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SEC Approves FINRA Rules Addressing Conflicts of Interest in Fairness Opinions

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The SEC has approved Rule 2290, proposed by the Financial Industry Regulatory Authority ("FINRA") for its member firms in connection with the issuance of fairness opinions.[1] FINRA (formerly known as the National Association of Securities Dealers) originally proposed the Rule in 2005, to address concerns that disclosures in fairness opinions might not inform shareholders sufficiently about potential conflicts of interest between the issuer of a fairness opinion and the parties to the transaction.

While many investment banks already have disclosure and procedural practices that conform to many of the Rule's requirements, upon effectiveness of the Rule most FINRA member firms will need to make some changes to their fairness opinion practices, although not as substantial as the changes that would have been required by FINRA's original proposal.

Procedural Requirements

Member firms must have written procedures with respect to approval of their fairness opinions.

1. **Fairness Committees and the Approval Process**. The procedures must address the types of transactions in which a fairness committee of the member firm will approve the opinion. For those transactions where a committee is used, the procedures must address the process for (1) selecting personnel to be on the committee, including their qualifications, and (2) promoting a balanced review by the committee, including the participation of some personnel who are not on the deal team. The Rule does not actually require that a committee be used, but the procedures must address when a committee will be used and, as noted below, the opinion will need to disclose whether a committee was, or was not, used.

FINRA noted that the procedure noted above with respect to non-deal team personnel was not intended to cover persons who only were consulted by members of the deal team, as is often the case today between members of a deal team and members of a committee. FINRA also noted that whether a person was deemed to be on the deal team for purposes of this requirement would be determined based on the facts and circumstances.

2. **Valuation Analyses**. The procedures must address the process for determining appropriate valuation analyses for a particular opinion. However, FINRA declined to require that the procedures specifically address the extent to which the type of company or transaction affects the analyses.

Disclosure Requirements

If the member firm knows (or has reason to know) that the fairness opinion will be included in a proxy statement or otherwise provided to or described to the company's shareholders, specific disclosure will be required in the opinion.

1. **Fairness Committee Approval**. The member firm must disclose whether or not the opinion was

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approved by a committee. This disclosure is not typically included in opinions today.

2. **Relative Compensation**. The member firm must disclose whether or not the opinion expresses an opinion about the fairness of the compensation in the transaction to any of the company's directors, officers or employees relative to the compensation to the company's shareholders. This disclosure is not typically included in opinions today.

FINRA declined to require, however, that members establish a process to evaluate the relative benefits of these insiders as compared to the shareholders, noting that the required disclosure would highlight the potential conflict of interest.

3. **Contingent Payments**. The member firm must disclose (1) if the member firm acted as financial advisor to any party to the transaction, and as applicable, that it will receive compensation that is contingent on successful completion of the transaction, for rendering the fairness opinion and/or serving as advisor, and (2) if the member firm will receive any other significant payment or compensation contingent upon successful completion of the transaction.

FINRA decided not to require disclosure of the actual amount of such payments or consideration, noting that descriptive disclosure would inform shareholders of the member firm's potential financial benefit and, hence, the potential conflict of interest.[2] FINRA also declined to specify a threshold amount or percentage that would render a payment "significant," other than to say it would be one that a "reasonable reader of the fairness opinion would have an interest in knowing … in order to assess whether the member … has a potential conflict of interest." FINRA noted that this would not include trading fees and other small fees.

4. **Material Relationships**. The member firm must disclose material relationships during the prior two years or that are contemplated between the member firm and any party to the transaction in which any compensation was received or intended to be received.[3]

5. **Verification of Information**. The member firm must disclose if it independently verified any information that formed a substantial basis for the opinion and was supplied to it by the company requesting the opinion. If so, the information, or the categories of information, verified must be described. FINRA noted, though, that when no information has been verified a blanket disclaimer, as typically included in fairness opinions today, would suffice.

Opinions Rendered by Firms that Are Not FINRA Member Firms

Rule 2290 will not apply to investment banks or other persons that are not FINRA member firm broker-dealers. FINRA, in making its initial proposal, acknowledged that accordingly there would be a differential impact between FINRA member firms and non-member firms, but indicated that this was not a sufficient reason to refrain from addressing conflicts of interest or inadequate disclosure by FINRA member firms.

Other Regulatory Requirements

In considering their fairness opinion process and disclosure practices, investment banks should keep in mind that they, or their opinions, also may be subject to other regulation (whether or not they are FINRA member firms). For example, the SEC has a number of requirements with respect to fairness opinion disclosure, and frequently comments on applicable portions of proxies and tender offer documents. Delaware and other states also impose on directors a fiduciary duty of disclosure that covers, among other things, the fairness opinions received by a board. [4] Fairness opinion disclosure also is increasingly the subject of shareholder complaints and class actions, and changes to such disclosure may be required in reaching settlements with plaintiffs. While investment banks issuing fairness opinions may not be subject directly to these regulations, the boards and committees receiving (and paying for) the opinions may be subject to these requirements, so investment banks are likely to face pressure to provide appropriate disclosure.

Conclusion

Rule 2290 in its final form reflects a number of current practices and is not as burdensome as the original proposal or as recommended by some commenters. However, it will require some changes to disclosure and other practices typically followed today. Many investment banks already have procedures with respect to the approval of fairness opinions, but the Rule may require additional

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items to be addressed in formal written procedures that in turn could be subject to third-party scrutiny. As with other types of internal procedures, it will be important for investment banks to adopt procedures that are easy to understand and verify, and to have some clear mechanism for granting exceptions when appropriate.

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[1] The SEC's approval is found in Release 34-56645, dated October 11, 2007. The final form of the Rule is contained in FINRA's amendment 4 to its proposed rule change, filed June 7, 2007.

[2] As noted below, though, there are other regulators, such as the Delaware courts and the SEC, that may require this more specific disclosure in some circumstances.

[3] This is similar to the standard provided in Item 1015(b)(4) of Regulation M-A with respect to relationships with the subject company and its affiliates.

[4] For an example of a Delaware court's comments on the need for disclosure with respect to the specific fees and fee structures applicable to fairness opinions, *see Ortsman v. Green*, Del. Ch. February 28, 2007 (granting expedited discovery into, among other things, the failure of the proxy statement to include the amount of the fee payable for the fairness opinion).

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