Rule 2710(a)(5) provides that "participation in a public offering" means participation in the

²⁰ SIFMA Letter.

²¹ See supra note 9.

preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, principal, agency or any other basis, participation in a shelf takedown, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering, but not the preparation of an appraisal in a savings and loan conversion or a bank offering or the preparation of a fairness opinion pursuant to SEC Rule 13e-3.

11. Definition of “Control”

As noted above, under the current Rule the control standard is incorporated in the definition of “affiliate.” The proposed rule change would instead adopt the following definition of “control:” (1) beneficial ownership of ten percent or more of voting securities of an entity, including any right to receive such securities within 60 days of the effective date of the public offering; (2) beneficial ownership of ten percent or more of the distributable profits or losses of an entity, including any right to receive an interest in such distributable profits or losses within 60 days of the effective date of the public offering; or (3) the power to direct or cause the direction of the management or policies of an entity. See proposed Rule 2720(f)(5). The proposed definition of control also would eliminate ownership of subordinated debt and preferred equity as a basis for a conflict of interest.²²

²² See current Rule 2720(b)(7)(A) and (C).

The proposed definition of control includes not only voting shares beneficially owned by a participating member, but also the right to receive voting securities within 60 days of the effective date of the public offering. Thus, warrants or rights for voting securities that are exercisable within 60 days of the effective date of the public offering would be included in the calculation of voting securities when determining whether control exists. In response to comments on the original proposal,²³ FINRA is clarifying that in calculating the percentage beneficial ownership, it is appropriate to include the potential ownership of shares in both the numerator and denominator. FINRA does not believe, however, that this calculation should include securities that could be received by all investors. Rather, it should be limited to the securities that could be received only by the participating member or its associated persons. This takes into account the possibility that only the member will exercise the warrants or rights within 60 days, in which case the member would control the issuer, irrespective of the number of outstanding shares. Additionally, in response to comments on the original proposal,²⁴ FINRA has clarified that for purposes of this provision, 60 days is from the effective date of the offering.²⁵

Finally, in response to comments on the original proposal,²⁶ FINRA is clarifying that under proposed Rule 2720(f)(5)(A)(iii) ownership of non-voting securities would fall within the definition of “control” if such ownership is substantial enough to influence

²³ ABA Letter.

²⁴ ABA Letter.

²⁵ For purposes of this proposed Rule, the “effective date” for a WKSI filing is the date the Automatic Shelf Registration Statement is filed with the SEC. See 17 CFR 230.405.

²⁶ SIFMA Letter; ABA Letter.

management.

12. Definition of “Entity”

Currently, Rule 2720 does not contain a definition of “entity.” Pursuant to proposed Rule 2720(f)(6), an “entity” would be defined, for purposes of the definitions of affiliate, conflict of interest and control under the Rule, as “a company, corporation, partnership, trust, sole proprietorship, association or organized group of persons.”

The proposed definition would expressly exclude: (i) an investment company registered under the Investment Company Act of 1940; (ii) a “separate account” as defined in Section 2(a)(37) of the Investment Company Act of 1940; (iii) a “real estate investment trust” as defined in Section 856 of the Internal Revenue Code; and (iv) a “direct participation program” as defined in Rule 2810. These exclusions are substantially similar to the exemptions from the “conflict of interest” provisions contained in current Rule 2720(b)(7)(D). In response to comments on the original proposal,²⁷ FINRA revised the proposed definition of “conflict of interest” to apply only to a public offering of an “entity.”

13. Definition of “Public Offering”

Proposed Rule 2720(f)(8) essentially mirrors the definition of “public offering” in current Rule 2720(b)(14) and would define the term as 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. The proposed definition excludes

²⁷ SIFMA Letter.

from its scope any offering made pursuant to: (i) an exemption from registration under Sections 4(1), 4(2) or 4(6) of the Securities Act of 1933;²⁸ and (ii) SEC Rule 504, if the securities are “restricted securities” under SEC Rule 144(a)(3), SEC Rules 505 or 506. FINRA currently does not interpret an offering made pursuant to SEC Regulation S to be within the scope of a “public offering” under this Rule and as such, is proposing also to exclude these offerings from the definition. Additionally, in response to comments on the original proposal,²⁹ FINRA has amended the proposed definition of “public offering” to expressly exclude exempted securities as defined in Section 3(a)(12) of the Act,³⁰ as in the current Rule.

One commenter suggested that the proposed Rule should provide an express exclusion for offerings made pursuant to SEC Rule 144A.³¹ FINRA agrees and has added an express exclusion for offerings under SEC Rule 144A.³² FINRA also notes that it currently does not interpret an offering made pursuant to Rule 144A to be within the scope of either Rule 2710 or Rule 2720.

14. Definition of “Qualified Independent Underwriter”

Proposed Rule 2720(f)(9) defines the term “qualified independent underwriter” as a member that meets the following conditions. First, the member must not have a conflict of interest and must not be an affiliate of any member that has a conflict of

²⁸ 15 U.S.C. 77d(1), (2) or (6).

²⁹ ABA Letter.

³⁰ 15 U.S.C. 78c(a)(12).

³¹ ABA Letter.

³² See Securities Act Release No. 6862, 55 FR 17933 (April 30, 1990) (File No. S7-23-88).

interest. See proposed Rule 2720(f)(9)(A). The Rule currently does not disqualify or prohibit a QIU from receiving proceeds from an offering. The proposed rule change would prohibit a QIU from receiving more than five percent of the offering proceeds because the receipt of such proceeds would disqualify a member from acting as a QIU because it would fall within the proposed definition of “conflict of interest.”

Second, the member cannot beneficially own, as of the date of filing of the registration statement and the effective date of the public offering, more than five percent of the class of securities that are publicly offered, including any right to receive any such securities exercisable within 60 days. See proposed Rule 2720(f)(9)(B). Current Rule 2720(b)(15)(E) prohibits a member from acting as a QIU if it is an affiliate of the issuer or if it beneficially owns at least five percent of the equity, subordinated debt or partnership interest of the issuer. The proposed rule change would maintain the prohibitions regarding affiliates and five percent equity positions, but delete ownership of subordinated debt as a basis for disqualification of a QIU.

Third, the member must have 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.³³ See proposed Rule 2720(f)(9)(C). The proposed provision mirrors current Rule 2720(b)(15)(F).

³³ 15 U.S.C. 77k.

Fourth, the member must have 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. This requirement will 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 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. See proposed Rule 2720(f)(9)(D). FINRA is specifically requesting comment on whether the 50% threshold should be lowered if an equity offering is particularly large (e.g., over \$1 billion). The proposed requirements mirror those set forth in current Rule 2720(b)(15)(C), except that currently, the relevant period is five years. In addition to shortening this period to three years, the proposed rule change would impose, as discussed above, the additional requirement that a QIU must have acted as a managing underwriter in at least three similar offerings during that time.

Additionally, Rule 2720(b)(15)(B) currently permits a member to serve as a QIU only if the member: (i) is a sole proprietorship and the sole proprietor has been actively engaged in the investment banking or securities business for the five year period immediately preceding the filing of the registration statement, or (ii) is a corporation or partnership and a majority of its board of directors or general partners has been similarly

engaged in the investment banking or securities business. The proposed rule change would eliminate the requirement regarding board or partner experience, since FINRA staff believes that the experience of the firm is more relevant.

Finally, none of the member's associated persons in a supervisory capacity who are responsible for organizing, structuring or performing due diligence with respect to corporate public offerings of securities shall: (i) have been convicted within ten years prior to the filing of the registration statement or the preparation of an offering circular in an offering without a registration statement of a violation of the anti-fraud provisions of the federal or state securities laws, or any rules or regulations promulgated thereunder, in connection with a registered or unregistered offering of securities; (ii) be subject to any order, judgment, or decree of any court of competent jurisdiction entered within ten years prior to the filing of the registration statement or the preparation of an offering circular in an offering without a registration statement 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, or any rules or regulations promulgated thereunder in connection with a registered or unregistered offering of securities; or (iii) have been suspended or barred from association with any member by an order or decision of the Commission, any state, NASD or any other self-regulatory organization within ten years prior to the filing of the registration statement or the preparation of an offering circular in an offering without a registration statement for any conduct or practice in violation of the anti-fraud provisions of the federal or state securities laws, or any rules, or regulations promulgated thereunder, or the anti-fraud rules of any self-regulatory organization in connection with a registered or unregistered

offering of securities. See proposed Rule 2720(f)(9)(E). The Rule currently prohibits an associated person's involvement in the due diligence process in a supervisory capacity if that person has been subject to certain criminal and disciplinary actions pertaining to the offering of securities within five years prior to the filing of the registration statement. The proposed rule change, as described above, would lengthen this period from five to ten years.

15. Deleted Definitions

Proposed Rule 2720 does not contain the following definitions that appear in current Rule 2720: common equity, company, effective date, immediate family, parent, person, preferred equity, public director, registration statement, settlement and subordinated debt. In response to comments on the original proposal,³⁴ FINRA is proposing to adopt the current definitions of company, effective date, immediate family, and person as new paragraphs (a)(11) through (14) of Rule 2710 because they are used in that Rule.³⁵

16. Corporate Governance and Periodic Reporting

Rule 2720 currently includes certain provisions that do not apply to the public offering itself and instead require the issuer to adopt corporate governance policies relating to an audit committee and public directors and to issue periodic reports to

³⁴ ABA Letter.

³⁵ Pursuant to the proposed shelf amendments, FINRA proposed to adopt certain new definitions as paragraphs (a)(11) through (14) of Rule 2710. See supra note 9. This proposed rule change is not intended to supersede those proposed amendments. Upon approval of SR-NASD-2004-022 by the Commission, FINRA proposes to renumber paragraphs (11) through (14) of Rule 2710 that are proposed herein as paragraphs (15) through (18) without a further rule change.

shareholders. See paragraphs (f), (g) and (h) of current Rule 2720. In light of the Sarbanes-Oxley Act and Securities Offering Reform rules, FINRA believes that separate Rule 2720 requirements for corporate governance and periodic reporting are unnecessary. One commenter expressed support for eliminating these provisions from Rule 2720.³⁶

17. Intrastate Offerings

Rule 2720(j) currently requires any member offering its securities pursuant to the intrastate offering exemption under the Securities Act to include in the offering documents information required in a release that the SEC published in 1972. The proposed amendments would delete this requirement from Rule 2720. FINRA believes that disclosure requirements for unregistered offerings should be addressed in a more comprehensive manner by the SEC, the states or FINRA, and not imposed under the narrow scope of Rule 2720 or limited to intrastate offerings. One commenter suggested that FINRA should not adopt disclosure requirements for intrastate offerings because such offerings are subject to the disclosure requirements of the state where the securities are offered.³⁷

18. Suitability

Rule 2720(k) currently requires that every member underwriting an issue of its own securities, or securities of an affiliate or company with which it has a conflict of interest that recommends to a customer the purchase of a security of such issue must have reasonable grounds to believe that the recommendation is suitable for the customer. FINRA is not proposing a similar provision in new Rule 2720 because NASD Rule 2310

³⁶ ABA Letter.

³⁷ ABA Letter.

already addresses a member's obligations relating to suitability.

As noted in Item 2 of this filing, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Regulatory Notice announcing Commission approval.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,³⁸ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change will simplify and modernize Rule 2720, thereby providing greater clarity regarding members' obligations and enhancing the regulation of public offerings in which members have a conflict of interest.

4. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in NASD Notice to Members 06-52 (September 2006). Two comments were received in response to the Notice. A copy of the Notice is attached as Exhibit 2a. A list of the comment letters

³⁸ 15 U.S.C. 78o-3(b)(6).

received in response to the Notice is attached as Exhibit 2b. Copies of the comment letters received in response to the Notice are attached as Exhibit 2c. Those comments that have not already been addressed herein are discussed below.³⁹

Comments on the Scope of Proposed Rule 2720

Both commenters suggested revising proposed Rule 2720(a)(1) to include additional categories of public offerings that would be exempt from the QIU and filing requirements by operation of proposed Rule 2720(d). As discussed in greater detail below, FINRA does not agree that the exemptions should be expanded further. FINRA notes that, as proposed, the Rule would significantly reduce the number of public offerings that must be filed and reviewed by FINRA staff. A public offering (that is not an offering of investment grade rated debt or equity securities with a bona fide public market) will be subject to the QIU and filing requirements under Rule 2720 only if a member with primary responsibility for managing the offering has a conflict of interest. As such, FINRA does not believe that it would be appropriate to further expand the automatic exemptions under the Rule, as suggested by the commenters.

Specifically, the commenters suggested that paragraph (a)(1) of the proposed Rule should include “well-known seasoned issuers” or “WKSIs.”⁴⁰ The commenters contend

³⁹ In addition, FINRA has incorporated some of the commenters’ non-substantive comments without specifically addressing them herein, e.g., comments regarding inconsistent use of the terms “entity,” “company” and “issuer.” See ABA Letter.

⁴⁰ SIFMA Letter; ABA Letter.

Pursuant to amendments to SEC rules governing shelf offerings, which became effective on December 1, 2005, WKSIs are defined as S-3 eligible issuers that have either \$700 million of worldwide equity market capitalization or an aggregate \$1 billion of non-convertible securities issued within the past three years.

that such a change would be consistent with the proposed shelf amendments, which would exempt all WKSI shelf offerings from the filing requirements of Rule 2710.⁴¹ FINRA does not agree. FINRA believes that if a participating member has a conflict of interest, the offering should be subject to the QIU and filing requirements, irrespective of whether the issuer involved is a WKSI. Today, a WKSI that is not required to file under Rule 2710 would nonetheless be required to obtain a QIU if it were to receive ten percent of the offering proceeds. See current Rules 2710(h) and 2720(m). In addition, FINRA does not agree that application of Rule 2720 to WSIs would slow the offering process.⁴² Currently, all WKSI filings are reviewed and cleared on the same day they are received by FINRA's Corporate Financing Department. In connection with the proposed shelf amendments, FINRA is developing upgrades to the COBRADesk electronic filing system that will implement a new same-day automatic review and clearance process for most shelf offerings and all WKSI shelf offerings.⁴³

Similarly, one commenter suggested that public offerings by issuers with investment grade rated debt, which are currently exempted by Rule 2710(b)(7)(A), should be included in proposed Rule 2720(a)(1).⁴⁴ FINRA does not agree. The proposed rule change is designed to focus on the particular public offering in which a member has a conflict of interest. FINRA believes that while it is appropriate to exempt certain public offerings from the Rule, it would be inappropriate to exempt an entire class of

⁴¹ SIFMA Letter; ABA Letter.

⁴² SIFMA Letter.

⁴³ See supra note 9.

⁴⁴ SIFMA Letter.

issuers such as WKSIs or all issuers with investment grade rated debt. The relevant inquiry is whether the member has a conflict of interest with respect to that offering of that security; the characteristics of the issuer should not be determinative. As such, FINRA also does not agree with the commenter that proposed paragraphs (a)(1)(B) and (C) should be amended to refer to the issuer of the securities, instead of the securities being offered.⁴⁵

One commenter suggested that the exception under proposed Rule 2720(a)(1)(B) should be available for public offerings of warrants, options, convertible debt and convertible preferred securities that are exercisable for or convertible into equity securities that meet the standard of having a bona fide public market.⁴⁶ FINRA does not believe that such an exemption would be appropriate because the characteristics of the derivative will not always be the same as the underlying security. The existence of a bona fide public market in the underlying equity security does not necessarily extend to an offering of a derivative on that security.

One commenter also suggested that there should be an exception for offerings by banks and other financial institutions that are the parents or affiliates of FINRA members of medium-term notes or similar securities, the return of which is linked to the performance of a particular stock, asset or index.⁴⁷ While an offering of these securities that are rated investment grade would be exempted under the proposed Rule, FINRA believes that an offering of such securities rated below investment grade should continue

⁴⁵ SIFMA Letter.

⁴⁶ ABA Letter.

⁴⁷ ABA Letter.

to be subject to the filing and QIU requirements. FINRA believes that an exemption for offerings of structured products rated below investment grade would be inconsistent with concerns recently expressed by FINRA about these securities.⁴⁸ However, to avoid potential unintended consequences of the proposed Rule, FINRA requests comment on whether certain other types of securities that are registered on a shelf registration statement or automatic shelf registration statement should be eligible for the exemption from the filing and QIU requirements.

Both commenters suggested that the reorganizations, mergers and acquisition transactions that are currently exempted by Rule 2720(a)(3) should be exempted under proposed Rule 2720(a)(1).⁴⁹ FINRA believes that unless a reorganization, merger or acquisition would otherwise meet the proposed Rule 2720(a)(1) exemptions, it should be subject to the QIU and filing requirements. The Rule currently applies to these transactions if the member or its parent issues shares or the transaction results in the public ownership of a member. Thus, there is not currently a blanket exemption for reorganizations, mergers and acquisitions.

One commenter also suggested that the proposed Rule should exempt all offerings

⁴⁸ See NASD Notice to Members 05-59 (September 2005). The Notice stated that FINRA is concerned that when members sell structured products, they may not be fulfilling their sales practice obligations, including the requirement to perform a reasonable-basis and customer-specific suitability determination. The Notice also raised specific concerns about member sales practice obligations when selling these instruments to retail customers. The Notice added that structured products have been increasingly targeted at retail investors and that FINRA is concerned about the manner in which such products are marketed and the types of investors purchasing such products.

⁴⁹ SIFMA Letter; ABA Letter.

by government entities.⁵⁰ FINRA has proposed to exclude certain government entities from the filing requirements of Rule 2710 pursuant to the proposed shelf amendments,⁵¹ however, FINRA does not agree that all such offerings should be excluded under Rule 2720. If a member has a conflict of interest with a government entity (e.g., the member will receive at least five percent of the net proceeds of the public offering) and the public offering does not otherwise meet the Rule 2720(a)(1) exemptions, FINRA believes that the offering documents should be filed and reviewed by FINRA staff.

One commenter suggested that offerings of securities exempt from registration with the Commission under Section 3(a)(4) of the Securities Act of 1933 should be exempt under proposed Rule 2720(a)(1), noting that such offerings currently are exempted from the conflict of interest provisions of Rule 2720.⁵² While FINRA is not aware of member conflicts with non-profit or charitable organizations, in the unlikely event that such a conflict does exist, FINRA believes that the offering should be filed and reviewed by FINRA staff.

This same commenter also suggested that proposed Rule 2720(a)(1) should exclude offerings conducted pursuant to the multi-jurisdictional disclosure system because they are already subject to regulation under the Canadian system.⁵³ FINRA does not agree that it should remove itself from public offerings in which an FINRA member with a conflict of interest is participating, even if such offerings are also subject to

⁵⁰ SIFMA Letter.

⁵¹ See supra note 9.

⁵² SIFMA Letter.

⁵³ SIFMA Letter.

regulation under the Canadian system.

Finally, with respect to proposed Rule 2720(a)(1)(A), one commenter suggested amending the provision to apply to any book-running manager, including co- or joint book-running managers, such that a QIU would not be required if any of the joint book-runners could meet the requirements of the Rule.⁵⁴ FINRA does not agree that the provision should be expanded in this way. FINRA understands that in some joint book offerings, members have been designated as a joint book-runner or co-lead manager in return for assistance with the road show or other services critical to marketing the offering. In some cases, the member designated as a co-lead would not be in the position of supervising due diligence for the offering or may not be involved in the due diligence at all. FINRA staff does not believe that including a book-runner or lead placement agent without a conflict of interest eliminates the conflict that exists with respect to the remaining book-runner(s) or lead placement agent(s). Therefore, amending the proposed provision as the commenter suggests would not fulfill the objective of ensuring independent due diligence by a member free of conflicts.

Comments on Proposed QIU Requirements

One commenter suggested that the references to “due diligence” and “usual standards of due diligence” should be eliminated from the Rule, expressing concern that such references could raise the due diligence defense to the level of a regulatory requirement.⁵⁵ The requirement that a QIU exercise the usual standards of due diligence has been in the Rule for 20 years (see, e.g., current Rule 2720(c)(3)(A) and (d)(2)) and

⁵⁴ SIFMA Letter.

⁵⁵ SIFMA Letter.

FINRA believes that it is an appropriate regulatory requirement. However, as discussed above, in response to comments, as well as similar concerns expressed by FINRA's Corporate Financing Committee, FINRA has eliminated the proposal to require that the offering documents include a statement that the QIU has assumed responsibilities for conducting due diligence.

The commenters also suggested that offerings in which a QIU participates should be exempt from the filing requirements of Rule 2710.⁵⁶ FINRA does not believe that the participation of a QIU in an offering sufficiently mitigates the conflicts of interest such that FINRA review is no longer necessary. Additionally, pursuant to current Rule 2720(m), the Rule 2710 filing requirements apply to all public offerings subject to Rule 2720, including public offerings in which a QIU has participated. Thus, the proposed rule change would not expand the current filing requirements.

Comments on the Proposed Discretionary Accounts Provision

One commenter⁵⁷ suggested that the rule should be revised to incorporate the advance authorization procedure in FINRA's Corporate Financing Department's exemption letter to Goldman Sachs (the "Goldman Letter").⁵⁸ The Goldman Letter applies to public offerings of straight debt securities, structured notes and straight preferred stock issued by Goldman or its affiliates and permits the firm to use an advance

⁵⁶ SIFMA Letter; ABA Letter.

⁵⁷ ABA Letter.

⁵⁸ See letter to Judith G. Belash, Esq., Goldman, Sachs & Co., from Joseph Price, NASD, Corporate Financing Department, dated June 14, 1999, available at <http://www.finra.org/RulesRegulation/PublicationsGuidance/ExemptiveLetters/P002617>.

authorization procedure in lieu of the requirement in Rule 2720 for prior specific written approval. Specifically, the firm could obtain an advance written letter of consent from certain customers with discretionary accounts and oral authorization by the customer prior to execution of the transaction. FINRA does not believe that Rule 2720 should expressly incorporate the advance authorization procedure set forth in the Goldman Letter. As discussed above, the written authorization requirements of this provision can be satisfied by email, which today may often prove quicker and easier than obtaining oral authorization.

Additionally, this commenter suggested that public offerings in which proceeds are being directed to a member should be exempted from the discretionary account provision.⁵⁹ FINRA does not agree. FINRA believes that the receipt of offering proceeds by members and their affiliates gives rise to conflicts that are of equal concern in the context of sales to a discretionary account.

Comments on the Proposed Definition of “Affiliate”

One commenter suggested that the definition of “affiliate” should be structured similar to the current definition as a control standard and a presumption of control as a result of management or share ownership.⁶⁰ FINRA recognizes that there are other ways to define “affiliate”; however, this commenter has not demonstrated that its recommended approach is better than the approach FINRA is proposing.

Comments on the Proposed Definition of “Bona Fide Public Market”

The commenters suggested that the definition of “bona fide public market” should

⁵⁹ ABA Letter.

⁶⁰ ABA Letter.

be amended to apply to equity securities of foreign issuers that meet the “actively traded” standards of Reg M and are designated offshore securities markets under Rule 902(b).⁶¹ Upon further consideration, FINRA is not proposing to amend the definition along these lines. Because securities with a bona fide public market are not subject to the QIU or filing requirements, amending the definition to apply to securities traded on a foreign market would make this exemption too broad.

One commenter also suggested that the definition should be amended to clarify that the issuer – and not the particular security – must have a bona fide public market.⁶² FINRA does not agree. As discussed above, the focus of this Rule is on the securities being offered and not the characteristics of the issuer.

Comments on the Proposed Definition of “Conflict of Interest”

The commenters suggested that there should be no filing requirement for public offerings in which the conflict of interest derives from the member’s receipt of proceeds.⁶³ One commenter asserted that “NASD has historically deemed a conflict of interest based on the receipt of offering proceeds by participating members to be a less significant conflict than one that is based on the ownership of an issuer’s securities or management control.”⁶⁴ FINRA does not agree and believes that the conflict deriving from a member’s receipt of proceeds warrants review and filing of the offering documents. Indeed, FINRA’s Corporate Financing Committee has identified conflicts

⁶¹ ABA Letter; SIFMA Letter.

⁶² SIFMA Letter.

⁶³ SIFMA Letter; ABA Letter.

⁶⁴ ABA Letter.

resulting from proceeds being directed to a member as one of the most important conflicts in public offerings today. Pursuant to the proposed rule change, all public offerings in which a QIU is involved – including those for which a QIU is required because proceeds are being directed to a member or its affiliate – must be filed and reviewed by FINRA staff.

Additionally, both commenters assert that the five percent threshold for a member's receipt of offering proceeds is too low.⁶⁵ FINRA does not agree and believes that in recognition of the significance of proceeds-related conflicts, it is appropriate to lower the threshold from ten percent to five percent.

One commenter suggested that the proposed definition of “conflict of interest” should exclude transactions by which the issuer will become a member or form a broker-dealer subsidiary.⁶⁶ This commenter also suggested that the definition be revised to exclude reorganizations and restructurings if no material change in the ownership of the issuer or participating member is taking place.⁶⁷ FINRA does not agree that merely because the corporate governance provisions have been deleted from the Rule, a member's participation in such offerings no longer creates a conflict of interest. FINRA believes that these offerings should be subject to the Rule.

This commenter also suggested that the old formulation in which conflicts of interest existed under specific circumstances, rather than as a result of a member's participation in public offerings where certain conditions apply, should be retained

⁶⁵ SIFMA Letter; ABA Letter.

⁶⁶ SIFMA Letter.

⁶⁷ SIFMA Letter.

because it was easier for members to argue that no conflict actually exists.⁶⁸ FINRA does not agree and believes that the proposed definition of “conflicts of interest” is preferable in that it clearly delineates the scope of the Rule.

The commenters suggested that the definition should not apply to arms length forward sales contracts and other derivatives where the proceeds are used by the issuer to purchase the securities to hedge risk in the transactions.⁶⁹ FINRA is requesting further comment on this issue and specifically how use of the proceeds by the issuer to buy derivatives or other hedging transactions is substantially different from other uses of proceeds contemplated by the Rule (e.g., to retire debt).

Comments on the Proposed Definition of “Control”

One commenter suggested that “control” should not be a defined term because an entity that is in a control relationship is an affiliate and thus, the control concept should remain in the definition of “affiliate.”⁷⁰ As previously noted, FINRA recognizes that there are other ways to approach the definitions and standards set forth in this Rule. However, FINRA does not believe that the approach the commenter has proposed is preferable to that outlined above.

Comments on the Proposed Definition of “Entity”

One commenter suggested that the proposed definition of “entity” be amended to include groups of persons only if they are organized to conduct business under the laws

⁶⁸ SIFMA Letter.

⁶⁹ SIFMA Letter; ABA Letter.

⁷⁰ ABA Letter.

of a jurisdiction.⁷¹ FINRA does not agree and believes that more flexibility is needed given that FINRA is not proposing to define “beneficial ownership” in accordance with SEC Rule 13d-3.

Comments on the Proposed Definition of “Public Offering”

One commenter reiterated its concern, also expressed in response to FINRA’s proposed shelf amendments, that Rules 2710, 2720 and 2810 should not be extended to any sale of securities (even one share) from a registration statement or offering circular, including a takedown of securities from a shelf registration statement that does not meet the standard of being a “distribution” for purposes of SEC Regulation M.⁷² The appropriate filing requirements for shelf takedowns are addressed in FINRA’s response to comments on the proposed shelf amendments.

Comments on the Proposed Definition of “QIU”

One commenter suggested that the disciplinary history lookback period should not be extended from five years to ten.⁷³ FINRA believes that a longer lookback period is consistent with the goal of ensuring that a QIU will provide the necessary investor protection in public offerings where a member has a conflict of interest. Additionally, FINRA notes that a ten-year lookback is consistent with the period used to determine whether a person is subject to a statutory disqualification.

One commenter suggested that ownership of five percent or more of the issuer’s securities is too low a threshold for purposes of disqualification as a QIU and should be

⁷¹ ABA Letter.

⁷² ABA Letter.

⁷³ ABA Letter.

increased to ten percent in proposed Rule 2720(f)(9)(B).⁷⁴ FINRA believes that the five percent threshold is not too low and in fact considered lowering it to three percent.

This commenter also believes that the term “5% of the class of securities that would give rise to a conflict of interest” contained in proposed Rule 2720(f)(9)(B) improperly suggests that the member’s conflict of interest is with the issuer’s securities rather than with the issuer and should be replaced with “5% of the issuer’s total equity securities.”⁷⁵ FINRA does not agree. Because the proposed Rule addresses conflicts resulting from the receipt of offering proceeds by the member, the five percent standard is appropriately limited to the class of securities offered.

One commenter suggested that the Rule should permit a prospective QIU to demonstrate on a case-by-case basis that it has acquired experience within the previous years involving the pricing and due diligence functions.⁷⁶ FINRA believes that such an approach would be unmanageable and that a bright-line test is necessary.

One commenter suggested that FINRA should eliminate the requirement that FINRA members wishing to act as a QIU must qualify on an annual basis.⁷⁷ This commenter stated that when a participating member acts as a QIU, that member represents by way of prospectus disclosure that it is qualified to act and the commenter believes that FINRA should not require proof in each case. FINRA notes that there is no annual qualification requirement contained in the current or proposed Rule. Rather, to

⁷⁴ SIFMA Letter.

⁷⁵ SIFMA Letter.

⁷⁶ SIFMA Letter.

⁷⁷ SIFMA Letter.

streamline the QIU process, FINRA's Corporate Financing Department permits members to provide information establishing that they meet the QIU qualification requirements in advance of participating in a particular public offering and to update this information annually. In the course of its review of information in connection with a public offering requiring a QIU, FINRA staff routinely asks for information that establishes that a member identified as a QIU is qualified to participate in that capacity. If a member has already provided this information within the last 12 months or has done an annual update, the member will not need to provide the information in connection with that particular offering.

6. Extension of Time Period for Commission Action

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.⁷⁸

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

⁷⁸ 15 U.S.C. 78s(b)(2).

9. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2. NASD Notice to Members 06-52 (September 2006) and comments received in response to NASD Notice to Members 06-52 (September 2006). A copy of the Notice is attached as Exhibit 2a. A list of the comment letters received in response to the Notice is attached as Exhibit 2b. Copies of the comment letters received in response to the Notice are attached as Exhibit 2c.

Exhibit 5. Text of proposed rule change marked to show additions to and deletions from the current rule language.

EXHIBIT 5

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2700. SECURITIES DISTRIBUTIONS

2710. Corporate Financing Rule – Underwriting Terms and Arrangements¹

(a) Definitions

For purposes of this Rule, the following terms shall have the meanings stated below. The definitions in Rule 2720 are incorporated herein by reference.

(1) through (10) No Change.

(11) Company

A corporation, a partnership, an association, a joint stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy or similar official or any liquidating agent for any of the foregoing, in his capacity as such.

(12) Effective Date

The date on which an issue of securities first becomes legally eligible for distribution to the public.

(13) Immediate Family

¹ Pursuant to SR-NASD-2004-022, FINRA proposed to adopt certain new definitions as paragraphs (a)(11) through (14) of Rule 2710. This proposed rule change is not intended to supersede those proposed amendments. Upon approval of SR-NASD-2004-022 by the Commission, FINRA proposes to renumber paragraphs (11) through (14) proposed herein as (15) through (18) without a further rule change.

The parents, mother-in-law, father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children of an employee or associated person of a member, except any person other than the spouse and children who does not live in the same household as, have a business relationship with, provide material support to, or receive material support from, the employee or associated person of a member. In addition, the immediate family includes any other person who either lives in the same household as, provides material support to, or receives material support from, an employee or associated person of a member.

(14) Person

Any natural person, partnership, corporation, association, or other legal entity.

(b) Filing Requirements

(1) through (6) No Change.

(7) Offerings Exempt from Filing

Notwithstanding the provisions of subparagraph (1) above, documents and information related to the following public offerings need not be filed with NASD for review, unless subject to the provisions of Rule 2720(a)(2). However, it shall be deemed a violation of this Rule or Rule 2810, for a member to participate in any way in such public offerings if the underwriting or other arrangements in connection with the offering are not in compliance with this Rule or Rule 2810, as applicable:

(A) through (G) No Change.

(8) through (11) No Change.

(c) through (g) No Change.

[(h) Proceeds Directed to a Member]

[(1) Compliance With Rule 2720]

[No member shall participate in a public offering of an issuer's securities where more than 10% of the net offering proceeds, not including underwriting compensation, are intended to be paid to participating members, unless the price at which an equity issue or the yield at which a debt issue is to be distributed to the public is established pursuant to Rule 2720(c)(3).]

[(2) Disclosure]

[All offerings included within the scope of subparagraph (h)(1) shall disclose in the underwriting or plan of distribution section of the registration statement, offering circular or other similar document that the offering is being made pursuant to the provisions of this subparagraph and, where applicable, the name of the member acting as qualified independent underwriter, and that such member is assuming the responsibilities of acting as a qualified independent underwriter in pricing the offering and conducting due diligence.]

[(3) Exception From Compliance]

[The provisions of subparagraphs (h)(1) and (2) shall not apply to:]

[(A) an offering otherwise subject to the provisions of Rule
2720;]

[(B) an offering of securities exempt from registration with the Commission under Section 3(a)(4) of the Securities Act of 1933;]

[(C) an offering of a real estate investment trust as defined in Section 856 of the Internal Revenue Code; or]

[(D) an offering of securities subject to Rule 2810, unless the net offering proceeds are intended to be paid to the above persons for the purpose of repaying loans, advances or other types of financing utilized to acquire an interest in a pre-existing company.]

(i) through (j) renumbered (h) through (i).

* * * * *

Rule 2720 is replaced in its entirety by the following proposed rule language.

2720. Public Offerings of Securities With Conflicts of Interest

(a) Requirements for Participation in Certain Public Offerings

No member that has a conflict of interest may participate in a public offering unless the offering complies with paragraphs (1) or (2).

(1) The prospectus, offering circular or similar document for the public offering prominently discloses the nature of the conflict of interest and one of the following conditions must be met:

(A) 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 requirement of paragraph (f)(9)(E):

(B) the securities offered have a bona fide public market; or

(C) the securities offered are debt or preferred securities that are investment grade rated or debt or preferred securities in the same series that have equal rights and obligations as investment grade rated securities.

(2) (A) A qualified independent underwriter has participated in the preparation of the registration statement and the prospectus, offering circular, or similar document and has exercised the usual standards of “due diligence” in respect thereto; and

(B) the prospectus, offering circular or similar document for the offering prominently discloses:

(i) the nature of the conflict of interest;

(ii) the name of the member acting as qualified independent underwriter; and

(iii) a brief statement regarding the role and responsibilities of the qualified independent underwriter.

(b) Escrow of Proceeds; Net Capital Computation

(1) All proceeds from a public offering by a member of its securities shall be placed in a duly established escrow account and shall not be released therefrom or used by the member in any manner until the member has complied with subparagraph (2) hereof.

(2) Any member offering its securities pursuant to this Rule shall immediately notify NASD when the public offering has been terminated and settlement effected and shall file with NASD a computation of its net capital computed pursuant to the provisions of SEC Rule 15c3-1 under the Act (the net capital rule) as of the settlement date. 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 provisions of Rule 15c3-1(f) are utilized in making such computation, the net capital is less than seven percent of aggregate debit items as computed in accordance with Rule 15c3-3a, all monies received from sales of securities of the public offering must be returned in full to the purchasers thereof and the offering withdrawn, unless the member has obtained from the Commission a specific exemption from the net capital rule. Proceeds from the sales of securities in the public offering may be taken into consideration in computing net capital ratio for purposes of this paragraph.

(c) Discretionary Accounts

Notwithstanding Rule 2510, 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 from the account holder and retains documentation of the approval in its records.

(d) Application of Rule 2710

Any public offering subject to paragraph (a)(2) is subject to Rule 2710, whether or not the offering would be otherwise exempted from the filing or other requirements of that rule.

(e) Requests for Exemption from Rule 2720

Pursuant to the Rule 9600 Series, NASD may in exceptional and unusual circumstances, taking into consideration all relevant factors, exempt a member unconditionally or on specified terms from any or all of the provisions of this rule that it deems appropriate.

(f) Definitions

For purposes of this Rule, the following words shall have the stated meanings:

(1) Affiliate

The term “affiliate” means an entity that controls, is controlled by or is under common control with a member.

(2) Beneficial Ownership

The term “beneficial ownership” means the right to the economic benefits of a security.

(3) Bona Fide Public Market

The term “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 Act) of at least \$1 million, provided that the issuer’s common equity securities have a public float value of at least \$150 million.

(4) Conflict of Interest

The term “conflict of interest” means a member’s participation in an entity’s public offering if any of the following applies:

(A) the securities are to be issued by the member or its affiliate;

(B) the issuer controls, is controlled by or is under common control with the member or the member’s associated persons;

(C) at least five percent of the net offering proceeds, not including underwriting compensation, are intended, as of the effective date of the registration statement or the date of first sale in an offering without a registration statement, 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

(D) 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.

(5) Control

(A) The term “control” means:

(i) beneficial ownership of 10 percent or more of the outstanding voting securities of an entity, including any right to receive such securities within 60 days of the effective date of the public offering;

(ii) beneficial ownership of 10 percent or more of the distributable profits or losses of an entity, including any right to receive an interest in such distributable profits or losses within 60 days of the effective date of the public offering; or

(iii) the power to direct or cause the direction of the management or policies of an entity.

(B) The term “common control” means the same natural person or entity controls two or more entities.

(6) Entity

For purposes of the definitions of affiliate, conflict of interest and control under this Rule, the term “entity”:

(A) includes a company, corporation, partnership, trust, sole proprietorship, association or organized group of persons; and

(B) excludes the following:

(i) an investment company registered under the Investment Company Act of 1940;

(ii) a “separate account” as defined in Section 2(a)(37) of the Investment Company Act of 1940;

(iii) a “real estate investment trust” as defined in Section 856 of the Internal Revenue Code; or

(iv) a “direct participation program” as defined in Rule 2810.

(7) Investment Grade Rated

The term “investment grade rated” refers to securities that are rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories.

(8) Public Offering

The term “public offering” means 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, except any offering made pursuant to:

(A) an exemption from registration under Sections 4(1), 4(2), or 4(6) of the Securities Act of 1933;

(B) SEC Rule 504, if the securities are “restricted securities” under SEC Rule 144(a)(3), SEC Rules 505 or 506; or

(C) SEC Rule 144A or Regulation S.

The term public offering shall exclude exempted securities as defined in Section 3(a)(12) of the Act.

(9) Qualified Independent Underwriter

The term “qualified independent underwriter” means a member:

(A) that does not have a conflict of interest and is not an affiliate of any member that has a conflict of interest;

(B) that does not beneficially own as of the date of filing of the registration statement and the effective date of 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;

(C) that has agreed in acting as a qualified independent underwriter to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act of 1933, specifically including those inherent in Section 11 thereof; and

(D) 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. This requirement will 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 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.

(E) none of 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:

(i) has been convicted within ten years prior to the filing of the registration statement or the preparation of an offering circular in an offering without a registration statement of a violation of the anti-fraud provisions of the federal or state securities laws, or any rules or regulations promulgated thereunder, 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 entered within ten years prior to the filing of the registration statement, or the preparation of an offering circular in an offering without a registration statement, 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, or any rules or regulations promulgated thereunder 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 Commission, any state, NASD or any other self-regulatory organization within ten years prior to the filing of the registration statement, or the preparation of an offering circular in an offering without a registration statement, for any conduct or practice in violation of the anti-fraud provisions of the federal or state securities laws, or any rules, or regulations promulgated thereunder, or the anti-fraud rules of any self-regulatory organization in connection with a registered or unregistered offering of securities.

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