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Via e-mail: rule-comments@sec.gov

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: **File No. SR-NASD-2004-022**
Securities and Exchange Commission Release No. 34-50749
Proposed Rule Change Relating to Shelf Offerings of Securities under the Corporate Financing Rule

Dear Mr. Katz:

Morgan Stanley appreciates the opportunity to comment on the above-referenced proposal (the "Proposal"). We are writing both in our capacity as a leading underwriter of securities offerings and as a frequent issuer of corporate securities. We understand that the objective of the Proposal is to streamline the procedure by which shelf offerings are filed and reviewed under the Corporate Financing Rule (Rule 2710) of the National Association of Securities Dealers, Inc. ("NASD"). We believe this is an important objective, particularly in view of the Commission's proposed reform of the shelf offering process.[1] However, we believe that some of the methods by which the NASD proposes to achieve this objective will be an unnecessary burden on the shelf offering process, both in terms of time and expense, and will frustrate the Commission's goal to assure that seasoned issuers can quickly access the securities markets.

I. The Proposal Should Eliminate or Reduce Substantive Review of Shelf Offerings of Well-Known Seasoned Issuers

The Proposal should be modified to conform to the Commission's proposed reform of the shelf registration process. The Commission has proposed automatic shelf registration of well-known seasoned issuers ("WKSIs"). WKSIs are defined in the Commission's reform proposal as issuers eligible to use Form S-3 or F-3 that have filed reports under the Securities Exchange Act of 1934 (the "Exchange Act") for at least one year and that have a common equity market capitalization (excluding securities held by affiliates) of $700 million or have issued $1 billion

[1] SEC Release No. 33-8501, 69 F.R. 67312 (Nov. 3, 2004).

aggregate amount of debt securities in registered offerings in the preceding three years and register only debt securities.

Although there are currently and, under the Proposal, will continue to be, exemptions from the filing requirements of Rule 2710 for certain shelf offerings registered on Forms S-3 or F-3,[2] offerings of investment grade debt and preferred stock meeting certain criteria and offerings by issuers that have such investment grade debt or preferred stock outstanding,[3] these exemptions are lost if the offering is subject to NASD Rule 2720. Rule 2720 is applicable to offerings where an NASD member participating in the distribution[4] is an affiliate of the issuer or is in a conflict of interest[5] with the issuer. A significant number of issuers meeting the Commission's proposed WKSI definition will be denied the benefit of more streamlined access to the capital markets if those WKSIs are required to file their shelf offerings with the NASD because they are subject to Rule 2720. The proposed NASD treatment of shelf offerings by these WKSIs could affect billions of dollars of financings. Morgan Stanley alone issued approximately $32 billion in SEC-registered debt and capital securities in 2004 pursuant to the shelf registration system.

The consequences of being subject to review under the Corporate Financing Rule are substantial expense and delay. Filing fees are not insignificant: the maximum NASD filing fee has just been increased to $75,500[6]. But even more onerous are the expense and delay of the review process itself. The information requirements of the Rule require extensive due diligence. For example, the Rule requires the filing of information regarding the receipt from the issuer or its affiliates of any item of value (cash, securities, right of first refusal, etc.) by an anticipated distribution participant (underwriter or dealer) and any of its affiliates in the 180-day period preceding the filing of the issuer's registration statement. This information requirement is even more burdensome for WKSIs, which generally have numerous affiliates. Even after all the information is provided to the NASD, clearance of a filing can take two weeks to several months.

[2] This exemption, discussed more fully in section II below, can be found in subsection (b)(7)(C) of Rule 2710.

[3] Rule 2710(b)(7)(B) exempts offerings of investment grade rated non-convertible debt securities and non-convertible preferred securities. Rule 2710(b)(7)(A) exempts offerings of securities of an issuer that has unsecured non-convertible debt with a term of issue of at least four years, or unsecured non-convertible preferred securities that are rated investment grade, except for IPO's.

[4] Participating in a public offering is defined in Rule 2710(a)(5) generally as participating in the distribution of the offering in any capacity or participating in any advisory or consulting capacity to the issuer related to the offering. The term "conflict of interest" is defined in Rule 2720(b)(7).

[5] An affiliate is defined in Rule 2720(b)(1) as "a company which controls, is controlled by or is under common control with a member."

[6] The Commission has proposed to permit WKSIs to pay SEC filing fees at the time of each securities offering, as opposed to paying a fee based on the amount of securities registered at the time a shelf registration is initially filed. If the NASD requires the filing of registration statements of WKSIs, the NASD filing fee provisions will have to be revised to conform to pay-as-you-go registration fees.

Presumably, this would continue to be the case for initial filings and, in some instances, subsequent filings under the Proposal.

The expense and delay of the review process under Rule 2710 would be appropriate if a regulatory purpose were being served. However, a number of NASD publications have stated that there is no regulatory purpose in reviewing the underwriting terms and arrangements of offerings where "the Association could reasonably assume that the issuer would be closely followed and that the market would efficiently determine a fair price for the securities being issued."[7] This is similar to the rationale under which the Commission has proposed the automatic shelf registration process for WKSIs: on the grounds that such issuers have a substantial reporting history under the Exchange Act and are the most widely followed issuers in the market place. Accordingly we believe the NASD should exempt all shelf offerings by WKSIs from review.

If the NASD continues to require filings even by WKSIs that are subject to 2720, we would propose, in the alternative, that the NASD establish a notice filing requirement[8] to assure compliance with, and directed solely at, the requirements of Rule 2720 intended to mitigate conflicts of interest (e.g., the requirement for the participation of a qualified independent underwriter ("QIU"), the prohibition on sales to discretionary accounts, the heightened suitability standard, etc.).

II. The Proposal Should Expand Certain Exemptions from Filing under the Rule

As stated above, there is an exemption from filing under Rule 2710 for shelf offerings registered on Form S-3 or F-3 if the issuer satisfies the eligibility criteria for such forms in effect prior to October 21, 1992 (the "old S-3/F-3 eligibility criteria").[9] We believe this exemption should be broadened to include all shelf offerings registered on Forms S-3 or F-3 not just those under Rule 415 and those by issuers that satisfy the old S-3/F-3 eligibility criteria.

In Notice to Members 88-101, the NASD states that the rationale for this exemption is that "an issuer able to satisfy Form S-3's 'registrant requirements' would be followed closely by investors and market professionals . . . the securities markets would efficiently determine a fair price for the securities being offered and . . . any underwriting compensation received by members ordinarily would be determined under very competitive circumstances . . . ." However, the NASD, in Notice to Members 93-88, declined to broaden the shelf exemption to issuers meeting the revised S-3/F-3 eligibility criteria on the basis that it did not have sufficient information about issuers meeting the new S-3/F-3 eligibility criteria to determine whether the

[7] NASD Notice to Members 83-12 (March 8, 1983).

[8] We propose a notice requirement that would consist of (i) filing a representation, at the time a shelf is registered, that each offering under the shelf will meet the conflict of interest requirements of Rule 2720 and an undertaking to make a QIU filing following each offering in which a QIU is required and (ii) a filing, following an offering in which a QIU has participated, identifying the QIU and providing a certification of the QIU's eligibility.

[9] *See supra* note 2.

shelf exemption should be extended to them. In that notice, the NASD undertook to perform a one-year review of such offerings "to determine whether the market forces related to such offerings result in the presence of fair and reasonable underwriting terms and arrangements."

Subsequent to that 1993 notice, there has been no public discussion of an NASD study or of any abuses in the underwriting terms and arrangements of shelf offerings registered on S-3 or F-3 by issuers that do not meet the old S-3/F-3 eligibility criteria. The Commission has proposed relief from aspects of the registration process under its reform proposal for seasoned issuers, which are defined as any issuer eligible to use Form S-3 or F-3 to register primary offerings. We believe the NASD should accord similar relief by exempting shelf offerings registered on Form S-3 or F-3 from the filing requirements of Rule 2710.[10] We believe this exemption should also be available to issuers subject to Rule 2720.

Rule 2720 regulates conflicts present in offerings where there is an affiliation or conflict of interest, as defined, between the issuer and an underwriter. It does so by requiring that (i) a QIU perform due diligence and price the offering, (ii) there be a prohibition on sales to discretionary accounts, (iii) issuers subject to the Rule meet certain corporate governance standards and (iv) there be disclosure of the conflict in the offering document. A QIU is not required when equity securities for which there is a bona fide independent market or investment grade debt or preferred securities are offered. The rationale for the exemption from the QIU requirement is that the market accurately prices an offering of a seasoned issuer about whom there is a significant amount of public information and which has an established, competitive market. These are the same factors the NASD cites as justification for the exemption for issuers meeting old S-3/F-3 eligibility criteria. We further note that underwriting compensation tends to be very low for the sale of investment grade securities and equity securities for which there is an active trading market. Accordingly, we do not believe there is any regulatory benefit derived from the review of underwriting terms of shelf offerings of seasoned issuers subject to Rule 2720. Further, the cost of filing fees, performing due diligence and the delays caused by the filing have a discriminatory effect on seasoned issuers whose broker-dealer affiliates participate in distributions of their securities.

We further note that the Rule was intended to prevent member firms from using their superior bargaining power to obtain excessive underwriting compensation or negotiate underwriting arrangements unfair to the issuer and the public. The NASD has acknowledged, in other contexts, that where the issuer has superior bargaining power and market forces assure the fairness of underwriting terms and arrangements, NASD review should not be required. We believe this is the case with all shelf offerings registered on Form S-3 or F-3, whether or not subject to Rule 2720, and believe the Commission's proposed registration reforms for seasoned issuers confirm this belief.

[10] By replacing the exemption in Rule 2710(b)(7)(C) with the seasoned issuer exemption, we believe the NASD inadvertently eliminated the exemption from filing for finance subsidiaries, subsidiary guarantors and trust vehicles of seasoned issuers. Those exemptions should be restored.

If, however, the NASD is unwilling to exempt all shelf offerings registered on Form S-3 or F-3, we propose that the exemption be modified so that even if the NASD applies the old S-3/F-3 eligibility criteria with respect to market capitalization, the exemption would be available to issuers that have been subject to and have filed reports pursuant to the reporting requirements of the Exchange Act for one year rather than three years.[11] In the alternative, we propose that the three year reporting history requirement be reduced to one year for WKSIs. Both of these alternatives would be consistent with the definition of both WKSIs and seasoned issuers under the Commission's reform proposals.

III. The Proposed New Filing Procedure will Delay Shelf Offerings rather than Expedite Them

Under the Proposal, each NASD member seeking to participate in offerings from an issuer's shelf registration statement will be required to have made a filing and received clearance (in the form of a no objections opinion) prior to such participation. Consequently, at the time of any particular shelf takedown, a filing and clearance will be required if (i) the member hasn't previously qualified with the NASD to participate in the shelf offering (i.e., wasn't a party to the initial filing) or (ii) there is a material change in the member's participation. Material change is not defined and could include matters as inconsequential as the receipt by the member of a cash fee for a private placement subsequent to the member's initial filing.[12]

We are concerned that the requirement that each member obtain its own no objections opinion before participating in a shelf offering could result in delays and could provide significant disincentives for issuers to invite additional members to participate in shelf takedowns after the initial filing with the NASD. Rule 415 under the Securities Act of 1933, as amended, is intended to allow issuers to avail themselves of the most advantageous market conditions, and shelf takedowns often occur within hours of an issuer's notification to underwriters that it wishes to meet a market "window." The proposed filing requirements could not help but delay that process. In addition, when time is of the essence and an issuer wants to price a shelf offering, we are concerned that issuers may exclude members who have not previously obtained clearance from the NASD rather than delay the offering in order to allow the time necessary to gather the information required for the new member's filing.

Under the existing procedure, the issuer or a member makes a filing relating to the shelf as a whole and once cleared, there is no requirement to pre-clear offerings off the shelf. We believe there is nothing wrong with the existing filing procedure other than perhaps a lack of clarity as to when the initial filing should be made. This problem could be resolved through the issuance of a notice to members. We believe the new filing procedures would cause unjustified delays that are antithetical to the objective of the Proposal.

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[11] The requirement under the old S-3/F-3 eligibility criteria was that the issuer had been subject to and have filed reports under the Exchange Act for three years.

[12] This is inconsequential because a cash fee received for acting as placement agent is not an item of value and therefore cannot be underwriting compensation.

If the NASD is unwilling to retain the existing filing procedure, we propose, with respect to shelf offerings filed only because they are subject to Rule 2720, elimination of the requirement for subsequent filings by members unaffiliated with the issuer. Under these circumstances, an initial filing will have been made by the broker-dealer affiliate of the issuer, whose participation has triggered the filing requirement. Without the affiliate's participation, no filing would have been required. Therefore, we believe that no subsequent filing should be required to permit the participation of members unaffiliated with the issuer. This approach is consistent with the regulatory purpose underlying the requirement that issuers, exempt from filing but for Rule 2720, file under the Corporate Financing Rule: the NASD can focus on compliance with Rule 2720's conflict of interest provisions rather than reviewing underwriting arrangements between the issuer and unaffiliated members.

IV. Certain Proposed Definitions are Overinclusive

Underwriter and related person. The proposed change to the definition of "underwriter and related person"[13] indirectly expands what may be considered underwriting compensation under the Corporate Financing Rule, both in shelf and non-shelf offerings. Currently, an item of value received by an underwriter or related person, which generally encompasses distribution participants, finders and financial advisors, may be underwriting compensation. Under the proposed revision, an item of value (e.g., cash or securities) given by an issuer to *anyone* can constitute underwriting compensation. To identify every person, including those not participating in the offering, who might be viewed by the NASD as having received an item of value unnecessarily increases the burden of due diligence already faced by members. We understand that the new definition is intended to address the possibility that traditional underwriting functions might be contracted out by an underwriter to affiliated entities as a way to avoid inclusion of fees received for such services as underwriting compensation. We believe third parties affiliated with a member, who perform services that are traditionally carried out by underwriters, would be "persons related to any participating member" within the current definition of "underwriter and related persons." If, however, the NASD believes the definition needs to be amended, we believe the proposed amendment is too broad. In addition, it is inconsistent with the March 2004 amendments to the Corporate Financing Rule, the stated goal of which was to provide certainty to NASD members with respect to what would be considered underwriting compensation in connection with a public offering.

As an alternative, the definition of underwriter and related person could be amended to include persons performing duties that an underwriter would typically perform when participating in a public offering. This would seem to address the NASD's concern that compensation earned by affiliates of underwriters for duties customarily performed by underwriters be counted under the Rule.

Participation in a public offering and the Market Transaction Exemption. The NASD's proposed revision of "participation in a public offering"[14] will have the effect of requiring the

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[13] Rule 2710(a)(6).

[14] *See supra* note 5.

filing under the Corporate Financing Rule of shelf offerings sold in ordinary market transactions. The view of members and their counsel has always been that such offerings are not required to be filed because, as stated in Notice to Members 83-12, offerings "in broker's transactions which are virtually indistinguishable from ordinary secondary trades…result in the amount of underwriting compensation being determined through a virtual competitive bidding process which helps to achieve its reasonableness." Such offerings do not raise the concerns of abuse that Rule 2710 is intended to prevent. Members believed the NASD had determined that review of such arrangements under the Corporate Financing Rule was unnecessary.

The Proposal subjects these offerings to filing and review under the Rule in the interest of clarifying the filing requirements but does not state a regulatory purpose for reviewing what are essentially brokers' transactions or market making. This change will be costly to issuers and selling shareholders under resale registration statements and are likely to diminish the use of shelf registration statements under these circumstances. Requiring filing and review of such shelf offerings will increase the cost of capital for issuers either by making the exit strategy for private investors more expensive or by eliminating registered exit strategies altogether.

The proposed change would require filings by members with no relationship to the issuer or to selling shareholders other than the party for which it is executing the trade. Generally, the broker will only be receiving an agreed upon commission as compensation for the sale, which should be of little interest to the NASD and, in any case, would be subject to the Mark-Up Policy. It is questionable whether any broker, asked to make limited sales on behalf of a selling shareholder, would be willing to pay up to $75,500 in filing fees in order to make an initial filing to qualify to make such sales. Such broker would also have to perform due diligence in order to satisfy the information requirements of the Corporate Financing Rule.

Even after an initial filing is made, brokers who were not party to the initial filing will be foreclosed from making at-the-market sales until they have made a filing with and been approved by the NASD. They too will have to perform the necessary due diligence to collect information required for a subsequent member filing. The expense of the collection and filing process may outweigh any possible profit on the transaction and may be significant enough to discourage members from participating in these trades and reducing the level of service and competition that currently benefits selling shareholders.

Another type of transaction that should not be subject to the filing requirements is the block sale. Members participating in block sales do not receive any fees or commissions, but instead profit only to the extent that they can sell their securities for more than their aggregate purchase price. Members incur significant market risk as they purchase and sell securities as principal. These sales, like the broker transactions described above, are more similar to secondary market transactions than to underwritten offerings, are covered by current markup/markdown rules and should not be subject to the 2710 filing requirements.

The proposed definition also seems to include transactions pursuant to market-making prospectuses on Rule 415 registration statements that are filed by issuers affiliated with a member. The market-making prospectus allows the affiliated member to act as market-maker in the purchase and sale of outstanding securities of the issuer in compliance with Section 5 of the Securities Act. Such market-making transactions, like the broker sales mentioned above, do not raise the potential for abuse that Rule 2710 is intended to prevent.

We recommend that instead of expanding the definition of "participating in a public offering" so that it covers participation in ordinary market transactions, the NASD clarify the meaning of "participation in the distribution" as that phrase currently appears in the definition. This could be accomplished by reference to Regulation M, as follows: "participation in the distribution, as defined in SEC Regulation M, of a public offering." A Regulation M distribution differs from ordinary market transactions in terms of the magnitude of the offering and the presence of special selling efforts. We believe the NASD has historically, and correctly, identified these distributions, rather than ordinary market transactions, as offerings requiring review. This view is supported by Notices to Members 83-12. 88-101 and 93-88. We believe the burdens imposed on members as a result of the proposed change are not justified by the need to review the amount of compensation payable in ordinary market transactions, which is generally limited by the NASD Mark-Up Policy.

If, notwithstanding the foregoing, the NASD determines to change "participating in a public offering" as set forth in the Proposal, the Market Transaction Exemption (the "MTE") should be expanded to include securities traded in over-the-counter markets and should not have any volume limitations. The only conditions to the MTE should be (i) that the shelf offering is not the initial public offering of the issuer's equity securities and does not occur within 90 days of the issuer's initial public offering, (ii) that there be no underwriting agreement with respect to such sale and (iii) that the member does not receive compensation that exceeds the amount permitted under the NASD's markup policies.

V. The Proposed Methods to Calculate Underwriting Compensation in the Absence of a Written Agreement is Problematic

We believe that the proposed formula for calculating the amount of underwriting compensation in a principal transaction where there is no governing agreement or where the discount from the offering price from the public is not specified in the agreement is problematic in offerings made at the market.

Under the formula, the amount of underwriting compensation is equal to the difference between the purchase price and the sale price of the security, or, if there is a bona fide independent market, the difference between the purchase price and (i) the "prevailing market price" in the principal market at the time of purchase, as calculated by reference to the Mark-Up Policy or (ii) the "initial resale price," if certain other conditions are met. This approach does not factor in the risk that a member, as principal, takes in purchasing securities in at the market offerings in situations where there is no bona fide independent market for a security and the security is not an Actively-Traded Security. Even where there may be a bona fide independent market, the amounts and percentages that must be sold in order to establish the "initial sale price of the security" under the Proposal are unrealistically high for thinly traded securities. Instead of rigidly treating the difference in price as underwriting compensation, the calculation should recognize market forces, which may (or may not) reward the member for taking the risk, but which should not count towards the amount of underwriting compensation received. This is particularly true in the context of at-the-market offerings of equity-linked securities or other securities the value of which could change during the period of sale for reasons totally out of the member's control. We believe the formula for calculating underwriting compensation should be amended to limit the time period following the transaction during which the difference between the purchase price of a security and the sale price of a security is measured. This would eliminate the possibility that changes in market conditions outside of the member's control could have the effect of increasing underwriting compensation to unreasonable levels. We would propose that this time period not exceed one hour following execution of the initial sale into the market.

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In summary, Morgan Stanley is concerned that the Proposal is inconsistent with the Commission's reform proposal and will inhibit the ability of WKSIs and seasoned issuers to access the capital markets. In addition, the Proposal advocates the expansion of the NASD's review to the sale of securities from shelves in ordinary market transactions, a significant change in market practice for which no regulatory purpose appears to be served. These changes will result in delays and considerable expense to issuers and selling shareholders and may have a chilling effect on the filing of shelf offerings with the Commission that increases the cost of capital for issuers. For these reasons and the reasons stated above, we respectfully request that you reconsider the Proposal.

If we can answer any questions or provide any further information, please contact either of the undersigned at (212) 761-4000.

Respectfully submitted,

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