Notice to Members

SEPTEMBER 2006

SUGGESTED ROUTING

Corporate Financing
Legal & Compliance
Senior Management
Trading & Market Making

KEY TOPICS

Affiliate
Conflicts of Interest
Equity & Debt Offerings
Investment Banking
Qualified Independent Underwriter
Rule 2710
Rule 2720
Underwriting Compensation

REQUEST FOR COMMENT

Proposed Amendments to Rule 2720

NASD Requests Comment on Proposed Amendments to Rules Governing Conflicts of Interest in Public Offerings of Securities; **Comment Period Expires October 30, 2006**

Executive Summary

NASD is issuing this *Notice to Members* to solicit comments from members and other interested parties on a proposal to modernize and simplify Rule 2720 (Distributions of Securities of Members and Affiliates – Conflicts of Interest). 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 more significant amendments that are proposed in this *Notice* would:

- exempt from the filing requirements and the qualified independent underwriter (QIU) requirements of Rule 2720 public offerings with a book-running lead manager or dealer-manager that does not have a conflict of interest and that can meet the disciplinary history requirements for a QIU and public offerings of investment-grade rated debt and securities that have a bona fide public market;
- change the definition of "conflict of interest" so that the Rule covers public offerings in which at least five percent of the offering proceeds are directed to a participating member or its affiliates and eliminates ownership of subordinated debt as a basis for a conflict of interest;
- modify the Rule's disclosure requirements so that more information relating to conflicts of interest is prominently disclosed in offering documents;
- 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;

- amend the QIU qualification requirements to focus on the experience of the firm rather than its board of directors, prohibit a member that would receive more than five percent of the proceeds of an offering from acting as a QIU, and 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;
- eliminate provisions in the Rule that do not apply to public offerings and instead address an issuer's corporate governance responsibilities; and
- eliminate a provision that applies certain disclosure requirements to intrastate offerings.

Action Requested

NASD requests comment on the proposed amendments. Comments must be received by October 30, 2006. Members and interested persons can submit their comments using the following methods:

- E-mailing written comments to *pubcom@nasd.com*
- Submitting written comments online at the NASD Web Site *(www.nasd.com)*
- Mailing hardcopy written comments to:

  Barbara Z. Sweeney
  NASD
  Office of the Corporate Secretary
  1735 K Street, NW
  Washington, D.C. 20006-1506

Important Notes: The only comments that will be considered are those submitted in writing via one of the methods set forth 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, any rule change developed as a result of comments received must be adopted by NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

Questions/Further Information

As noted, written comment should be submitted to Barbara Z. Sweeney. Questions concerning this *Notice* should be directed to Thomas M. Selman, Senior Vice President, Corporate Financing/Investment Companies, Regulatory Policy and Oversight (RPO), at (240) 386-4623; Joseph E. Price, Vice President, Corporate Financing Department, RPO, at (240) 386-4623; Gary L. Goldsholle, Vice President and Associate General Counsel, Office of the General Counsel (OGC), RPO, at (202) 728-8104; or Lisa C. Horrigan, Assistant General Counsel, OGC, RPO, at (202) 728-8190.

Background

A. Rule 2720

Rule 2720 generally requires members to file public offerings for NASD review and imposes certain substantive requirements when members participate in offerings: (i) of their own or their affiliates' securities; (ii) in which they or their affiliates have a "conflict of interest"; or (iii) that result in a member becoming a public company. The Rule defines "affiliate" to include companies under common control or that control one another.

One of the principal substantive requirements in Rule 2720 is the requirement that the underwriting syndicate retain a QIU in certain circumstances. This requirement is discussed in greater detail below.

B. Rule 2710

Rule 2710 generally requires members to file public offerings for NASD review of proposed underwriting terms and arrangements. The underwriting terms and arrangements must comply with the substantive requirements in Rule 2710, including limits on the compensation that can be charged for performing underwriting services.

Rule 2710 contains certain exemptions to its filing requirements, including exemptions for public offerings of the securities of seasoned issuers and offerings of investment-grade debt.[2] These exemptions, however, are inapplicable to offerings that fall within the scope of Rule 2720 because Rule 2720(m) specifically directs that such offerings must be filed with NASD, notwithstanding any express exemption in Rule 2710. Thus, for example, while a public offering of the securities of a seasoned issuer is exempt from filing under Rule 2710, it must nevertheless be filed and comply with Rule 2710 if a member participating in the offering has a conflict of interest, as defined in Rule 2720, with the seasoned issuer.

Discussion

A. Offerings Governed by Rule 2720 and Rule 2710

Under existing Rule 2720, a "conflict of interest" is presumed to exist if the member or any of its associated persons or affiliates owns ten percent or more of the common or preferred stock or subordinated debt of the issuer, or participates in ten percent of the profits or losses of the issuer. The proposed amendments would eliminate ownership of subordinated debt as a basis for a conflict of interest.

In addition, the proposed amendments would expand the definition of "conflict of interest" to include a member's participation in an offering in which at least five percent of the proceeds are intended to be directed to the member, its affiliates or its associated persons. Rule 2710(h) requires that public offerings in which ten percent or more of the offering proceeds (not including the underwriting discount) will be paid to participating members must comply with Rule 2720's QIU requirements. The proposed amendments would eliminate Rule 2710(h). The new five percent threshold for proceeds directed to a member in Rule 2720 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 if a member received five percent of the proceeds, but not if two unaffiliated members each received three percent of the proceeds.

The proposed amendments would also amend the definition of "conflict of interest" to expressly include instances in which the issuer is controlled by or under common control with the member or any of its affiliates or associated persons. Control under the current Rule is presumed at ten percent beneficial ownership of voting securities, ten percent interest in a partnership's profits or losses, or the power to direct management or policies of the entity. The proposed amendments would expand the definition of "control" to include 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. Accordingly, 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 a member, company or natural person will be presumed to control an entity.

B. Scope of Rule 2720

Rule 2720 requires that all public offerings within the scope of the Rule comply with its provisions and the provisions of Rule 2710, including the Rule 2710 filing requirement. Under the current Rule, public offerings of investment-grade rated securities and offerings of equity securities for which there is a "bona fide independent market"[3] are exempt from the Rule's QIU requirement, but subject to all other requirements.

The proposed amendments would establish an exemption from the QIU and filing requirements of Rule 2720 for two types of offerings: (1) an offering with a book-running lead manager or dealer-manager that does not have a conflict of interest, is not an affiliate of any member that does have a conflict of interest, and can meet the disciplinary history requirements for a QIU; or (2) an offering of investment-grade rated securities or equity securities for which there is a "bona fide public market."[4] While these two types of offerings would be exempt from the filing requirements, they would be subject to Rule 2720's disclosure requirements and, if applicable, the Rule's escrow and discretionary account requirements.[5]

If an offering does not meet either of these two exemptions, a QIU must participate in the preparation of the offering documents and perform due diligence, and the offering must meet Rule 2720's disclosure requirements and, if applicable, the Rule's escrow and discretionary account requirements.

C. Disclosure Requirement

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 Rule requires the following disclosure in the underwriting section of the registration statement or offering circular:

- The fact that the offering is being made pursuant to Rule 2720;
- The member's status in the offering; and
- Disclosure about the QIU, if one is required.

In lieu of these disclosure requirements, the proposed amendments would require prominent disclosure of the nature of the conflict of interest in offerings in which a participating member has a conflict of interest, but the Rule does not require a QIU (*i.e.*, offerings falling into either of the two QIU and filing exemptions discussed above).

For offerings that require a QIU, the proposed amendments would require prominent disclosure of the following:

- The nature of the conflict of interest;
- The name of the member acting as QIU; and
- The fact that the QIU will assume due diligence responsibilities.

D. QIU Requirement

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 Rule also requires the QIU to participate in the preparation of the registration statement, prospectus or offering circular and perform due diligence. A QIU is not required under the existing Rule if there is a bona fide independent market for the equity or the securities are rated investment grade.

The proposed amendments would eliminate the requirement that the QIU provide a pricing opinion. In an offering in which a participating member has a conflict of interest, but the book-running lead manager or dealer-manager does not have a conflict of interest, a QIU would not be required because the book-running lead manager or dealer-manager could be expected to perform the necessary due diligence.[6] The proposed amendments would retain the current exemption from the QIU requirement for offerings of securities with an investment grade rating or for which there is a bona fide public market.[7] For offerings in which a QIU is required, the QIU must participate in the preparation of the registration statement, prospectus and offering circular and perform due diligence.

E. QIU Qualifications

Rule 2720 contains lengthy requirements for a member firm to qualify to act as a QIU. The Rule currently permits a member to serve as a QIU only if (i) the member is "actively engaged" in the investment banking or securities business and has been so engaged for at least five years immediately preceding the filing of the registration statement and (ii) a majority of its board of directors or general partners has been similarly engaged in the investment banking or securities business. The proposed amendments would eliminate the requirement regarding board or partner experience, since NASD staff believes that the experience of the firm is more relevant.

The Rule also currently requires that a QIU must have acted as a managing underwriter for offerings of a similar size and type for at least five years. The proposed amendments would shorten this period from five years to three years but impose the additional requirement that a QIU must have acted as a managing underwriter in at least three similar offerings during that time.

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 amendments would lengthen this period from five to ten years.

The Rule currently 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 amendments would delete the provision that makes ownership of subordinated debt a basis for disqualification of a QIU. NASD specifically requests comment on whether the five percent ownership threshold should apply to securities held not only by the QIU, but also by its affiliates and natural control persons. If so, should the determination of beneficial ownership incorporate the principles of Securities Exchange Act Section 13(d)?[8]

Finally, the Rule currently does not disqualify or prohibit a QIU from receiving proceeds from an offering. The proposed amendments would prohibit a QIU from receiving more than five percent of the offering proceeds. The receipt of such proceeds would disqualify a member from acting as a QIU because it would fall within the proposed expansion of the definition of "conflict of interest," which is discussed above.

F. 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 shareholders.

The proposed amendments would delete these requirements. Congress recently passed corporate governance legislation and the Securities and Exchange Commission recently passed comprehensive new rules that govern reporting requirements.[9] The Sarbanes-Oxley Act addresses the role of public directors and audit committees for U.S. companies. and the Securities Offering Reform rules address periodic reporting requirements for United States issuers. Accordingly, NASD believes that separate Rule 2720 requirements for corporate governance and periodic reporting are unnecessary.

G. Intrastate Offerings

Rule 2720 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. NASD requests comment on whether NASD should propose a new rule that would govern disclosure requirements in offering documents used in intrastate offerings.

Endnotes

1 *See Notice to Members 03-73* (Nov. 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 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 $150 million float or $100 million float plus annual trading volume of three million shares.

3 A "bona fide independent market" is currently 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, aggregate trading volume of 500,000 shares over 90 days and a public float of 5 million shares. The proposed amendments would eliminate the definition of "bona fide independent market" and replace it with a new definition of "bona fide public market."

4 The proposed amendments would define "bona fide public market" 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. These numerical standards are derived from Regulation M under the Securities Exchange Act of 1934. NASD requests comment on whether the proposed bona fide public market definition's listing requirement should include OTC-traded equity securities of foreign issuers listed on a foreign exchange deemed comparable to a national securities exchange and, if so, what criteria should be used to determine the eligible foreign exchanges.

5 The proposed amendments would provide that offerings of investment-grade rated securities include securities that have not received an individual rating but are of the same class or series and are considered "pari passu" with other investment-grade rated securities issued by the same company.

6 All syndicate members have due diligence responsibility, but typically the book-runner hires outside counsel to help all syndicate members meet their due diligence obligations.

7 The bona fide independent market standards would be replaced with new standards in the definition of "bona fide public market."

8 SEC Rule 13d-3 provides the basis for determining "beneficial ownership" under Securities Exchange Act Section 13(d), which includes voting power, investment power and the power to divest or prevent the vesting of beneficial ownership as part of a plan to evade the reporting requirements of Section 13(d).

9 Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002); Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005), 70 FR 44722 (August 3, 2005).

ATTACHMENT A

2710. Corporate Financing Rule – Underwriting Terms and Arrangements

Rule 2710 is proposed to be amended by deleting paragraph (h) and renumbering the remaining paragraphs.

2720. Public Offering 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 registration statement, prospectus, offering circular or similar document for the public offering prominently discloses the nature of the conflict of interest and either:

(A) the book-running lead-manager or dealer manager 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)(8)(E);

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

(C) the securities offered are debt or preferred securities that have been rated investment grade (Baa or better by Moody's rating service or BBB or better by Standard & Poor's rating service or rated in a comparable category by another rating service acceptable to NASD) or debt or preferred securities that rank pari passu with such 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 registration statement, 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) the fact that the qualified independent underwriter is assuming the responsibilities of a qualified independent underwriter in conducting due diligence.

(b) Escrow of Proceeds; Net Capital Computation

(1) All proceeds from an 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 a 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 offering has been terminated and settlement effected and it 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 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 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 any security to a discretionary account 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 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

An entity that controls, is controlled by or is under common control with another entity or member.

(2) Beneficial Ownership

The right to the economic benefits of a security.

(3) Bona Fide Public Market

A market for a security issued by a company that has been reporting under the Exchange Act for at least 90 days, is current in its reporting requirements, and whose securities are traded on a national securities exchange with an ADTV (as provided by Regulation M under the Securities Exchange Act of 1934) of at least $1 million, provided that the issuer's common equity securities have a public float value of at least $150 million.

(4) Conflicts of Interest

A member's participation in a public offering of securities 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, its affiliates or the member's associated persons;

(C) at least five percent of the offering proceeds are intended, as of the effective date of the 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) A member, entity, or associated person controls another member or entity if the member, entity or associated person:

(i) beneficially owns 10 percent or more of the outstanding voting securities of an entity that is a corporation, including any right to receive such securities within 60 days;

(ii) beneficially owns 10 percent or more of the distributable profits or losses of an entity that is a partnership or similar vehicle, including any right to receive within 60 days any interests in such distributable profits or losses; or

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

(B) A member,and entity are under common control if the same natural person or entity controls both of them.

(6) Entity

For purposes of the definitions of affiliate and control under this Rule, an entity:

(A) includes a company, corporation, partnership, trust, 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

(iv) a "direct participation program" as defined in Rule 2810; or

(v) a corporation, trust, partnership or other entity issuing financing instrument-backed securities which are rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories.

(7) Public Offering

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 Regulation S.

(8) 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 does have 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 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; and

(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.

(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. This requirement will be deemed satisfied if, during the past three years, the member:

(i) with respect to a proposed debt offering, 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 equity offering, 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 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 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 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.