

Fairness Opinions

SEC Approves New NASD Rule 2290 Regarding Fairness Opinions

Effective Date: December 8, 2007

Executive Summary

Effective December 8, 2007, new NASD Rule 2290 (Fairness Opinions) requires specific disclosures and procedures addressing conflicts of interest when member firms provide fairness opinions in change of control transactions, such as a merger or sale or purchase of assets.¹ NASD Rule 2290, as adopted, is set forth in Attachment A of this *Notice*.

Questions regarding this *Notice* may be directed to:

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November 2007

Notice Type

- New Rule

Suggested Routing

- Compliance
- Corporate Finance
- Legal
- Senior Management

Key Topic(s)

- Fairness Opinions
- Mergers and Acquisitions

Referenced Rules & Notices

- NASD Rule 2290

Background and Discussion

A fairness opinion addresses, from a financial point of view, the fairness of the consideration in a transaction. Fairness opinions are routinely used by directors of companies in connection with a change of control transaction, such as a merger or sale or purchase of assets, to satisfy their fiduciary duties to act with due care and in an informed manner.

Although not required by statute or regulation, fairness opinions have become commonplace in change of control transactions following the 1985 Delaware Supreme Court case of *Smith v. Van Gorkom*,² in which a corporate board was held to have 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.

In addition to providing a basis for the exercise of care by the board of directors, a fairness opinion, or information about a fairness opinion, is often provided to shareholders as a part of the proxy materials relating to a change of control transaction. Fairness opinions express a conclusion as to the whether the consideration offered in a transaction is within the range of what would be considered “fair”; such opinions generally do not offer an opinion as to whether the consideration offered is the best price that could likely be attained or reach other matters, such as solvency issues, that may arise from the transaction.

Under the SEC’s proxy rules, which apply to issuers, certain disclosures about potential conflicts of interest are provided to investor-shareholders. NASD Rule 2290 is a complementary rule that requires broker-dealers that render fairness opinions to inform investor-shareholders about the potential conflicts of interest that may exist between the firm rendering the fairness opinion and the issuer. The Rule also addresses specific procedures concerning the issuance of fairness opinions.

Disclosures Required by NASD Rule 2290(a)

The Rule sets forth the parameters when the disclosures are required to be contained in a fairness opinion. If a member firm knows or has reason to know, at the time a fairness opinion is issued to a company’s board, that the opinion will be provided or described to the company’s public shareholders, the firm must make the enumerated disclosures in the fairness opinion. A firm will be deemed to have a reason to know that the fairness opinion will be provided or described to public shareholders, if, for example, the structure of the transaction will require a shareholder vote. The fairness opinions covered by the Rule include those issued to the board of directors, and/or any special committee or other subset or committee of the board.

Acting as Financial Advisor and Contingent Compensation

A member firm is required to disclose if the firm has acted as a financial advisor to any party to the transaction that is the subject of the fairness opinion, and, if applicable, that it will receive compensation that is contingent upon the successful completion of the transaction, for rendering the fairness opinion and/or serving as an advisor. This requirement includes significant payments or compensation from related transactions (*e.g.*, stapled financings) if such transactions are contingent upon the completion of the transaction for which the fairness opinion was issued. This disclosure, along with the disclosures in paragraphs (a)(2) and (a)(3), requires descriptive information rather than quantitative information. In addition, FINRA notes that none of the Rule's disclosure provisions requires a member to breach any of its confidentiality obligations.

Other Significant Payment or Compensation

A member firm must disclose if it will receive any other significant payment or compensation contingent upon the successful completion of the transaction. FINRA has chosen not to establish a particular dollar or percentage figure as to what may be considered "significant" out of a concern that establishing a specific figure may become a *de facto* standard for such payments. Given that the nature of the provision is to inform investors of conflicts of interest, and that paragraph (a)(2) is to prevent circumvention of the provisions in paragraph (a)(1), the receipt of *de minimis* fees (such as trading fees or other small incremental fees from account assets or activity) would not be required to be disclosed. FINRA believes that a "significant" payment or contingent compensation is one that a reasonable person, who reads a fairness opinion, would have an interest in knowing about in order to assess whether the member firm authoring the fairness opinion has a potential conflict of interest.

Material Relationships

A member firm is required to disclose any material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the firm and any party to the transaction that is the subject of the fairness opinion. FINRA notes that this disclosure requirement attaches to material relationships between the member firm and all parties to the transaction, not just the party whose board of directors selected the member firm to render the fairness opinion; *e.g.*, in the case of a takeover, a member issuing a fairness opinion to the target's board of directors would also have to disclose any material relationships it had with the acquiror. As noted above, the disclosure is not required to be quantified, but each of the material relationships should be identified in the fairness opinion.

Independent Verification of Information

A member firm is required to disclose if any information that formed a substantial basis for the fairness opinion that was supplied to the firm by the company requesting the opinion concerning the companies that are parties to the transaction has been independently verified by the firm, and if so, a description of the information or categories of information that were verified. When no information has been verified, a blanket statement to that effect is sufficient. On the other hand, if a member firm independently verifies some or all of the information supplied to it concerning the companies that are parties to the transaction, it must describe the information or the categories of information that were verified. In those instances, FINRA notes that a firm making such a representation may also wish to explain in the fairness opinion its process or standards for independent verification.

Use of Fairness Committee

A disclosure of whether or not the fairness opinion was approved or issued by a fairness committee is required. For purposes of the Rule, the term, “fairness committee” includes any committee or group that approves a fairness opinion in accordance with the requirements of paragraph (b) regardless of whether the member firm calls it a “fairness committee.”

Compensation to Insiders

Finally, member firms are required to disclose whether or not the fairness opinion expresses an opinion about the fairness of the amount or nature of the compensation to any of the company’s officers, directors or employees, or class of such persons, relative to the compensation to the public shareholders of the company. This disclosure highlights to the investor the potential conflict of interest between the member issuing the fairness opinion and the issuer receiving the opinion by requiring disclosure of whether the member did or did not take into account the amount and nature of compensation flowing to certain insiders relative to the benefits to shareholders in reaching a fairness determination.

Procedures Required by NASD Rule 2290(b)

NASD Rule 2290(b) requires that any member firm issuing a fairness opinion must have written procedures for approval of a fairness opinion. The firm must have procedures regarding the types of transactions and the circumstances in which the firm will use a fairness committee to approve or issue a fairness opinion, and in those transactions in which it uses a fairness committee:

- (A) the process for selecting personnel to be on the fairness committee;
- (B) the necessary qualifications of persons serving on the fairness committee; and
- (C) the process to promote a balanced review by the fairness committee, which shall include the review and approval by persons who do not serve on the deal team to the transaction.

FINRA notes that paragraph (b)(1)(C) does not require that the fairness committee be comprised entirely of persons not serving on or advising the deal team. Rather, the provision requires that the firm have procedures to promote a balanced review by including on the fairness committee persons who are not serving on the deal team. Whether a person is considered to be part of the deal team requires an analysis of the particular facts and circumstances, and will not necessarily be determined by whether a person is included on all document distributions or participated in certain meetings. The determination of whether a person is part of a deal team will depend on the nature and substance of his or her contacts and the advice rendered to the firm.

Firms are also required to have a process to determine whether the valuation analyses used in the fairness opinion are appropriate.

The new rule becomes effective on December 8, 2007. An outline of the disclosure and procedural requirements under the Rule is included in Attachment B.

Endnotes

- 1 See Securities Exchange Act Release No. 56645 (October 11, 2007), 72 FR 59317 (October 19, 2007) (Approval Order of SR-NASD-2005-080).
- 2 488 A.2d 858 (Del. 1985).

ATTACHMENT A

New language is underlined, deletions are in brackets.

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2200. COMMUNICATIONS WITH CUSTOMERS AND THE PUBLIC

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2290. Fairness Opinions

(a) Disclosures

If at the time a fairness opinion is issued to the board of directors of a company the member issuing the fairness opinion knows or has reason to know that the fairness opinion will be provided or described to the company's public shareholders, the member must disclose in the fairness opinion:

(1) if the member has acted as a financial advisor to any party to the transaction that is the subject of the fairness opinion, and, if applicable, that it will receive compensation that is contingent upon the successful completion of the transaction, for rendering the fairness opinion and/or serving as an advisor;

(2) if the member will receive any other significant payment or compensation contingent upon the successful completion of the transaction;

(3) any material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the member and any party to the transaction that is the subject of the fairness opinion;

(4) if any information that formed a substantial basis for the fairness opinion that was supplied to the member by the company requesting the opinion concerning the companies that are parties to the transaction has been independently verified by the member, and if so, a description of the information or categories of information that were verified;

(5) whether or not the fairness opinion was approved or issued by a fairness committee; and

(6) whether or not the fairness opinion expresses an opinion about the fairness of the amount or nature of the compensation to any of the company's officers, directors or employees, or class of such persons, relative to the compensation to the public shareholders of the company.

(b) Procedures

Any member issuing a fairness opinion must have written procedures for approval of a fairness opinion by the member, including:

(1) the types of transactions and the circumstances in which the member will use a fairness committee to approve or issue a fairness opinion, and in those transactions in which it uses a fairness committee:

(A) the process for selecting personnel to be on the fairness committee;

(B) the necessary qualifications of persons serving on the fairness committee;

(C) the process to promote a balanced review by the fairness committee, which shall include the review and approval by persons who do not serve on the deal team to the transaction; and

(2) the process to determine whether the valuation analyses used in the fairness opinion are appropriate.

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ATTACHMENT B

Outline of Fairness Opinion Rule Requirements

This outline highlights the disclosure and procedural requirements under NASD Rule 2290. Please be aware that, in the case of any misunderstanding, the rule language prevails. In addition, please note that your firm may have additional policies and procedures that must be followed.

Disclosures

A broker-dealer issuing a fairness opinion that will be disclosed to a company's public shareholders must make the following disclosures in the fairness opinion:

- If the broker-dealer will receive any compensation contingent on the successful completion of the transaction for acting as a financial adviser to any party to the transaction or otherwise;
- Any contemplated or existing material relationships involving the payment or receipt of compensation between the broker-dealer and any party to the transaction during the last two years;
- If the firm has independently verified any information supplied by the company requesting the fairness opinion, which is a substantial basis for the opinion and, if so, describe the information;
- Whether the fairness opinion was approved or issued by a fairness committee; and
- Whether the fairness opinion expresses an opinion about the fairness of the compensation to any of the company's insiders, relative to the compensation to the company's public shareholders.

Procedures

Any broker-dealer issuing a fairness opinion must have written procedures for approval of a fairness opinion including:

- When a member will use a fairness committee and where a fairness committee is used, the firm must specify:
 - the process for selecting members of the fairness committee;
 - the necessary qualifications for committee members; and
 - the process to promote a balanced review by the fairness committee, which includes the review and approval of persons who are not on the transaction deal team.
- The firm must specify the process to determine that valuation analyses used are appropriate.