

NASD NOTICE TO MEMBERS 97-68

SEC Approves Amendment To Definition Of Qualified Independent Underwriter In Conduct Rule 2720; Effective September 4, 1997

Suggested Routing

- Senior Management
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Executive Summary

On September 4, 1997, the Securities and Exchange Commission (SEC) approved an amendment to the definition of "qualified independent underwriter" in Rule 2720 of the National Association of Securities Dealers, Inc. (NASD[®]) Conduct Rules that eliminates the requirement that a member intending to act as a qualified independent underwriter in a public offering record net income in three of the five years immediately preceding the offering.¹ The net income requirement was found to be an unreliable indicator of a member's ability to fulfill the responsibilities of a qualified independent underwriter. The amendment is effective as of the date of SEC approval with respect to all offerings of securities that have not, as yet, commenced sales of securities.

Questions concerning this *Notice* may be directed to Richard J. Fortwengler, Associate Director, Corporate Financing, NASD Regulation, Inc., at (202) 974-2700.

Background

When a member proposes to participate in the distribution of a public offering of its own or an affiliate's securities, or of securities of a company with which it otherwise has a conflict of interest, NASD Rule 2720 requires that the price at which an equity issue or the yield at which a debt issue is to be distributed to the public must be established at a price no higher or a yield no lower than that recommended by a member acting as a "qualified independent underwriter." The qualified independent underwriter must also participate in the preparation of the offering document and is expected to exercise the usual standards of due diligence in respect thereto. The participation of a qualified independent underwriter assures the public of the independence of the pricing and due diligence func-

tions in a situation where a member is participating in an offering where the member has an affiliation or conflict of interest.

Because of the important investor protections provided by qualified independent underwriters, they must meet certain standards as prescribed in Rule 2720 of the Conduct Rules. Qualified independent underwriters must have a certain level of experience as demonstrated by having been engaged in the investment banking and securities business for at least five years; by recording net income in three of the five years immediately preceding the offering (net income requirement); by a majority of directors (or general partners) having been actively engaged in the investment banking and securities business for five years; and by acting as manager or co-manager in the underwriting of offerings of a similar size and type for a five-year period prior to the offering. Further, qualified independent underwriters may not be affiliates or own more than five percent of certain securities of the issuing company; are subject to provisions ensuring that associated persons of the member have not been convicted, suspended, barred or otherwise disciplined for actions related to an offering; and must agree to accept the legal responsibilities and liabilities of an underwriter under Section 11 of the Securities Act of 1933.

The net income requirement referenced above was adopted in 1972 as part of the original provisions of Rule 2720, and was viewed as a gauge for monitoring a member's ability to act as a qualified independent underwriter. In the ensuing years, however, amendments to the definition of qualified independent underwriter have imposed more specific requirements that are more pertinent to ensuring that members have the experience and ability to be effective qualified independent underwriters.

In particular, the definition of qualified independent underwriter was amended in 1988 to preclude a member from acting as a qualified independent underwriter if, within the previous five-year period, any of its associated persons having supervisory responsibility for organizing, structuring, or performing due diligence with respect to corporate public offerings of securities have been convicted, enjoined, suspended, barred, or otherwise subject to disciplinary action by the NASD, SEC or other self-regulatory organizations for violation of the anti-fraud provisions of the federal or state securities laws for distribution-related activities.³ In addition, the 1988 amendments require a qualified independent underwriter to have experience in managing or co-managing public offerings of a size and type similar to the proposed offering. This latter requirement is the most pertinent, since it most directly measures the member's experience in performing the duties and responsibilities necessary of a qualified independent underwriter.

Finally, the 1988 amendments restrict the beneficial ownership of the issuer's voting equity securities by the qualified independent underwriter to less than five percent. Later amendments in 1994 extended these ownership restrictions to non-voting equity securities, preferred equity, and subordinated debt. Taken together, these modifications to the definition of "qualified independent underwriter" have significantly improved confidence in the ability, quality, and integrity of qualified independent underwriters.

Adoption of Amendment

NASD RegulationSM believes that the net income requirement now operates as an arbitrary standard for assessing the abilities of potential qualified independent underwriters, particular-

ly where members intentionally avoid experiencing net income for tax reasons. This occurs where a member is organized as either a sole proprietorship, partnership, or subchapter S corporation that routinely distributes its net income to the owner, partners, or shareholders to minimize taxes. The application of a net income requirement is not appropriate in these cases, as the legal structure of the member is a business decision within the discretion of the member that is unrelated to the firm's underwriting activities.

In addition, a lack of net income may not be directly connected to the profitability of the member's underwriting activities and, thus, not a reliable indicia of underwriting experience, since the overall profitability of a member can be impacted by the performance of other business lines within multi-functional members.

Losses in one or more departments of a member can unnecessarily disqualify the firm from acting as a qualified independent underwriter. The lack of net income can also reflect accounting anomalies related to infrequent events that result in charges against earnings for mergers, consolidations, restructurings, or divestitures.

Finally, net income is also subject to the vagaries of the market, when a decline in income is often attributable to trading activities rather than underwriting. This was apparent during the five-year periods following the market breaks that occurred in October 1987 and October 1989, when a number of members failed to meet the net income requirement.

In light of the foregoing, NASD Regulation has amended Rule 2720 to eliminate the net income requirement from the definition of "qualified independent underwriter," as it may operate as an unfair barrier or restraint that disqualifies otherwise qualified firms from acting as qualified inde-

pendent underwriters. The elimination of the net income requirement allows the staff of NASD's Corporate Financing Department to focus on these more substantive requirements when approving members to be qualified independent underwriters.

The amendment was approved by the SEC on September 4, 1997, and is effective as of that date with respect to public offerings to be filed after that date with the Corporate Financing Department for review, and with respect to public offerings that have been filed with the Corporate Financing Department but have not, as yet, commenced sales of securities.

Text Of Amendment

(Note: Deletions are bracketed.)

CONDUCT RULES

Rule 2720. Distribution of Securities of Members and Affiliates—Conflicts of Interest

(a) No change.

(b) Definitions

(15) Qualified independent underwriter³—a member which:

(A) is actively engaged in the investment banking or securities business and which has been so engaged, in its present form or through predecessor broker/dealer entities, for at least five years immediately preceding the filing of the registration statement;

[(B) in at least three of the five years immediately preceding the filing of the registration statement has had net income from operations of the broker/dealer entity or from the *pro forma* combined operations of predecessor broker/dealer entities, exclusive of extraordinary items, as computed in accordance with generally accepted accounting principles;]

Paragraphs (C) through (G) redesignated as (B) through (F).

Endnotes

¹ Securities Exchange Act Release No. 39021 (September 4, 1997).

² *NASD Notice to Members 88-89* (November 1988).

³ In the opinion of the Association and the Commission the full responsibilities and liabilities of an underwriter under the Securities Act of

1933 attach to a “qualified independent underwriter” performing the functions called for by the provisions of paragraph (c) hereof.

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