

Client Alert

A report
for clients
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of the firm November 2004

Investment Bank Fairness Opinions— The NASD Requests Comment on Whether to Propose New Rule to Address Conflicts of Interest

For several months, the Securities and Exchange Commission and the NASD have increased their focus on conflicts of interest with respect to investment banks delivering fairness opinions. The SEC staff has focused considerable attention to conflicts issues where fairness opinions are included in proxy statements and similar filings. In situations where there is a conflict, some banks have recently refused to give fairness opinions while others have recommended that clients obtain a second, independent fairness opinion. Many observers have expected NASD rulemaking in this area, with some speculating that the NASD might *require* independent fairness opinions (i.e., separating the financial advisor from the opinion giver).

The NASD has issued a notice to members requesting comment on whether it should propose new rules in the fairness opinion area. The contemplated rules stop short of requiring independent opinions, but would rather address (i) disclosure of conflicts and (ii) procedures to be followed by NASD members to guard against conflicts.

Summary

The NASD may begin requiring its member investment banks to change their procedures and disclosures for fairness opinions rendered in mergers, acquisitions, divestitures, buybacks and other

significant corporate transactions. The NASD has expressed concern that existing SEC rules governing disclosure of fairness opinions may not sufficiently inform investors about the subjective nature of some opinions and their potential biases. If adopted, a rule could address potential conflicts of interest by requiring new disclosures regarding advisor status, advisor success fees, reliance on information provided by management and independent verification of that information. In addition, a rule could impose new procedures to govern the preparation, approval and compensation for fairness opinions.

Background

A fairness opinion generally sets forth an investment bank's opinion as to the fairness, from a financial point of view, of the consideration involved in a transaction.

Fairness opinions are not required under the federal securities laws, state corporate laws, or SEC, NASD or stock exchange rules. However, obtaining a fairness opinion became standard procedure in certain corporate transactions in the 1980s after a Delaware court found that a corporate board had breached its fiduciary duty of care by approving a merger without adequate information on the transaction, including information on the value of the company and the fairness of the offering price. Relying in good faith on a fairness opinion can be one way for directors to satisfy their duty of care - a practice that has been endorsed by a number of courts.

If a fairness opinion has been obtained with respect to a particular transaction, existing SEC rules require disclosure of that fact in documents filed with respect to such transaction. For example, the proxy statement relating to the transaction must fairly summarize the opinion, describing the procedures followed, the findings and recommendations, the bases for and methods of arriving at such findings and recommendations, any instruction received from the subject company concerning the investigation, and

any limitation imposed by the subject company on the scope of the investigation.

Fairness opinions often state that the opinion is for the use and benefit of the board of directors only. Nevertheless, the SEC takes the position that shareholders are entitled to rely on fairness opinions obtained by a company when considering whether to approve a corporate transaction.

The NASD's proposal would directly affect investment banks by imposing a new rule on their conduct. Companies undertaking corporate transactions would be indirectly affected by the NASD's proposal to the extent that it requires investment banks to change the disclosures in their fairness opinions or the terms by which the banks offer to render opinions to clients.

The NASD's Concern

The NASD cites the following concerns with the existing fairness opinion preparation and disclosure regime:

- the multiplicity of valuation methodologies employed;
 - the sensitivity of results to small changes in underlying assumptions;
 - a perceived tendency to make judgment calls that support the preferred outcome of company management;
 - biases in favor of transactions in which:
 - the investment bank rendering the fairness opinion also acts as the financial advisor to the company in recommending or structuring the transaction and/or where the investment bank will receive financial advisory fees upon successful completion of the transaction; or
 - one group of shareholders, a director or employee receives a benefit or payout that is materially different than that received by the unaffiliated shareholders, if the people receiving the benefit were involved in hiring the investment bank or are in the position to direct future business to the investment bank.
- Require a member to provide in any fairness opinion that will be included in a proxy statement a description of any significant conflict of interest by the member, including, if applicable, that the member has served as an advisor on the transaction and the nature of compensation that the member will receive upon the successful completion of the transaction (including any variance or contingency in the fee charged for the fairness opinion).
 - Require a member to disclose the extent to which the firm relied on key information supplied by a company or its management, or whether it independently verified certain information.
 - Set forth specific procedures that members must follow to guard against conflicts of interest in rendering fairness opinions. These procedures also could address the substantive factors used by members in reaching a fairness opinion. These procedures could address:
 - the process by which fairness opinions are approved by a firm, including whether the firm uses a fairness committee, and, if so, the selection of personnel for the fairness committee, the level of experience of such persons, procedures designed to provide balanced review, and whether steps have been taken to require review by persons whose compensation is not directly related to the transaction underlying the fairness opinion;
 - the process to determine whether the valuation analyses used are appropriate for the type of transaction and the type of companies that propose to participate in the transaction; and
 - the process to evaluate the degree to which the amount and nature of the compensation from the transaction underlying the fairness opinion benefits any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company, is a factor in reaching a fairness determination.

The NASD's Request for Comment

The NASD has not issued the text of a proposed rule, but is seeking public comment on "the best way to improve the processes by which investment banks render fairness opinions and manage the inherent conflicts."

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- Require a member to provide in any fairness opinion that will be included in a proxy statement a description of any significant conflict of interest by the member, including, if applicable, that the member has served as an advisor on the transaction and the nature of compensation that the member will receive upon the successful completion of the transaction (including any variance or contingency in the fee charged for the fairness opinion).
 - Require a member to disclose the extent to which the firm relied on key information supplied by a company or its management, or whether it independently verified certain information.
 - Set forth specific procedures that members must follow to guard against conflicts of interest in rendering fairness opinions. These procedures also could address the substantive factors used by members in reaching a fairness opinion. These procedures could address:
 - the process by which fairness opinions are approved by a firm, including whether the firm uses a fairness committee, and, if so, the selection of personnel for the fairness committee, the level of experience of such persons, procedures designed to provide balanced review, and whether steps have been taken to require review by persons whose compensation is not directly related to the transaction underlying the fairness opinion;
 - the process to determine whether the valuation analyses used are appropriate for the type of transaction and the type of companies that propose to participate in the transaction; and
 - the process to evaluate the degree to which the amount and nature of the compensation from the transaction underlying the fairness opinion benefits any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company, is a factor in reaching a fairness determination.
- The NASD is seeking comments on its proposed rule until January 10, 2005. Before becoming effective, the proposed rule must be authorized for filing with the SEC and by the NASD's Board, and then must be approved by the SEC, following publication for public comment in the Federal Register.

Where to Find the Full Text of the NASD's Request for Comment

The NASD's Request for Comment is titled, "Fairness Opinions Issued by Members - NASD Requests Comment on Whether to Propose New Rule That Would Address Conflicts of Interest When Members Provide Fairness Opinions in Corporate Control Transactions" (NASD Notice to Members 04-83, November 2004). The Request for Comment may be obtained from the NASD's website at: http://www.nasd.com/stellent/groups/rules_regs/documents/notice_to_members/nasdw_012248.pdf

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