

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59880; File No. SR-FINRA-2007-009)

May 7, 2009

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto to Modernize and Simplify NASD Rule 2720

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on September 6, 2007, Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) filed with the Securities and Exchange Commission (“SEC” or “Commission”), and amended on May 1, 2009,³ the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing 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”).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 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).

Amendment No. 1 to SR-FINRA-2007-009 makes certain changes to the original filing of September 6, 2007 to address the Commission staff's comments. The proposed rule change replaces and supersedes the proposed rule change filed on September 6, 2007 in its entirety, except with regard to Exhibit 2, NASD Notice to Members 06-52 and comments received in response to NASD Notice to Members 06-52.

The text of the proposed rule change is available on FINRA's Web site at <http://www.finra.org>, at the principal office of FINRA and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

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.⁴ 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.” Some of the more significant amendments that FINRA is proposing in this proposed rule change are to: (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 focus on the QIU’s due diligence responsibilities and eliminate the

⁴ 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”).

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 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 Generally

Proposed Rule 2720(a) provides 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).

b. Offerings Exempt from the QIU and Filing Requirements under Paragraph (a)(1)

First, FINRA is proposing 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).⁵ FINRA staff believes 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

⁵ See proposed Rule 2720(a)(1)(A).

necessary due diligence that would otherwise be required of a QIU.⁶

In response to comments on the original proposal,⁷ FINRA has 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, each would need to be free of conflicts of interest. 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.

Second, FINRA is proposing an exemption from the QIU and filing requirements for public offerings of securities that have a bona fide public market.⁸ 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.⁹ 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

⁶ 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.

⁷ SIFMA Letter.

⁸ See proposed Rule 2720(a)(1)(B).

⁹ "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.

numerical standards set forth in SEC’s Regulation M.¹⁰ Specifically, “bona fide public market” is 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.”¹¹

Third, FINRA is proposing to exempt from the filing requirement, and to retain the existing exemption from the QIU requirement for, public offerings of investment grade rated securities and securities in the same series that have equal rights and obligations as investment grade rated securities.¹² In response to comments on the original proposal,¹³ FINRA has 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

¹⁰ 17 CFR 242.100 to 105.

¹¹ ABA Letter.

¹² 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.

¹³ ABA Letter.

shelf amendments”).¹⁴

The three types of public offerings 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).¹⁵ 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.¹⁶ Proposed Rule 2720(f)(10) provides a description of how a member may make “prominent disclosure” for purposes of paragraphs (a)(1) and (a)(2)(B). Specifically, a member could make the notation “(Conflicts of Interest)” following the listing of the Plan of Distribution in the

¹⁴ 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>.

¹⁵ 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).

¹⁶ ABA Letter.

Table of Contents section required in Item 502 of SEC 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 SEC Regulation S-K. For offering documents not subject to SEC 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. These methods of disclosure would be considered a non-exclusive safe harbor for effecting “prominent disclosure,” and FINRA would consider alternative – but equally prominent – disclosures on a case-by-case basis.

c. 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.¹⁷

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

¹⁷ 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.

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,¹⁸ FINRA is proposing to replace this disclosure requirement with a more general statement about the role and responsibilities of a QIU.

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 5110.¹⁹ 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 is 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 believes that 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.²⁰

¹⁸ ABA Letter; SIFMA Letter.

¹⁹ See proposed Rule 2720(d).

²⁰ ABA Letter; SIFMA Letter.

d. 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 shall be placed in a duly established escrow account and shall 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).²¹

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) provides that any member offering its securities pursuant to this Rule shall 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).

e. 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).

²¹ Members are reminded that additional escrow account maintenance and payment requirements may be applicable under Exchange Act Rule 15c2-4.

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)).

f. Discretionary Accounts

Proposed Rule 2720(c) provides that, notwithstanding NASD Rule 2510 (Discretionary Accounts), no member that has a conflict of interest would be permitted to sell 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(l), 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(l) 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.²² Additionally, FINRA notes that the “specific written approval” requirement in this provision can be satisfied by an email from the customer.

g. Application of Rule 5110

As noted above, proposed Rule 2720(d) provides that any public offering subject to the QIU requirements of paragraph (a)(2) would be subject to Rule 5110, whether or

²² ABA Letter.

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 issuers²³ and offerings of investment grade debt. However, pursuant to 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,²⁴ FINRA is proposing 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

²³ 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 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.

²⁴ SIFMA Letter.

2720(a)(1), such offering would not be subject to the filing requirements of Rule 5110.

h. Requests for Exemption from Rule 2720

Proposed Rule 2720(e) provides that pursuant to the Rule 9600 Series, FINRA could 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 the proposed Rule that it would deem appropriate. This provision mirrors existing Rule 2720(o).

i. Definition of “Affiliate”

Proposed Rule 2720(f)(1) defines 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 is proposing instead to adopt a separate definition of “control,” which is discussed below.

In response to comments on the original proposal,²⁵ FINRA has 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 applied where an entity was under common control with another entity that controls, was controlled by or was under common control with a member.

j. Definition of “Beneficial Ownership”

Proposed Rule 2720(f)(2) defines “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

²⁵ ABA Letter.

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,²⁶ FINRA is proposing to retain the current definition of “beneficial ownership.”

k. Definition of “Common Equity”

Proposed Rule 2720(f)(4) defines “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).

l. Definition of “Conflict of Interest”

Proposed Rule 2720(f)(5) would define “conflict of interest” to mean if, 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)

²⁶ Id.

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,²⁷ FINRA has 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 is proposing 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 is being 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

²⁷ SIFMA Letter.

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,²⁸ FINRA is clarifying 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 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-3.²⁹

m. Definition of “Control”

As noted above, under the current Rule, the control standard is incorporated in the definition of “affiliate.” The proposal would define “control” as any of: (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

²⁸ Id.

²⁹ Rule 5110(a)(5). Pursuant to the proposed shelf amendments (see supra note 14), 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.”

participation in the public offering;³⁰ (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;³¹ (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;³² (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;³³ or (5) The power to direct or cause the direction of the management or policies of an entity.³⁴ FINRA believes it is 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.³⁵

However, in response to comments from Commission staff, FINRA is now proposing to

³⁰ Proposed Rule 2720(f)(6)(A)(i). The term "beneficial ownership" is defined in proposed paragraph (f)(2). In response to a comment by Commission staff, FINRA is clarifying that the use of the term "beneficial ownership" in proposed paragraph (f)(6) is a more narrow interpretation of the term as compared to the definition in proposed paragraph (f)(2), owing to the numerical thresholds imposed by proposed paragraph (f)(6).

³¹ Proposed Rule 2720(f)(6)(A)(ii).

³² Proposed Rule 2720(f)(6)(A)(iii).

³³ Proposed Rule 2720(f)(6)(A)(iv).

³⁴ Proposed Rule 2720(f)(6)(A)(v).

³⁵ See current Rule 2720(b)(7)(A) and (C).

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. FINRA is specifically requesting comment on whether such forms of ownership give rise to a conflict of interest and should be included in the proposed Rule.

The proposed definition of control includes not only 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.”³⁶ This would ensure that the Rule properly applies to takedowns from an effective shelf registration. FINRA believes 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

³⁶ 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.”

exists. In response to comments on the original proposal, FINRA is clarifying that in calculating the percentage beneficial ownership, it is appropriate to include the potential ownership of shares in both the numerator and denominator.³⁷ FINRA does not believe, however, that this calculation should include securities that could be received by all investors. Rather, 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.

n. 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;³⁸ (2) A “separate account” as defined in Section 2(a)(37) of the Investment Company Act of 1940;³⁹ (3) A “real estate investment trust” as defined in Section 856 of the Internal Revenue Code;⁴⁰ and (4) A “direct participation program” as defined in NASD Rule 2810.⁴¹ These exclusions are

³⁷ 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).

³⁸ Proposed Rule 2720(f)(7)(B)(i).

³⁹ Proposed Rule 2720(f)(7)(B)(ii).

⁴⁰ Proposed Rule 2720(f)(7)(B)(iii).

⁴¹ Proposed Rule 2720(f)(7)(B)(iv).

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,⁴² FINRA revised the proposed definition of “conflict of interest” to apply only to a public offering of an “entity.”

o. Definition of “Preferred Equity”

Proposed Rule 2720(f)(9) defines 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).

p. 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 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”),⁴³ 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

⁴² SIFMA Letter.

⁴³ 15 U.S.C. 77d(1), (2), and (6).

offering made pursuant to Regulation S to be within the scope of a “public offering” under this Rule and as such, is proposing also to exclude these offerings from the definition. Additionally, in response to comments on the original proposal,⁴⁴ FINRA has amended the proposed definition of “public offering” to expressly exclude exempted securities as defined in Section 3(a)(12) of the Exchange Act,⁴⁵ as in the current Rule.

One commenter suggested that the proposed Rule should provide an express exclusion for offerings made pursuant to SEC Rule 144A.⁴⁶ FINRA agrees and has added an express exclusion for offerings under SEC Rule 144A. FINRA also notes that it currently does not interpret an offering made pursuant to SEC Rule 144A to be within the scope of either Rule 5110 or Rule 2720.

q. Definition of “Qualified Independent Underwriter”

Proposed Rule 2720(f)(12) defines the term “qualified independent underwriter” as a member that meets the certain conditions. First, the member must not have a conflict of interest and must not be an affiliate of any member that has a conflict of interest.⁴⁷ 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

⁴⁴ ABA Letter.

⁴⁵ 15 U.S.C. 78c(a)(12).

⁴⁶ ABA Letter.

⁴⁷ Proposed Rule 2720(f)(12)(A).

member cannot 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.⁴⁸ 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 must 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.⁴⁹ The proposed provision mirrors current Rule 2720(b)(15)(F).

Fourth, the member must 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.⁵⁰ This requirement will 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 will be deemed satisfied if, during the past three years, the member has acted as sole underwriter or book-running lead or

⁴⁸ Proposed Rule 2720(f)(12)(B).

⁴⁹ Proposed Rule 2720(f)(12)(C).

⁵⁰ Proposed Rule 2720(f)(12)(D).

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. FINRA is specifically requesting comment on whether the 50% threshold should be lowered if an equity offering is particularly large (e.g., over \$1 billion). The proposed requirements are 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 believes that the experience of the firm is more relevant.

The final condition for being considered a QIU in the proposed Rule is 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 cannot have certain criminal or disciplinary histories.⁵¹ These associated persons cannot have been convicted within ten years prior to the filing of the

⁵¹ See proposed Rule 2720(f)(12)(E).

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 cannot 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 cannot 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 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.

r. Definition of “Registration Statement”

Proposed Rule 2720(f)(13) defines the term “registration statement” as a registration statement as defined by Section 2(a)(8) of the Securities Act,⁵² 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.

s. Definition of “Subordinated Debt”

Proposed Rule 2720(f)(14) defines “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 shall 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).

t. Deleted Definitions

Proposed Rule 2720 does not contain definitions of the following terms that appear in current Rule 2720: “company,” “effective date,” “immediate family,” “parent,” “person,” “public director,” and “settlement.” In response to comments on the original

⁵² 15 U.S.C. 77b(a)(8).

proposal,⁵³ FINRA is proposing to adopt the current 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.

u. 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.⁵⁴ With the enactment of the Sarbanes-Oxley Act of 2002 and recent SEC rulemaking and interpretive actions, FINRA believes 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, at this time, FINRA believes that separate Rule 2720 requirements for corporate governance and periodic reporting are unnecessary. One commenter expressed support for eliminating these provisions from Rule 2720.⁵⁵

v. 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 believes

⁵³ ABA Letter.

⁵⁴ See current Rule 2720(f), (g), and (h).

⁵⁵ ABA Letter.

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.⁵⁶

x. 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 is not proposing a similar provision in new Rule 2720 because NASD Rule 2310 already addresses a member's obligations relating to suitability.

FINRA will announce the implementation date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The implementation date will be 30 days following publication of the Regulatory Notice announcing Commission approval.

⁵⁶ Id.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁵⁷ which requires, among other things, that FINRA rules must 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. FINRA believes that the proposed rule change will simplify and modernize Rule 2720, thereby providing greater clarity regarding members' obligations and enhancing the regulation of public offerings in which members have a conflict of interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in NASD Notice to Members 06-52 (September 2006). Two comments were received in response to the Notice. A copy of the Notice is attached as Exhibit 2a. A list of the comment letters received in response to the Notice is attached as Exhibit 2b. Copies of the comment letters received in response to the Notice are attached as Exhibit 2c. Those comments that have not already been addressed herein are discussed below.⁵⁸

⁵⁷ 15 U.S.C. 78o-3(b)(6).

⁵⁸ In addition, FINRA has incorporated some of the commenters' non-substantive comments without specifically addressing them herein, e.g., comments regarding inconsistent use of the terms "entity," "company" and "issuer." See ABA Letter.

Comments on the Scope of Proposed Rule 2720

Both commenters suggested revising proposed Rule 2720(a)(1) to include additional categories of public offerings that would be exempt from the QIU and filing requirements by operation of proposed Rule 2720(d). As discussed in greater detail below, FINRA does not agree that the exemptions should be expanded further. FINRA notes that, as proposed, the Rule would significantly reduce the number of public offerings that must be filed and reviewed by FINRA staff. A public offering (that is not an offering of investment grade rated securities or securities with a bona fide public market) will be subject to the QIU and filing requirements under Rule 2720 only if a member with primary responsibility for managing the offering has a conflict of interest. As such, FINRA does not believe that it would be appropriate to further expand the automatic exemptions under the Rule, as suggested by the commenters.

Specifically, the commenters suggested that paragraph (a)(1) of the proposed Rule should include “well-known seasoned issuers” or “WKSI.”⁵⁹ The commenters contend that such a change would be consistent with the proposed shelf amendments, which proposes exempt all WKSI shelf offerings from the filing requirements of the predecessor to Rule 5110.⁶⁰ FINRA does not agree. FINRA believes that if a participating member has a conflict of interest, the offering should be subject to the QIU and filing requirements, irrespective of whether the issuer involved is a WKSI. Today, a WKSI that

⁵⁹ ABA Letter; SIFMA Letter. See also Securities Act Rule 405 (defining WKSI); Exchange Act Release No. 52056 (July 19, 2005), 70 FR 44722 (August 3, 2005) (adopting the WKSI definition).

⁶⁰ ABA Letter; SIFMA Letter. The proposed shelf amendments were proposed to amend NASD Rule 2710, which has since been moved to the Consolidated FINRA Rulebook as Rule 5110. See supra note 15.

is not required to file under Rule 5110 would nonetheless be required to obtain a QIU if it were to receive ten percent of the offering proceeds.⁶¹ In addition, FINRA does not agree that application of Rule 2720 to WKSIs would slow the offering process.⁶² Currently, all WKSI filings are reviewed and cleared on the same day they are received by FINRA's Corporate Financing Department. In connection with the proposed shelf amendments, FINRA is developing upgrades to the COBRADesk electronic filing system that will implement a new same-day automatic review and clearance process for most shelf offerings and all WKSI shelf offerings.⁶³

Similarly, one commenter suggested that public offerings by issuers with investment grade rated debt, which are currently exempted by Rule 5110(b)(7)(A), should be included in proposed Rule 2720(a)(1).⁶⁴ FINRA does not agree. The proposed rule change is designed to focus on the particular public offering in which a member has a conflict of interest. FINRA believes that while it is appropriate to exempt certain public offerings from the Rule, it would be inappropriate to exempt an entire class of issuers such as WKSIs or all issuers with investment grade rated debt. The relevant inquiry is whether the member has a conflict of interest with respect to that offering of that security; the characteristics of the issuer should not be determinative. As such, FINRA also does not agree with the commenter that proposed paragraphs (a)(1)(B) and (C) should be

⁶¹ See Rule 5110(h) and current Rule 2720(m).

⁶² SIFMA Letter.

⁶³ See supra note 14.

⁶⁴ SIFMA Letter.

amended to refer to the issuer of the securities, instead of the securities being offered.⁶⁵

One commenter suggested that the exception under proposed Rule 2720(a)(1)(B) should be available for public offerings of warrants, options, convertible debt and convertible preferred securities that are exercisable for or convertible into equity securities that meet the standard of having a bona fide public market.⁶⁶ FINRA does not believe that such an exemption would be appropriate because the characteristics of the derivative will not always be the same as the underlying security. The existence of a bona fide public market in the underlying equity security does not necessarily extend to an offering of a derivative on that security.

One commenter also suggested that there should be an exception for offerings by banks and other financial institutions that are the parents or affiliates of FINRA members of medium-term notes or similar securities, the return of which is linked to the performance of a particular stock, asset or index.⁶⁷ While an offering of these securities that are rated investment grade would be exempted under the proposed Rule, FINRA believes that an offering of such securities rated below investment grade should continue to be subject to the filing and QIU requirements. FINRA believes that an exemption for offerings of structured products rated below investment grade would be inconsistent with concerns expressed by FINRA about these securities.⁶⁸ However, to avoid potential

⁶⁵ Id.

⁶⁶ ABA Letter.

⁶⁷ Id.

⁶⁸ See NASD Notice to Members 05-59 (September 2005). The Notice stated that FINRA is concerned that when members sell structured products, they may not be

unintended consequences of the proposed Rule, FINRA is specifically requesting comment on whether certain other types of securities that are registered on a shelf registration statement or automatic shelf registration statement should be eligible for the exemption from the filing and QIU requirements.

Both commenters suggested that the reorganizations, mergers and acquisition transactions that are currently exempted by Rule 2720(a)(3) should be exempted under proposed Rule 2720(a)(1).⁶⁹ FINRA believes that unless a reorganization, merger or acquisition would otherwise meet the proposed Rule 2720(a)(1) exemptions, it should be subject to the QIU and filing requirements. The Rule currently applies to these transactions if the member or its parent issues shares or the transaction results in the public ownership of a member. Thus, there is not currently a blanket exemption for reorganizations, mergers and acquisitions.

One commenter also suggested that the proposed Rule should exempt all offerings by government entities.⁷⁰ FINRA has proposed to exclude certain government entities from the filing requirements of Rule 5110 pursuant to the proposed shelf amendments.⁷¹ However, FINRA does not agree that all such offerings should be excluded under Rule

fulfilling their sales practice obligations, including the requirement to perform a reasonable-basis and customer-specific suitability determination. The Notice also raised specific concerns about member sales practice obligations when selling these instruments to retail customers. The Notice added that structured products have been increasingly targeted at retail investors and that FINRA is concerned about the manner in which such products are marketed and the types of investors purchasing such products.

⁶⁹ ABA Letter; SIFMA Letter.

⁷⁰ SIFMA Letter.

⁷¹ See supra note 14.

2720. If a member has a conflict of interest with a government entity (e.g., the member will receive at least five percent of the net proceeds of the public offering) and the public offering does not otherwise meet the Rule 2720(a)(1) exemptions, FINRA believes that the offering documents should be filed and reviewed by FINRA staff.

One commenter suggested that offerings of securities exempt from registration with the Commission under Section 3(a)(4) of the Securities Act of 1933 should be exempt under proposed Rule 2720(a)(1), noting that such offerings currently are exempted from the conflict of interest provisions of Rule 2720.⁷² While FINRA is not aware of member conflicts with non-profit or charitable organizations, in the unlikely event that such a conflict does exist, FINRA believes that the offering should be filed and reviewed by FINRA staff.

This same commenter also suggested that proposed Rule 2720(a)(1) should exclude offerings conducted pursuant to the multi-jurisdictional disclosure system because they are already subject to regulation under the Canadian system.⁷³ FINRA does not agree that it should remove itself from public offerings in which a FINRA member with a conflict of interest is participating, even if such offerings also are subject to regulation under the Canadian system.

Finally, with respect to proposed Rule 2720(a)(1)(A), one commenter suggested amending the provision to apply to any book-running manager, including co- or joint book-running managers, such that a QIU would not be required if any of the joint book-

⁷² SIFMA Letter.

⁷³ Id.

runners could meet the requirements of the Rule.⁷⁴ FINRA does not agree that the provision should be expanded in this way. FINRA understands that in some joint book offerings, members have been designated as a joint book-runner or co-lead manager in return for assistance with the road show or other services critical to marketing the offering. In some cases, the member designated as a co-lead would not be in the position of supervising due diligence for the offering or may not be involved in the due diligence at all. FINRA staff does not believe that including a book-runner or lead placement agent without a conflict of interest eliminates the conflict that exists with respect to the remaining book-runner(s) or lead placement agent(s). Therefore, amending the proposed provision as the commenter suggests would not fulfill the objective of ensuring independent due diligence by a member free of conflicts.

Comments on Proposed QIU Requirements

One commenter suggested that the references to “due diligence” and “usual standards of due diligence” should be eliminated from the Rule, expressing concern that such references could raise the due diligence defense to the level of a regulatory requirement.⁷⁵ The requirement that a QIU exercise the usual standards of due diligence has been in the Rule for 20 years and FINRA believes that it is an appropriate regulatory requirement.⁷⁶ However, as discussed above, in response to comments, as well as similar concerns expressed by FINRA’s Corporate Financing Committee, FINRA has eliminated the proposal to require that the offering documents include a statement that the QIU has assumed responsibilities for conducting due diligence.

⁷⁴ Id.

⁷⁵ Id.

⁷⁶ See, e.g., current Rule 2720(c)(3)(A) and (d)(2).

The commenters also suggested that offerings in which a QIU participates should be exempt from the filing requirements of Rule 5110.⁷⁷ FINRA does not believe that the participation of a QIU in an offering sufficiently mitigates the conflicts of interest such that FINRA review is no longer necessary. Additionally, pursuant to current Rule 2720(m), the Rule 5110 filing requirements apply to all public offerings subject to Rule 2720, including public offerings in which a QIU has participated. Thus, the proposed rule change would not expand the current filing requirements.

Comments on the Proposed Discretionary Accounts Provision

One commenter⁷⁸ suggested that the Rule should be revised to incorporate the advance authorization procedure in FINRA's Corporate Financing Department's exemption letter to Goldman Sachs (the "Goldman Letter").⁷⁹ The Goldman Letter applies to public offerings of straight debt securities, structured notes and straight preferred stock issued by Goldman or its affiliates and permits the firm to use an advance authorization procedure in lieu of the requirement in Rule 2720 for prior specific written approval. Specifically, the firm could obtain an advance written letter of consent from certain customers with discretionary accounts and oral authorization by the customer prior to execution of the transaction. FINRA does not believe that Rule 2720 should expressly incorporate the advance authorization procedure set forth in the Goldman Letter. As discussed above, the written authorization requirements of this provision can

⁷⁷ ABA Letter; SIFMA Letter.

⁷⁸ ABA Letter.

⁷⁹ See letter to Judith G. Belash, Esq., Goldman, Sachs & Co., from Joseph Price, NASD, Corporate Financing Department, dated June 14, 1999, available at <http://www.finra.org/Industry/Regulation/Guidance/ExemptiveLetters/P002617>.

be satisfied by email, which today may often prove quicker and easier than obtaining oral authorization.

Additionally, this commenter suggested that public offerings in which proceeds are being directed to a member should be exempted from the discretionary account provision.⁸⁰ FINRA does not agree. FINRA believes that the receipt of offering proceeds by members and their affiliates gives rise to conflicts that are of equal concern in the context of sales to a discretionary account.

Comments on the Proposed Definition of “Affiliate”

One commenter suggested that the definition of “affiliate” should be structured similar to the current definition as a control standard and a presumption of control as a result of management or share ownership.⁸¹ FINRA recognizes that there are other ways to define “affiliate.” However, this commenter has not demonstrated that its recommended approach is better than the approach FINRA is proposing.

Comments on the Proposed Definition of “Bona Fide Public Market”

The commenters suggested that the definition of “bona fide public market” should be amended to apply to equity securities of foreign issuers that meet the “actively traded” standards of Regulation M and are designated offshore securities markets under Rule 902(b).⁸² Upon further consideration, FINRA is not proposing to amend the definition along these lines. Because securities with a bona fide public market are not subject to the QIU or filing requirements, amending the definition to apply to securities traded on a

⁸⁰ ABA Letter.

⁸¹ Id.

⁸² Id.; SIFMA Letter.

foreign market would make this exemption too broad.

One commenter also suggested that the definition should be amended to clarify that the issuer – and not the particular security – must have a bona fide public market.⁸³ FINRA does not agree. As discussed above, the focus of this Rule is on the securities being offered and not the characteristics of the issuer.

Comments on the Proposed Definition of “Conflict of Interest”

The commenters suggested that there should be no filing requirement for public offerings in which the conflict of interest derives from the member’s receipt of proceeds.⁸⁴ One commenter asserted that “NASD has historically deemed a conflict of interest based on the receipt of offering proceeds by participating members to be a less significant conflict than one that is based on the ownership of an issuer’s securities or management control.”⁸⁵ FINRA does not agree and believes that the conflict deriving from a member’s receipt of proceeds warrants review and filing of the offering documents. Indeed, FINRA’s Corporate Financing Committee has identified conflicts resulting from proceeds being directed to a member as one of the most important conflicts in public offerings today. Pursuant to the proposed rule change, all public offerings in which a QIU is involved – including those for which a QIU is required because proceeds are being directed to a member or its affiliate – must be filed and reviewed by FINRA staff.

Additionally, both commenters assert that the five percent threshold for a

⁸³ SIFMA Letter.

⁸⁴ ABA Letter; SIFMA Letter.

⁸⁵ ABA Letter.

member's receipt of offering proceeds is too low.⁸⁶ FINRA does not agree and believes that in recognition of the significance of proceeds-related conflicts, it is appropriate to lower the threshold from ten percent to five percent.

One commenter suggested that the proposed definition of "conflict of interest" should exclude transactions by which the issuer will become a member or form a broker-dealer subsidiary.⁸⁷ This commenter also suggested that the definition be revised to exclude reorganizations and restructurings if no material change in the ownership of the issuer or participating member is taking place.⁸⁸ FINRA does not agree that merely because the corporate governance provisions have been deleted from the Rule, a member's participation in such offerings no longer creates a conflict of interest. FINRA believes that these offerings should be subject to the Rule.

This commenter also suggested that the old formulation in which conflicts of interest existed under specific circumstances, rather than as a result of a member's participation in public offerings where certain conditions apply, should be retained because it was easier for members to argue that no conflict actually exists.⁸⁹ FINRA does not agree and believes that the proposed definition of "conflicts of interest" is preferable in that it clearly delineates the scope of the Rule.

The commenters suggested that the definition should not apply to arms length forward sales contracts and other derivatives where the proceeds are used by the issuer to

⁸⁶ ABA Letter; SIFMA Letter.

⁸⁷ SIFMA Letter.

⁸⁸ Id.

⁸⁹ Id.

purchase the securities to hedge risk in the transactions.⁹⁰ FINRA is requesting further comment on this issue and specifically how use of the proceeds by the issuer to buy derivatives or other hedging transactions is substantially different from other uses of proceeds contemplated by the Rule (e.g., to retire debt).

Comments on the Proposed Definition of “Control”

One commenter suggested that “control” should not be a defined term because an entity that is in a control relationship is an affiliate and thus, the control concept should remain in the definition of “affiliate.”⁹¹ As previously noted, FINRA recognizes that there are other ways to approach the definitions and standards set forth in this Rule. However, FINRA does not believe that the approach the commenter has proposed is preferable to that outlined above.

Comments on the Proposed Definition of “Entity”

One commenter suggested that the proposed definition of “entity” be amended to include groups of persons only if they are organized to conduct business under the laws of a jurisdiction.⁹² FINRA does not agree and believes that more flexibility is needed given that FINRA is not proposing to define “beneficial ownership” in accordance with Exchange Act Rule 13d-3.

Comments on the Proposed Definition of “Public Offering”

One commenter reiterated its concern, also expressed in response to FINRA’s proposed shelf amendments, that Rules 5110 and 2720, and NASD Rule 2810, should not

⁹⁰ ABA Letter; SIFMA Letter.

⁹¹ ABA Letter.

⁹² Id.

be extended to any sale of securities (even one share) from a registration statement or offering circular, including a takedown of securities from a shelf registration statement that does not meet the standard of being a “distribution” for purposes of Regulation M.⁹³ The appropriate filing requirements for shelf takedowns are addressed in FINRA’s response to comments on the proposed shelf amendments.

Comments on the Proposed Definition of “QIU”

One commenter suggested that the disciplinary history lookback period should not be extended from five years to ten.⁹⁴ FINRA believes that a longer lookback period is consistent with the goal of ensuring that a QIU will provide the necessary investor protection in public offerings where a member has a conflict of interest. Additionally, FINRA notes that a ten-year lookback is consistent with the period used to determine whether a person is subject to a statutory disqualification.

One commenter suggested that ownership of five percent or more of the issuer’s securities is too low a threshold for purposes of disqualification as a QIU and should be increased to ten percent in proposed Rule 2720(f)(12)(B).⁹⁵ FINRA believes that the five percent threshold is not too low and in fact considered lowering it to three percent.

This commenter also believes that the term “5% of the class of securities that would give rise to a conflict of interest” contained in proposed Rule 2720(f)(12)(B) improperly suggests that the member’s conflict of interest is with the issuer’s securities rather than with the issuer and should be replaced with “5% of the issuer’s total equity

⁹³ Id.

⁹⁴ Id.

⁹⁵ SIFMA Letter.

securities.”⁹⁶ FINRA does not agree. Because the proposed Rule addresses conflicts resulting from the receipt of offering proceeds by the member, the five percent standard is appropriately limited to the class of securities offered.

One commenter suggested that the Rule should permit a prospective QIU to demonstrate on a case-by-case basis that it has acquired experience within the previous years involving the pricing and due diligence functions.⁹⁷ FINRA believes that such an approach would be unmanageable and that a bright-line test is necessary.

One commenter suggested that FINRA should eliminate the requirement that FINRA members wishing to act as a QIU must qualify on an annual basis.⁹⁸ This commenter stated that when a participating member acts as a QIU, that member represents by way of prospectus disclosure that it is qualified to act and the commenter believes that FINRA should not require proof in each case. FINRA notes that there is no annual qualification requirement contained in the current or proposed Rule. Rather, to streamline the QIU process, FINRA’s Corporate Financing Department permits members to provide information establishing that they meet the QIU qualification requirements in advance of participating in a particular public offering and to update this information annually. In the course of its review of information in connection with a public offering requiring a QIU, FINRA staff routinely asks for information that establishes that a member identified as a QIU is qualified to participate in that capacity. If a member has already provided this information within the last 12 months or has done an annual update,

⁹⁶ Id.

⁹⁷ Id.

⁹⁸ Id.

the member will not need to provide the information in connection with that particular offering.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

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. Please include File Number SR-FINRA-2007-009 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-FINRA-2007-009. 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 such filing also will be available for inspection and copying at the

principal office of FINRA. 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-FINRA-2007-009 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁹⁹

Florence E. Harmon
Deputy Secretary

⁹⁹ 17 CFR 200.30-3(a)(12).