

Notice to Members

NOVEMBER 2004

SUGGESTED ROUTING

Legal & Compliance
Operations
Senior Management

KEY TOPICS

Fairness Opinions
Investment Banks
Mergers and Acquisitions
Proxy Statements

REQUEST FOR COMMENT

Fairness Opinions Issued by Members

NASD Requests Comment on Whether to Propose New Rule That Would Address Conflicts of Interest When Members Provide Fairness Opinions in Corporate Control Transactions; **Comment Period Expires January 10, 2005**

Executive Summary

NASD is requesting comment on whether it should propose a new rule that would address procedures, disclosure requirements, and conflicts of interest when members provide fairness opinions in corporate control transactions. A fairness opinion addresses the fairness, from a financial point of view, of the consideration involved in a transaction. Investment banks typically provide fairness opinions in corporate control transactions, including mergers and acquisitions, the disposition or divestiture of material assets, divisions or subsidiaries, and buybacks of outstanding securities ("transactions"). The scope of the investment bank's involvement typically is set out in an engagement letter between the bank and the company.

Investment banks that render fairness opinions may be influenced by whether the company's management supports the transaction. In other words, the investment bank may find that the transaction is fair from a financial viewpoint if the transaction is favored by the company's management, and, alternatively, opine that the financial terms are not fair if management opposes the transaction. This conflict may be especially strong when a transaction that is supported by management is also one in which the investment bank acted as the financial advisor to the company in recommending or structuring the transaction and/or where the investment bank will receive financial advisory fees upon successful completion of the transaction.

NASD is considering whether to propose a new rule that would require members to: (1) disclose in any fairness opinion appearing in any proxy statement any significant conflicts of interest, including, if applicable, that the member has served as an advisor on the transaction in question, and the nature of compensation that the member will receive upon the successful completion of the transaction; and (2) require specific procedures that members must follow to identify and disclose potential conflicts of interest in rendering fairness opinions.

Questions/Further Information

Questions concerning this *Notice* should be directed to Joseph E. Price, Vice President, Corporate Financing, at (240) 386-4623; or Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8104.

Action Requested

NASD encourages all interested parties to comment on the proposed rule. Comments must be received by **January 10, 2005**. Members and other interested parties can submit their comments using the following methods:

- ◆ mailing in written comments; or
- ◆ e-mailing written comments to pubcom@nasd.com.

Comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1500

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) and by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.²

Background and Discussion

Although fairness opinions are not required by any statute or regulation, they have become a regular feature of corporate control transactions since 1985, when the Delaware Supreme Court found that a corporate board breached its fiduciary duty of care by approving a merger without adequate information on the transaction, including information on the value of the company and the fairness of the offering price.³

Fairness opinions assist directors in fulfilling their fiduciary obligations. Under the business judgment rule, a corporate board of directors is protected from liability to a company's shareholders for decisions made in good faith, in an informed manner and on a rational basis. A number of courts have held that directors can fulfill their fiduciary duty of care by relying in good faith on fairness opinions.⁴ Fairness opinions typically provide that the opinion is for the use and benefit of the board of directors, but the opinions are disclosed in various SEC forms and investors often refer to them.⁵

The SEC's proxy rules require that when a company's board of directors obtains a fairness opinion that is referred to in the proxy statement, the opinion must be fairly summarized and describe:

- ◆ the procedures followed;
- ◆ findings and recommendations;
- ◆ bases for and methods of arriving at such findings and recommendations;
- ◆ any instruction received from the subject company concerning the investigation; and
- ◆ any limitation imposed by the subject company on the scope of the investigation.⁶

Fairness opinions typically disclose that in preparing the opinion, the investment bank has assumed and relied on the accuracy and completeness of all information made available to the investment bank by the company and the investment bank has not assumed any responsibility to independently verify such information or undertaken an independent appraisal of the assets or liabilities of the company.

Notwithstanding the proxy statement disclosure requirements, NASD is concerned that these disclosures may not sufficiently inform investors about the subjective nature of some opinions and their potential biases.

In addition, the multiplicity of valuation methodologies employed, the sensitivity of results to small changes in the underlying assumptions, and a perceived tendency to make judgment calls that support the company managers' preferred outcome have been the subject of criticism.⁷

Finally, when the transaction will result in one group of shareholders, a Board member, or employee receiving a benefit or payout that is materially different than that received by the unaffiliated shareholders, this result may create biases in favor of the transaction if the people receiving the benefit were involved in hiring the investment bank or are in the position to direct future business to the investment bank.

NASD requests comment on the best way to improve the processes by which investment banks render fairness opinions and manage the inherent conflicts.

In particular, NASD requests comment on whether it should propose a new rule to regulate the identification and disclosure of conflicts by members that provide fairness opinions in corporate control transactions. Such a rule could require a member to provide in any fairness opinion that will be included in a proxy statement a clear and complete description of any significant conflict of interest by the member, including, if applicable, that the member has served as an advisor on the transaction in question and the nature of compensation that the member will receive upon the successful completion of the transaction (including any variance or contingency in the fee charged for the fairness opinion). Such a rule also could require a member to disclose the extent to which the firm relied on key information supplied by a company or its management, or whether it independently verified certain information.

In addition, the new rule could set forth specific procedures that members must follow to guard against conflicts of interest in rendering fairness opinions. Such procedures also could address the substantive factors used by members in reaching a fairness opinion. These procedures could address:

- ▶ the process by which fairness opinions are approved by a firm, including whether the firm uses a fairness committee, and, if so, the selection of personnel for the fairness committee, the level of experience of such persons, procedures designed to provide balanced review, and whether steps have been taken to require review by persons whose compensation is not directly related to the underlying transaction of the fairness opinion;
- ▶ the process to determine whether the valuation analyses used are appropriate for the type of transaction and the type of companies that propose to participate in the transaction; and
- ▶ the process to evaluate the degree to which the amount and nature of the compensation from the transaction underlying the fairness opinion benefits any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company, is a factor in reaching a fairness determination.

Endnotes

- 1 See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or email addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.
- 2 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
- 3 See *Smith v. Van Gorkum*, 488 A. 2d 858 (Del. 1985). However, neither the Van Gorkum court nor subsequent Delaware case law requires a corporation's board to procure a fairness opinion in connection with its duty to consider necessary information, including valuation, pertaining to a corporate control transaction.
- 4 See, e.g., *Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980).
- 5 SEC Rule 13e-3 requires the issuer or affiliate engaging in the going-private transactions to state whether it believes the transaction is fair to the unaffiliated security holders and to disclose any fairness opinion prepared by an investment bank. See also Item 14(b)(6) of SEC Schedule 14A, Item 4(b) of SEC Form S-4, and Item 1015 of SEC Regulation M-A.
- 6 Item 1015(b)(6) of SEC Regulation M-A.
- 7 See, e.g., David Henry, *A Fair Deal - But For Whom?*, Business Week Online, Nov. 24, 2003; Elson, Rosenbloom and Chapman, *Fairness Opinions - Can They be Made Useful?*, 35 Securities Regulation & Law 46, Nov. 24, 2003, at p. 1984.

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