On October 11, 2007 the SEC approved FINRA’s new Rule 2290 regarding the preparation of fairness opinions and the disclosures required in fairness opinions. The rule, which began to take form in 2004 and was opened for comments in early 2006, was fast tracked for approval by the SEC. While Rule 2290 is officially applicable only to member firms of FINRA, it is likely to become a market standard by which all fairness opinions are evaluated.

The purpose of the new rule is to address increasing concerns that disclosures provided in fairness opinions may not sufficiently inform shareholders of potential conflicts of interest that may exist among the parties to a deal, those advising on the deal, and those opining to the fairness of the deal. Unfortunately, avoiding the appearance of a conflict is not quite the same as avoiding a conflict. While the new rule provides for added transparency, it does not eliminate potential conflicts of interest.

The portion of the new rule related to disclosures [2290(a)] is applicable if the FINRA member issuing the opinion “knows or has reason to know that the fairness opinion will be provided or described to the company’s public shareholders” and covers the following general topics:

1. **Contingent Compensation.** Section 2290(a)(1) of the rule requires that the firm issuing the fairness opinion must disclose any contingent compensation to be received upon successful completion of the transaction. This includes contingent compensation received for rendering the fairness opinion, serving as an advisor or for any other reason so long as payment is contingent on closing the deal. It is common for a firm to be compensated with fees contingent upon the completion of the deal when acting in an advisory role. However, a contingent payment structure for an opinion that is intended to be strictly informative in nature only serves to create biases where there should be none.

Public shareholders would be better served if instead of simply requiring disclosure, firms were forbidden to perform fairness opinions if they are to receive any fees contingent upon the deal. This would eliminate the ability of firms who hold an advisory role in the deal to also perform the fairness opinion – a clear conflict of interest. It is also noteworthy that the rule does not require the disclosure of the amount of the contingent fee to be received. Surely a firm receiving a $1 million contingent fee would be cause for more concern than a $50 thousand contingent fee.

FINRA stands for the Financial Industry Regulatory Authority. This organization was formed in July 2007 through the consolidation of the National Association of Securities Dealers (NASD) and the regulation, enforcement and arbitration functions of the New York Stock Exchange.
2. **Preceding Relationships.** Section 2290(a)(3) is meant to provide shareholders with information regarding any existing relationships between the firm providing the fairness opinion and any party to the transaction to which the fairness opinion applies. The types of relationships that must be disclosed are those that have existed in the past two years (either explicit or mutually understood among the parties) for which any compensation has been or will be received as a result of the relationship.

There were concerns over the fact that this rule may cause an issuing firm to breach confidentiality or otherwise disclose private information of clients. FINRA offered guidance to suggest that the disclosure of a relationship need only be descriptive (as opposed to quantitative in nature). Thus, clients should feel confident hiring a firm with which they have former experience without worrying that sensitive information could be divulged.

3. **Independent Verification of Information.** Section 2290(a)(4) requires that a firm disclose whether or not underlying information was independently verified. The rule is clear that a lack of independent verification does not necessarily imply a conflict or diminish the reliability of the opinion. It is uncommon for a firm issuing a fairness opinion to independently verify much, if any, of the information that is provided by management of the companies which are parties to the deal.

4. **Approval by a Fairness Committee.** Section 2290(a)(5) requires the issuing firm to disclose whether or not the opinion was approved by a committee. As opposed to independent verification of information, failure to submit the fairness opinion for the approval of a committee, particularly in the instance of complicated or controversial transactions, can be cause for alarm on the part of a shareholder. The new rule provides further guidance concerning committee review in the section regarding procedures.

5. **Fairness of Compensation.** Section 2290(a)(6) requires an issuing firm to disclose whether an opinion is expressed regarding the fairness of compensation to officers, directors, and other personnel, although the validity of the opinion is not necessarily affected one way or the other.

It is rare that a fairness opinion involves the analysis of the fairness of compensation that will be paid as a result of the transaction to the officers, directors, or other personnel of either the buyer or the seller. One reason is that issuing firms are rarely experts in compensation. Additionally, a fairness opinion opines to the fairness of the amount to be received by shareholders according to how the deal is constructed. That amount is either fair or unfair, and any number of factors (one of which could be compensation) can cause the deal to be unfair to shareholders.

The new rule also contains a section [2290(b)] that delineates certain written procedures an issuing firm must develop (and of course follow) in the preparation of a fairness opinion. The majority of these procedures relate to the use of a fairness committee.

1. The issuing firm must develop written procedures for determining the circumstances under which a fairness committee must approve a fairness opinion. When a committee is deemed to be appropriate, the firm must also have developed and followed procedures concerning the following:

   a) The issuing firm must have a written procedure which is used to select the personnel that comprise the fairness committee.

   b) Those procedures must specify the qualifications required for persons to sit on the fairness committee.
c) The process must promote a balanced review of the opinion, and the review should involve personnel who are not on the deal team to the transaction. If the firm issuing the opinion is not involved in the transaction as an advisor, then it follows that those persons reviewing, as well as working on, the fairness opinion will not be on the deal team.

2. The issuing firm must also create procedures with which to evaluate the appropriateness of the valuation analyses used in the fairness opinion. The addition of this rule demonstrates that FINRA recognizes the importance of valuation technique in rendering a fairness opinion.

Several conclusions can be drawn from the new FINRA rule. First, FINRA is clearly attempting to provide shareholders with more information and allow them to make their own decisions regarding the existence of conflicts. However, it appears to still be the responsibility of various parties to the transaction and their advisors to ensure that no conflicts exist, or at the very least, are minimized. Despite the new disclosure rules, any time the advisor on a deal prepares the fairness opinion or any time compensation for preparation of the fairness opinion is on a contingent basis, there exists the possibility for real or perceived conflicts of interest.

Further, FINRA pays significant attention to “quality control” issues within the issuing firm. While some of these issues would be rendered moot if FINRA would simply disallow firms with potentially large conflicts of interest from preparing the fairness opinion, the focus does indeed center on what is in the best interest of the shareholder.

Mercer Capital is well equipped to deal with the new FINRA rule for a number of reasons. We do not perform fairness opinions for a contingent fee and in instances where we act as an advisor on a deal, we will not perform the fairness opinion ourselves. In addition, Mercer Capital is very familiar with the concept of “committee review,” having used committees to tackle complex valuation problems for years. It is almost certain that a fairness committee at Mercer Capital would have at least one member with a respected industry credential (CFA, ASA, CPA/ABV, etc.) and possibly several members. Mercer Capital’s experience as an independent business valuation firm means that a client can be certain that any valuation analysis developed in the preparation of a fairness opinion will be both appropriate and objective.

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While the new rule provides for added transparency, it does not eliminate potential conflicts of interest.
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