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Business Law Section
Committee on Securities Regulation

January 28, 2005

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

E-mail address: rule-comments@sec.gov

Attention: Jonathan G. Katz, Secretary

Re: File No. SR-NASD-2004-022
NASD Proposed Rule Change Relating to Shelf Offerings
Release No. 34-50749

Ladies and Gentlemen:

The Committee on Securities Regulation (the "Committee") of the Business Law Section of the New York State Bar Association appreciates the invitation in Release No. 34-50749 to comment on the proposed rule change by the National Association of Securities Dealers, Inc. ("NASD") to amend NASD Rules 2710, 2810, IM-2440 and Schedule A to the NASD By-Laws relating to shelf offerings under Rule 415 of the Securities Act.

The Committee is composed of members of the New York Bar, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this letter was reviewed by certain members of the Committee, and the views expressed in this letter are generally consistent with those of the majority of members who reviewed and commented on the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views

of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

Summary

The Committee supports providing greater clarity on when to make filings for shelf offerings and ensuring that filing requirements do not undermine the flexibility intended by the shelf registration process. However, we have some concerns, and believe that certain revisions to the proposed rule change recommended below are necessary in order to accomplish those objectives.

Discussion

We recommend that the following changes be made in the proposed rule change for the reasons discussed below.

Definition of "Participation or Participating in a Public Offering." Rule 2710(a)(5)

The NASD has proposed amending the definition of "participation or participating in a public offering" in Rule 2710(a)(5) to include agency and market transactions. The NASD recognizes that currently there is some confusion about whether or when a filing is required in the shelf registration context.

Historically, the function of Rules 2710, 2720 and 2810 has been to address the reasonableness of compensation in the context of a firm commitment or best efforts underwriting in which one or more NASD member firms enter into an agreement to distribute securities of an issuer or selling securityholders to the public. The review of underwriting arrangements includes the receipt of items of value from the issuer, unreasonable underwriting terms, and conflicts of interest or affiliation with the issuer. These issues are not relevant to, hence Rules 2710, 2720 and 2810 historically did not and should not regulate, ordinary trading market transactions, that is, the sale of shares on market terms by selling securityholders from time to time to or through (but not underwritten by) NASD member firms chosen by them, with individually negotiated fees or discounts.

We agree with the NASD's goal to provide certainty as to when members are required to file. However, we believe that the proposal to extend the definition of "participation or participating in a public offering" to include agency and market transactions would provide certainty at the price of requiring filings that would serve no demonstrated public interest while imposing unnecessary costs and burdens. The costs include the direct expenses of filing, the indirect expenses of due diligence and other procedures required for such filing, and the even more indirect but equally important costs inherent in the potential loss of market timing and competitive opportunities caused by the timing and delays implicit in compliance. Selling securityholders and their brokers are especially likely to find it difficult to obtain the information needed for compliance because of an attenuated, or in some instances, no relationship with the issuer, its affiliates and other securityholders. The costs of compliance would ultimately be paid by these selling securityholders, or by issuers and, in turn, their shareholders. It is also possible that the proposal could create competitive disadvantages for certain NASD member firms who, on account of prior relationships with and services to the issuer, might not be able to file as expeditiously as other members holding no securities of the issuer and having no historical relationship with the issuer (including no prior knowledge of the issuer's management, business or financial prospects, which might in fact be counterproductive). In terms of cost/benefit analysis, there has been no demonstration of problems or abuse that would balance these costs and to justify the extension of the definition in Rule 2710 to cover agency and market transactions.

The NASD acknowledges that shelf registration is designed to provide flexibility to take advantage of market opportunities, and that its current compliance and review processes could delay an offering when information is not readily available or errors in the filing process are made. We note as well that shelf registration takedown decisions are often made quickly with little or no advance notice and not necessarily during normal business hours for the NASD. While the NASD is attempting to design a system that it characterizes as more "streamlined" and "more automated," we have great concern that the new process will not prevent delays, and other costs, for which no solid justification has been provided. Hence, we urge elimination of the proposed change to the definition of "participation or participating in a public offering," and that

the NASD expressly confirm in its rules that filing is not required for an ordinary trading market transaction.

Market Transactions Exemption. Rule 2710(b)(10)(B)

The NASD in part justifies its extension of the definition "participation or participating in a public offering" by carving out certain small unsolicited transactions from shelf registration filing requirements through its proposed Market Transactions Exemption ("MTE"). As discussed above, we urge that the proposed exemption be eliminated, and that the NASD confirm that ordinary trading market transactions are not subject to filing, in which case the MTE exemption may not be necessary. If, however, the NASD retains the MTE exemption, we recommend that the following changes be made in the definition of MTE.

Transactions within the MTE are intended to be those that are more like ordinary trading transactions than public offerings. As discussed above, Rules 2710, 2720 and 2810 historically have not, and should not, apply to ordinary trading market transactions. If there is to be an MTE, however, we are concerned that the current proposal is not adequate and is unnecessarily complicated and restrictive. We believe that a determination of 2% of average daily trading volume on the date of the transaction is unwieldy for a member to easily assess whether or not a filing is required, and should be eliminated. Further, there has been no rationale put forth for limiting an MTE to 10,000 shares or the formula amount, and we suggest elimination of a volume restriction in any MTE, without a compelling justification to the contrary.

Further, we suggest that there is no basis to require that a member utilizing MTE not be an affiliate of the issuer and not have a conflict of interest. There has been no demonstration and we have no reason to believe that a takedown in an ordinary market trading transaction even by a member that is affiliated or conflicted with the issuer has or would give rise to abuse. Determining affiliation and/or conflict on short notice in connection with an ordinary market trading transaction is unduly burdensome and time consuming under the circumstances and in relation to the value of the information to the regulatory process, and should not be required. In addition, we see no reason to limit the exemption to securities listed on the Nasdaq Stock Market

or a national securities exchange. If there is to be an MTE exemption, we suggest that it be more widely drawn to include all ordinary trading market transactions, *i.e.*, transactions on any market on behalf of selling securityholders not underwritten by a NASD member firm.

Definition of "Underwriter and Related Persons." Rule 2710(a)(6)

The current definition of "Underwriter and Related Persons" includes only "underwriter's counsel, financial consultants and advisors, finders, any participating member, and any other persons related to any participating member." The NASD has proposed to delete the phrase "and any other persons related to any participating member" and to add the phrase "any other persons that receive any item of value that would be considered underwriting compensation." We are not aware of any written basis set forth by the NASD for this proposal.

While the proposed deletion would be helpful because there is no defined concept of a person "related to a member," the proposed new phrase would not be workable for member firms and their counsels who are charged with the due diligence responsibilities.

The proposed new phrase is open-ended in a manner that would leave member firms exposed to enforcement claims. A member firm would have substantial difficulty in identifying every person, particularly those not participating in an offering and over which the member firm has no privity of agreement (e.g., underwriting agreement, agreement among underwriters or selected dealer agreement), that might be viewed by the NASD as having received "an item of value that would be considered underwriting compensation." The definition is particularly problematic because there is no limitation based on control, affiliation or even privity of relationship to the issuer, an underwriter or the transaction in question.

At present, the NASD requires a member firm submitting a filing in COBRADesk to make representations as to (i) unregistered securities of the issuer acquired by any person who has an "association or affiliation with any member" (NASD Conduct Rule 2710(b)(6)(A)(iii) – Unregistered Securities) and (ii) the receipt of other items of value from the issuer to the "underwriter and related persons" (NASD Conduct Rule 2710(B)(6)(A)(iv) – Other Items of

Value). Based on the present definition of "Underwriter and Related Persons," an underwriter, in order to engage in reasonable due diligence necessary to make these representations, would review records of the issuer and would request relevant information from or on behalf of the issuer and all members "participating in the public offering." Underwriters' counsels have developed standard due diligence questionnaires to assist in this due diligence process.

Opening up the definition to include "other persons that receive any item of value" would necessitate a dramatic and unworkable expanding of the due diligence process to virtually every party that received some form of compensation or value from the issuer within a 180 day period, so that the compensation or value can then be analyzed to determine whether it could somehow be construed, in the subjective determination of the NASD, as "underwriting compensation." It then follows that member firms would defensively submit extensive and often irrelevant data to the NASD in COBRADesk in response to "2710(B)(6)(A)(iv) – Other Items of Value" which would increase the legal costs of the issuer (because issuers typically reimburse the legal fees of underwriters' counsel in connection with NASD Rule 2710 compliance), and necessitate significant additional NASD resources for review, with no identified benefits.

We assume that the NASD is making this proposal in order to prevent member firms from somehow funneling payments to unrelated parties. The NASD proposal has made no showing of this practice, and we believe that the NASD has both appropriate enforcement powers and other more suitable means to deter member firms from engaging in such practices should they become evident.

Accordingly, while we recommend adoption of the proposal to delete the phrase "and any other persons related to any participating member," we urge the NASD not to adopt the proposed additional phrase "any other persons that receive any item of value that would be considered underwriting compensation."

<u>Conflict of Interest or Affiliation; Filing Requirements.</u>

The NASD proposes to replace its current exemption from the NASD filing requirements under Rule 2710(b)(7)(C)(i) and (ii) as applicable to Rule 415 shelf registrations of

issuers meeting the standards for Forms S-3 and F-3 as they existed prior to October 21, 1992 and for Form F-10 as it existed prior to June 21, 1991, with a new "Seasoned Issuer Exemption." We applaud this effort, as the standards of Forms S-3 and F-3 as they existed in 1992 are increasingly difficult to determine with the passage of time. The proposed replacement Seasoned Issuer Exemption provides the specific criteria necessary to claim the exemption.

As with the current exemption under Rule 2710(b)(7)(C)(i) and (ii), seasoned issuers that are subject to Rule 2720 because of an affiliation or conflict of interest between the issuer and an underwriter, would remain subject to all of the Rule 2710 requirements of filing and review without regard to its seasoned issuer status. We recommend that the NASD expand the Seasoned Issuer Exemption to include all seasoned issuers, whether or not subject to Rule 2720.

Rule 2720 generally requires that, in the case of an offering where there is an affiliation or conflict of interest between the issuer and an underwriter, a qualified independent underwriter ("QIU") must perform independent due diligence of the issuer and provide a pricing opinion with respect to the securities offered. The rule further sets forth the qualification requirements of a QIU, the corporate governance standards for an issuer covered by the rule and the required disclosure of certain information, and prohibits sales to discretionary accounts without prior specific written authorization by the account holders.

However, in the case of a seasoned issuer, the NASD provides exemption from pricing by the QIU, presumably because such pricing is directed by sufficient market forces. Similarly, the shelf prospectus of a seasoned issuer is in most cases an incorporation by reference document referring to the issuer's extensive and already existing array of disclosures in proxy and periodic public reports filed with the SEC. On the other hand, Rule 2720 imposes on a seasoned issuer having an affiliation or conflict of interest with an underwriter, the Rule 2710 requirement to file with the NASD and obtain a no-objections letter just as though the issuer were not seasoned and even in instances where the SEC has determined not to review the issuer's registration statement. We are not aware of any concern with seasoned issuers having affiliations or conflicts of interest with underwriters being subjected to unreasonable amounts of underwriting compensation. Indeed, we believe that in most instances the underwriters' compensation is well below the

amounts deemed by the NASD to be unreasonable and quite possibly the issuer benefits from superior offering terms as the result of the affiliation or conflict of interest.

Accordingly, there would appear to be no cost/benefit justification for requiring NASD filings by seasoned issuers who fall under Rule 2720, for the purpose of substantiating due diligence performed by the QIU or for the purpose of reviewing the terms of the offering, and we recommend that the seasoned issuer exemption be adopted and made available to all seasoned issuers, including those under Rule 2720. For the same reasons, we further recommend that the seasoned issuer exemption be made available to all seasoned issuers, not just those under Rule 415 shelf registrations.

In the event that the NASD continues to require filing by seasoned issuers who are subject to Rule 2720, doing so for each shelf-takedown and on behalf of each underwriter, whether or not affiliated or in a conflict of interest with the issuer does not appear to make sense or provide any public or market benefit. On the other hand, it does impose market costs and timing issues as the result of the need to coordinate the short offering time frame of such offerings and the NASD review process. Accordingly, we recommend that NASD, in the case of seasoned issuers, require no more than an initial "shelf" filing, including all appropriate and necessary representations required by Rule 2720. There would be no reason for the NASD to require specific underwriter information or information related to determining underwriting compensation. In addition, there should be no requirement for a filing by members participating in such shelf-takedowns who do not themselves have an affiliation or conflict of interest.

Timing Issues.

Under normal circumstances, current compliance and review processes can delay an offering when information is not readily available or errors in the filing process are made. In the shelf takedown context, the need for speed to take advantage of market and competitive opportunities means that the time line is likely to be short or even miniscule, and the need for filing may arise at times that are not normal business hours for the NASD. We know and appreciate that the NASD staff has always tried to work with members and their counsel to work

around these problems and that the NASD proposes a more streamlined system for shelf filings - one that will provide an automated clearance on a 24/7 basis for some transactions. Nevertheless, we have great concern that the new process will not prevent delays, and other related costs. For example, the need to gather and assess information will continue to be costly and time consuming, and the proposed automated response will not be available in a conflict situation, if the system does not recognize that all criteria are satisfied because of manual or machine error, or if additional fee payment is required.

It seems likely that more filings would be made if the current NASD proposals are implemented, stretching staff even further and possibly increasing delays. At the very least, we respectfully recommend the determination and clarification that all ordinary trading market transactions are exempt from filing requirements, thereby eliminating the need for compliance for certain transactions that have not been shown to give rise to abuse and also freeing up more staff time for transactions that do require review. Further, we suggest that not requiring information about conflicts and affiliations, as discussed above, would reduce the time required for gathering of information and permit these transactions to be cleared on an automated response basis.

Exemption of All Form S-3, F-3 and F-10 Offerings by Seasoned Issuers.

In addition, as noted above, we respectfully suggest consideration of extending the S-3/F-3/F-10 exemption to all offerings registered on those Forms, not just those pursuant to Rule 415. We believe that a straight registration on those Forms by a seasoned and experienced issuer whose securities have been marketed for a considerable period should give rise to no greater potential for abuse than in a shelf registration context. We see no valid basis to exclude other Form S-3/F-3/F-10 registered offerings. Again, eliminating the need for filing for transactions that are not likely to give rise to abuse will free up staff time and reduce delays for shelf registration and other offerings that do get filed.

Harmonization of NASD Shelf Filing Requirements with SEC Proposed Securities Offering Reform

Finally, we urge the NASD to modify its proposed filing requirements for shelf offerings to be compatible with the registration filing requirements proposed by the SEC in its Release on Securities Offering Reform regarding the registration, communications and offering processes under the Securities Act (November 17, 2004). Specifically, the Commission has proposed "automatic shelf registration" for a category of issuers defined as "well-know seasoned issuers" or "WKSIs". Furthermore, the Commission has requested comment on whether this treatment should be available to a broader class of issuers than WKSIs, and we expect that there will be support in the comments for extending automatic registration to a broader class of issuers.

The SEC proposal is intended, among other things, to provide issuers with flexibility to take advantage of market windows, which would benefit both issuers and investors. However, application of NASD's proposed filing requirements could result in delays in offerings, which could in some cases eliminate flexibility and undermine the SEC's proposed automatic shelf registration. Accordingly, we urge that NASD modify its filing requirements so that filing would not be required for offerings pursuant to an automatic shelf registration statement, including issuers other than WKSIs to the extent they are eligible for automatic shelf registration under future SEC rules.

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We hope the Commission and the NASD find these comments helpful. We would be happy to discuss these comments further with the Staff or the NASD.

Respectfully submitted,

COMMITTEE ON SECURITIES REGULATION

By Michael J. Holliday
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