

such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### *Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NYSEArca-2009-51 on the subject line.

##### *Paper Comments*

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-NYSEArca-2009-51. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NYSEArca-2009-51 and

should be submitted on or before July 10, 2009.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>13</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-60113; File No. SR-FINRA-2007-009]

### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change, as Modified by Amendment No. 1 Thereto, To Modernize and Simplify NASD Rule 2720

June 15, 2009.

#### I. Introduction

The Financial Industry Regulatory Authority, Inc. ("FINRA") (f/k/a National Association of Securities Dealers, Inc. ("NASD")) filed with the Securities and Exchange Commission ("Commission" or "SEC") on September 6, 2007, and amended on May 1, 2009,<sup>1</sup> pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act" or "Act")<sup>2</sup> and Rule 19b-4 thereunder,<sup>3</sup> a proposal to modernize and simplify NASD Rule 2720 (Distributions of Securities of Members and Affiliates—Conflicts of Interest) ("Rule 2720" or "Rule"), which governs public offerings of securities in which a member with a conflict of interest participates, and make corresponding changes to FINRA Rule 5110 (Corporate Financing Rule) ("Rule 5110"). This proposal was published for comment in the **Federal Register** on May 13, 2009.<sup>4</sup> The Commission received no comments on the proposal. This order approves the proposed rule change, as modified by Amendment No. 1.

<sup>13</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> This Amendment No. 1 to SR-FINRA-2007-009 replaces and supersedes the original filing submitted on September 6, 2007, except with regard to Exhibit 2 (NASD *Notice to Members* 06-52 and comments received in response to NASD *Notice to Members* 06-52).

<sup>2</sup> 15 U.S.C. 78s(b)(1).

<sup>3</sup> 17 CFR 240.19b-4.

<sup>4</sup> Exchange Act Release No. 59880 (May 7, 2009), 74 FR 22600 (May 13, 2009) (SR-FINRA-2007-009).

## II. Description of the Proposed Rule Change

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 (the "original proposal"). FINRA received two comment letters that generally supported the proposal and recognized the need to modernize the Rule.<sup>5</sup> However, in response to the comments received, FINRA staff made certain revisions to the original proposal in its September 6, 2007 filing with the Commission. In order to address Commission staff's comments, FINRA filed Amendment No. 1 to SR-FINRA-2007-009 on May 1, 2009.

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." The proposal would, among other things: (1) Exempt from the filing and qualified independent underwriter ("QIU") requirements public offerings of investment grade rated securities, public offerings of securities that have a bona fide public market, and public offerings in which the member primarily responsible for managing the offering does not have a conflict of interest and 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 eliminate the requirement that the QIU render a pricing opinion. In addition, the proposed rule change would amend the QIU qualification requirements to focus on the experience of the firm

<sup>5</sup> 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").

rather than its board of directors, prohibit a member from acting as a QIU if it would receive more than five percent of the proceeds of an offering, 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. These and the other proposed amendments are discussed in greater detail below.

#### A. Proposed Rule 2720(a)

Proposed Rule 2720(a) would provide 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)

FINRA proposed an exemption from the QIU and filing requirements for public offerings in which the member primarily 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)(12)(E).<sup>6</sup> FINRA staff believed 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.<sup>7</sup>

In response to comments on the original proposal,<sup>8</sup> FINRA amended this provision to clarify that it would apply 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, FINRA clarified that each would need to be free of conflicts of interest. FINRA believes that, 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.

FINRA also proposed an exemption from the QIU and filing requirements for public offerings of securities that have a bona fide public market.<sup>9</sup> The current Rule exempts public offerings of securities for which there is a "bona fide independent market" from Rule 2720's QIU requirement, but not the filing requirement.<sup>10</sup> 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 Regulation M.<sup>11</sup> Specifically, "bona fide public market" would be defined in the proposal as 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 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."<sup>12</sup>

FINRA also proposed to exempt from the filing requirement (and retain the existing exemption from the QIU requirement) public offerings of investment grade rated securities and securities in the same series that have equal rights and obligations as investment grade rated securities.<sup>13</sup> In response to comments on the original proposal,<sup>14</sup> FINRA proposed to define "investment grade rated" in proposed Rule 2720(f)(8) 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 filing

requirements and the regulation of public offerings of securities registered with the Commission and offered by members pursuant to Securities Act Rule 415 (the "proposed shelf amendments").<sup>15</sup>

These three types of public offerings described above and enumerated in paragraphs (a)(1)(A) through (a)(1)(C) of proposed Rule 2720 would not be subject to the QIU requirements of the proposed Rule and, by operation of proposed Rule 2720(d), they would not be subject to the filing requirements of Rule 5110 (formerly NASD Rule 2710).<sup>16</sup> They would be, however, subject to the other provisions of proposed Rule 2720, *e.g.*, the escrow and discretionary account requirements in paragraphs (b) and (c) respectively, if applicable. Additionally, these public offerings would be subject to certain disclosure requirements. Proposed Rule 2720(a)(1) would require prominent disclosure of the nature of the conflict of interest in the prospectus, offering circular, or similar document for the public offering.

In response to the original proposal, one commenter requested clarification regarding the "prominent disclosure" requirement in the proposed Rule.<sup>17</sup> Proposed Rule 2720(f)(10) provides a description of how a member could make "prominent disclosure" for purposes of paragraphs (a)(1) and (a)(2)(B) of the proposed Rule. Specifically, a member could make the notation "(Conflicts of Interest)" following the listing of the Plan of Distribution in the Table of Contents section required in Item 502 of Regulation S-K, and provide such disclosures in the Plan of Distribution section required in Item 508 and any Prospectus Summary section required in Item 503 of Regulation S-K. For offering documents not subject to Regulation S-K, "prominent disclosure" could be made by providing disclosure on the front page of the offering document that a conflict exists, with a cross-reference to the discussion within the offering document and in the summary of the offering document if one is included.

<sup>9</sup> See proposed Rule 2720(a)(1)(B).

<sup>10</sup> "Bona fide independent market" is defined in current Rule 2720(b)(3) 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.

<sup>11</sup> 17 CFR 242.100 to 105.

<sup>12</sup> ABA Letter.

<sup>13</sup> See proposed Rule 2720(a)(1)(C). Thus, proposed Rule 2720(a)(1)(C) would apply to public offerings of 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.

<sup>14</sup> ABA Letter.

<sup>15</sup> See 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/Industry/Regulation/RuleFilings/2004/P036671>.

<sup>16</sup> On September 11, 2008, the Commission approved proposed rule change SR-FINRA-2008-039, in which FINRA proposed, among other things, to adopt NASD Rule 2710 as Rule 5110 in the Consolidated FINRA Rulebook. See Exchange Act Release No. 58514 (September 11, 2008), 73 FR 54190 (September 18, 2008). SR-FINRA-2008-039 was implemented on December 15, 2008. See *Regulatory Notice* 08-57 (October 2008).

<sup>17</sup> ABA Letter.

<sup>6</sup> See proposed Rule 2720(a)(1)(A).

<sup>7</sup> FINRA clarified their understanding that all syndicate members have due diligence responsibility, but the book-runner(s) in a firm commitment offering and the lead placement agent(s) in a best efforts offering typically hire outside counsel to help members meet their due diligence obligations.

<sup>8</sup> SIFMA Letter.

FINRA stated that these methods of disclosure would be considered a non-exclusive safe harbor for effecting “prominent disclosure,” and clarified it would consider alternative but equally prominent disclosures on a case-by-case basis.

## 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 proposed Rule 2720(a)(2)(A) would require that a QIU participate in the preparation of the registration statement and the prospectus, offering circular or similar document and exercise the usual standards of “due diligence” with respect thereto.<sup>18</sup>

Like proposed Rule 2720(a)(1), proposed Rule 2720(a)(2)(B) would require “prominent disclosure” (as defined in proposed Rule 2720(f)(10)) in the prospectus, offering circular, or similar document of the nature of the conflict of interest. In addition, proposed Rule 2720(a)(2)(B) would require disclosure of 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,<sup>19</sup> FINRA proposed to replace this disclosure requirement with a more general statement about the role and responsibilities of a QIU.

FINRA clarified that a public offering in which a QIU participates pursuant to proposed paragraph (a)(2) would continue to be subject to the filing requirements of Rule 5110.<sup>20</sup> Additionally, as in the Rule currently, a public offering in which a QIU participates would be required to meet proposed 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. FINRA staff stated that they were unaware of instances where QIUs have made recommendations that were inconsistent with pricing decisions by the book-running lead manager or lead placement agent. In addition, FINRA staff stated that they believe QIU pricing opinions in at-the-market offerings are of little to no value. Both commenters expressed strong support for eliminating the QIU pricing requirement.<sup>21</sup>

## B. Escrow of Proceeds; Net Capital Computation

Proposed Rule 2720(b)(1) would require that all proceeds from a public offering by a member of its securities be placed in a duly established escrow account and 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).<sup>22</sup>

The net capital requirements set forth in proposed Rule 2720(b)(2) mirror current Rule 2720(e)(2), except that FINRA is proposing to replace the reference to Exchange Act Rule 15c3–1(f) with a reference in proposed Rule 2720(b)(2) to the alternative standard for calculating net capital under Exchange Act Rule 15c3–1(a)(1)(ii).

In addition, proposed Rule 2720(b)(3) would require that any member offering its securities pursuant to the proposed Rule disclose in the registration statement, offering circular, or similar document a date by which the offering is reasonably expected to be completed and the terms upon which the proceeds will be released from the escrow account described in paragraph (b)(1). This provision mirrors current Rule 2720(d)(1).

## C. Disclosure

Current Rule 2720(d)(1) 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. Current Rule 2720(d)(2) 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 delete current paragraph (d) of Rule 2720. As discussed above, the proposal would move the disclosure requirements in current paragraph (d)(1) to proposed paragraph (b)(3) and establish separate disclosure requirements for public offerings in which a QIU participates (proposed Rule 2720(a)(2)(B)) and public offerings in which a QIU does not participate (proposed Rule 2720(a)(1)).

## D. Discretionary Accounts

Proposed Rule 2720(c) would prohibit, notwithstanding NASD Rule 2510 (Discretionary Accounts), members that have a conflict of interest from selling 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(I), which also places limitations on sales to discretionary accounts, in that proposed Rule 2720(c) would only apply to the sale of securities by the member with the conflict of interest. Current Rule 2720(I) limits 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.<sup>23</sup> FINRA has clarified that the “specific written approval” requirement in this provision could be satisfied by an e-mail from the customer.

## E. Application of Rule 5110

As noted above, proposed Rule 2720(d) would provide that any public offering subject to the QIU requirements of paragraph (a)(2) would also be subject to Rule 5110, whether or not the offering would otherwise be exempted from Rule 5110’s filing or other requirements. Rule 5110 generally requires members to file with FINRA public offerings for review of the proposed underwriting terms and arrangements. Rule 5110 contains certain exemptions from the filing requirements for, among others, public offerings of the securities of seasoned issuers and offerings of investment grade debt.<sup>24</sup> However, pursuant to

<sup>23</sup> ABA Letter.

<sup>24</sup> The “seasoned issuer” filing exemption in Rule 5110(b)(7)(C) currently exempts offerings registered on Forms S–3 and F–3 by issuers that meet the standards for those Forms prior to October 21, 1992 (*i.e.*, a three-year reporting history and either \$150 million float or \$100 million float and annual

<sup>18</sup> The requisite qualifications of a QIU are set forth in the definition of “qualified independent underwriter” in proposed Rule 2720(f)(12), which is discussed in greater detail below.

<sup>19</sup> ABA Letter; SIFMA Letter.

<sup>20</sup> See proposed Rule 2720(d).

<sup>21</sup> ABA Letter; SIFMA Letter.

<sup>22</sup> Members are reminded that additional escrow account maintenance and payment requirements may be applicable under Exchange Act Rule 15c2–4.

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 5110, if a member participating in the offering has a conflict of interest with the seasoned issuer, it must be filed and comply with Rule 5110. The proposed rule change would narrow 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,<sup>25</sup> FINRA proposed to amend current Rule 5110(b)(7), which lists offerings that are exempt from the Rule 5110 filing requirements, to specify that documents and information related to the public offerings listed in Rule 5110(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 5110(b)(7) is subject to Rule 2720(a)(1), such offering would not be subject to the filing requirements of Rule 5110.

#### F. Requests for Exemption From Rule 2720

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

#### G. Definition of "Affiliate"

Proposed Rule 2720(f)(1) would define 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 proposed instead to adopt a separate definition of "control," which is discussed below.

In response to comments on the original proposal,<sup>26</sup> FINRA 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

trading volume of three million shares). The proposed shelf amendments (*see supra* note 14) would preserve the current filing requirements and amend the Rule to specifically describe the pre-October 21, 1992 standards.

<sup>25</sup> SIFMA Letter.

<sup>26</sup> ABA Letter.

applied where an entity was under common control with *another entity* that controls, was controlled by or was under common control with a member.

#### H. Definition of "Beneficial Ownership"

Proposed Rule 2720(f)(2) would define "beneficial ownership" as the right to the economic benefits of a security. This provision mirrors the definition contained in current Rule 2720(b)(2). In NASD *Notice to Members* 06-52, FINRA requested comment on whether Rule 2720 should incorporate the definition of "beneficial ownership" found in Exchange Act 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,<sup>27</sup> FINRA is proposing to retain the current definition of "beneficial ownership."

#### I. Definition of "Common Equity"

Proposed Rule 2720(f)(4) would define "common equity" as the total number of shares of common stock outstanding without regard to class, whether voting or non-voting, convertible or non-convertible, exchangeable or non-exchangeable, redeemable or non-redeemable, as reflected on the consolidated financial statements of the company. This definition mirrors current Rule 2720(b)(5).

#### J. Definition of "Conflict of Interest"

Proposed Rule 2720(f)(5) would define "conflict of interest" to be the situation where, at the time of a member's participation in an entity's public offering, any of four conditions applies. The proposed Rule would operate much as it does currently. 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)(5)(A), a conflict of interest would exist if the securities are to be issued by the member.

Second, pursuant to proposed Rule 2720(f)(5)(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)(6) and is discussed below.

Third, pursuant to proposed Rule 2720(f)(5)(C), a conflict of interest would exist where at least five percent

of the net offering proceeds, not including underwriting compensation, are intended to be either 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 otherwise directed to the member, its affiliates, and associated persons (in the aggregate). In response to comments on the original proposal,<sup>28</sup> FINRA amended the proposed definition to clarify that the proceeds are net of underwriting compensation.

Currently, Rule 5110(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 proposed to delete Rule 5110(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 would be 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)(5)(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, the member will be an affiliate of the issuer, the member will become publicly owned, or the issuer will become a member or form a broker-dealer subsidiary.

In response to comments on the original proposal,<sup>29</sup> FINRA clarified that for purposes of Rule 2720, "participation in a public offering" has the same meaning as in Rule 5110. Rule 5110(a)(5) provides that "participation or participating in a public offering" means:

Participation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer

<sup>28</sup> SIFMA Letter.

<sup>29</sup> *Id.*

<sup>27</sup> *Id.*

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 [Exchange Act] Rule 13e-3.<sup>30</sup>

#### K. Definition of "Control"

As noted above, under the current Rule, the control standard is incorporated in the definition of "affiliate." The proposal would create a separate definition of "control," which would be defined as any of the following: (1) Beneficial ownership of ten percent or more of the outstanding common equity of an entity, including any right to receive such securities within 60 days of the member's participation in the public offering;<sup>31</sup> (2) The right to ten percent or more of the distributable profits or losses of an entity that is a partnership, including any right to receive an interest in such distributable profits or losses within 60 days of the member's participation in the public offering;<sup>32</sup> (3) Beneficial ownership of ten percent or more of the outstanding subordinated debt of an entity, including any right to receive such subordinated debt within 60 days of the member's participation in the public offering;<sup>33</sup> (4) Beneficial ownership of ten percent or more of the outstanding preferred equity of an entity, including any right to receive such preferred equity within 60 days of the member's participation in the public offering;<sup>34</sup> or (5) The power to direct or cause the direction of the management or policies of an entity.<sup>35</sup> FINRA believed it was important in subparagraph (i) to include entities other than corporations in order to expressly include conflicts that may arise in connection with the offerings of, for example, trusts.

FINRA had originally proposed that the definition of control would eliminate ownership of subordinated debt and preferred equity as a basis for a conflict of interest.<sup>36</sup> However, in response to comments from Commission staff, FINRA proposed to include beneficial ownership of ten percent or

more of the outstanding common equity (which is defined expressly to include non-voting stock), subordinated debt or preferred equity in the proposed definition of control. Thus, for example, "control" could derive from the restrictive covenants typically found in debt indentures, preferred rights to dividends given to holders of non-voting common or preferred stock or special voting rights given to certain classes of (generally) non-voting stock. While FINRA specifically requested comment on whether such forms of ownership give rise to a conflict of interest and should be included in the proposed rule, no comments were received in regards to this filing.

The proposed definition of control would not only include shares beneficially owned by a participating member, but also the right to receive such securities within 60 days of the member's participation in the public offering. In its original filing of September 6, 2007, FINRA proposed that for purposes of this provision, 60 days would be from the effective date of the offering. However, in Amendment No. 1, FINRA revised the proposed rule text to provide that the relevant time frame is "within 60 days of the member's participation in the public offering."<sup>37</sup> This would ensure that the Rule properly applies to takedowns from an effective shelf registration. FINRA stated their belief that the determination of control should be when the member participates in an offering, not the date that a registration statement for the offering is declared effective.

Thus, under the proposed rule change, warrants or rights for voting securities that are exercisable within 60 days of the member's participation in 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, FINRA clarified that in calculating the percentage beneficial ownership, it would be appropriate to include the potential ownership of shares in both the numerator and denominator.<sup>38</sup> FINRA did not believe, however, that this calculation should include securities that could be received by all investors. Rather, FINRA clarified

that the calculation would be limited to warrants or rights that are exercisable within 60 days and received by the participating member only and would not include warrants or rights held by other investors.

#### L. Definition of "Entity"

Currently, Rule 2720 does not contain a definition of "entity." Pursuant to proposed Rule 2720(f)(7), 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: (1) An investment company registered under the Investment Company Act of 1940 ("Investment Company Act");<sup>39</sup> (2) A "separate account" as defined in Section 2(a)(37) of the Investment Company Act;<sup>40</sup> (3) A "real estate investment trust" as defined in Section 856 of the Internal Revenue Code;<sup>41</sup> and (4) A "direct participation program" as defined in NASD Rule 2810.<sup>42</sup> 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,<sup>43</sup> FINRA revised the proposed definition of "conflict of interest" to apply only to a public offering of an "entity."

#### M. Definition of "Preferred Equity"

Proposed Rule 2720(f)(9) would define the term "preferred equity" as the aggregate capital invested by all persons in the preferred securities outstanding without regard to class, whether voting or non-voting, convertible or non-convertible, exchangeable or non-exchangeable, redeemable or non-redeemable, as reflected on the consolidated financial statements of the company. This definition mirrors current Rule 2720(b)(12).

#### N. Definition of "Public Offering"

Proposed Rule 2720(f)(11) is substantively similar to 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

<sup>30</sup> Rule 5110(a)(5). Pursuant to the proposed shelf amendments (*see supra* note 15), this definition in former NASD Rule 2710 (which has since been moved to the Consolidated FINRA Rulebook as Rule 5110) would be amended to specify participation in the distribution of the offering on an "underwritten, non-underwritten, principal, agency or any other basis" and to include "participation in a shelf takedown."

<sup>31</sup> Proposed Rule 2720(f)(6)(A)(i). The term "beneficial ownership" is defined in proposed paragraph f(2).

<sup>32</sup> Proposed Rule 2720(f)(6)(A)(ii).

<sup>33</sup> Proposed Rule 2720(f)(6)(A)(iii).

<sup>34</sup> Proposed Rule 2720(f)(6)(A)(iv).

<sup>35</sup> Proposed Rule 2720(f)(6)(A)(v).

<sup>36</sup> *See* current Rule 2720(b)(7)(A) and (C).

<sup>37</sup> For purposes of Rule 2720, "participation in a public offering" has the same meaning as in Rule 5110(a)(5). *See supra* for further discussion of the definition of the term "participation in a public offering."

<sup>38</sup> *See* ABA Letter (requesting that FINRA clarify whether the amount of securities to be received by a member and any other person within 60 days of the offering will be included in the denominator in order to calculate the member's total ownership interest in the issuer's securities).

<sup>39</sup> Proposed Rule 2720(f)(7)(B)(i).

<sup>40</sup> Proposed Rule 2720(f)(7)(B)(ii).

<sup>41</sup> Proposed Rule 2720(f)(7)(B)(iii).

<sup>42</sup> Proposed Rule 2720(f)(7)(B)(iv).

<sup>43</sup> SIFMA Letter.

to a merger or acquisition and all other securities offerings of any kind whatsoever. The proposed definition excludes from its scope any offering made pursuant to an exemption from registration under Sections 4(1), 4(2) or 4(6) of the Securities Act of 1933 ("Securities Act"),<sup>44</sup> Securities Act Rule 504, if the securities are "restricted securities" under Securities Act Rule 144(a)(3), Securities Act Rule 505, or Securities Act Rule 506, and Securities Act Rule 144A or Regulation S. FINRA currently does not interpret an offering made pursuant to Regulation S to be within the scope of a "public offering" under this Rule and as such, proposed also to exclude these offerings from the definition. Additionally, in response to comments on the original proposal,<sup>45</sup> FINRA amended the proposed definition of "public offering" to expressly exclude exempted securities as defined in Section 3(a)(12) of the Exchange Act,<sup>46</sup> as in the current Rule.

One commenter suggested that the proposed rule should provide an express exclusion for offerings made pursuant to Securities Act Rule 144A.<sup>47</sup> FINRA agreed and added an express exclusion for offerings under Securities Act Rule 144A. FINRA also noted that it currently does not interpret an offering made pursuant to Securities Act Rule 144A to be within the scope of either Rule 5110 or Rule 2720.

#### *O. Definition of "Qualified Independent Underwriter"*

Proposed Rule 2720(f)(12) defines the term "qualified independent underwriter" as a member that meets five specified conditions. Specifically, the member must first not have a conflict of interest and must not be an affiliate of any member that has a conflict of interest.<sup>48</sup> 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."

The second condition for being considered a QIU in the proposed Rule is the member could not beneficially own, as of the date of the member's participation in the public offering, more than five percent 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.<sup>49</sup> 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 these prohibitions.

Third, the member would need to have agreed, in acting as a QIU, to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act, specifically including those inherent in Section 11 thereof.<sup>50</sup> The proposed provision mirrors current Rule 2720(b)(15)(F).

Fourth, the member would need to 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 or the date of first sale in an offering for which there is no registration statement.<sup>51</sup> This requirement would be deemed satisfied if, during the past three years, the member, 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. With respect to a proposed public offering of equity securities, this requirement would be deemed satisfied if, during the past three years, the member 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. While FINRA specifically requested comment on whether the 50% threshold should be lowered if an equity offering is particularly large (e.g., over \$1 billion), no comments were received in regards to the filing. The proposed requirements would be similar those set forth in current Rule 2720(b)(15)(C). The proposal would, however, shorten the relevant period from five to three years and would impose, as discussed above, the 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 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 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 believed that the experience of the firm is more relevant.

The fifth and final condition for being considered a QIU in the proposed Rule would be that 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 could not have certain criminal or disciplinary histories.<sup>52</sup> These associated persons could not 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. These associated persons also could not 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. Finally, these associated persons could not have been suspended or barred from association with any member by an order or decision of the Commission, any state, FINRA, 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

<sup>44</sup> 15 U.S.C. 77d(1), (2), and (6).

<sup>45</sup> ABA Letter.

<sup>46</sup> 15 U.S.C. 78c(a)(12).

<sup>47</sup> ABA Letter.

<sup>48</sup> Proposed Rule 2720(f)(12)(A).

<sup>49</sup> Proposed Rule 2720(f)(12)(B).

<sup>50</sup> Proposed Rule 2720(f)(12)(C).

<sup>51</sup> Proposed Rule 2720(f)(12)(D).

<sup>52</sup> See proposed Rule 2720(f)(12)(E).

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. 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.

#### *P. Definition of "Registration Statement"*

Proposed Rule 2720(f)(13) would define the term "registration statement" as a registration statement as defined by Section 2(a)(8) of the Securities Act,<sup>53</sup> notification on Form 1A filed with the Commission pursuant to the provisions of Securities Act Rule 252, or any other document, by whatever name known, initiating a registration or similar process for an issue of securities which is required to be filed by the laws or regulations of any federal or state agency. This definition mirrors current Rule 2720(b)(16), except for technical changes to correct the references in the current Rule to Securities Act Section 2(8) and Securities Act Rule 255.

#### *Q. Definition of "Subordinated Debt"*

Proposed Rule 2720(f)(14) would define "subordinated debt" to include debt of an issuer which is expressly subordinate in right of payment to (or with a claim on assets subordinate to) any existing or future debt of such issuer or all debt that is specified as subordinated at the time of issuance. Subordinated debt would not include short-term debt with maturity at issuance of less than one year and secured debt and bank debt not specified as subordinated debt at the time of issuance. This definition mirrors current Rule 2720(b)(18).

#### *R. Deleted Definitions*

Proposed Rule 2720 would not include definitions for some terms that appear in current Rule 2720. These would be the definitions for "company," "effective date," "immediate family," "parent," "person," "public director," and "settlement." In response to comments on the original proposal,<sup>54</sup> FINRA proposed to adopt the current Rule 2720 definitions of "company," "effective

date," "immediate family," and "person" as new paragraphs (a)(11) through (14) of Rule 5110 because they are used in that rule. Proposed Rule 2720(f) provides that the definitions in Rule 5110 are incorporated by reference in Rule 2720.

#### *S. 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, public directors, and to issue periodic reports to shareholders.<sup>55</sup> With the enactment of the Sarbanes-Oxley Act of 2002 and recent SEC rulemaking and interpretive actions, FINRA enunciated its belief that issuers' periodic reporting requirements under the Exchange Act have been enhanced and listing standard changes intended to improve corporate governance and enhance the role of audit committees have been adopted. Accordingly, FINRA decided that separate Rule 2720 requirements for corporate governance and periodic reporting would be unnecessary. One commenter expressed support for eliminating these provisions from Rule 2720.<sup>56</sup>

#### *T. 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 Commission published in 1972. The proposed amendments would delete this requirement from Rule 2720. FINRA stated their belief that disclosure requirements for unregistered offerings should be addressed in a more comprehensive manner by the Commission, 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.<sup>57</sup>

#### *U. 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 did not propose a similar provision in proposed Rule 2720 because NASD Rule 2310 already addresses a member's obligations relating to suitability.

### **III. Discussion and Findings**

After careful review of the proposed rule change, the Commission finds that the proposed rule change is consistent with the requirements of the Act, and the rules and regulations thereunder that are applicable to a national securities association.<sup>58</sup> In particular, the Commission believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>59</sup> which requires, among other things, that FINRA rules 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. The Commission believes that FINRA has substantially streamlined the Rule thus enhancing its members' ability to comply with the rule while maintaining investor protections. The Rule, as amended in the proposal, continues regulation that protects investors in offerings where the member has a conflict of interest.

### **IV. Conclusion**

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>60</sup> that the proposed rule change (File No. SR-FINRA-2007-009), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority,<sup>61</sup>

**Florence E. Harmon,**  
*Deputy Secretary.*

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### **SOCIAL SECURITY ADMINISTRATION**

**[Docket No. SSA-2009-0033]**

#### **Occupational Information Development Advisory Panel Meeting**

**AGENCY:** Social Security Administration (SSA).

<sup>58</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>59</sup> 15 U.S.C. 78o-3(b)(6).

<sup>60</sup> 15 U.S.C. 78s(b)(2).

<sup>61</sup> 17 CFR 200.30-3(a)(12).

<sup>53</sup> 15 U.S.C. 77b(a)(8).

<sup>54</sup> ABA Letter.

<sup>55</sup> See current Rule 2720(f), (g), and (h).

<sup>56</sup> ABA Letter.

<sup>57</sup> *Id.*