



February 1, 2005

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

Re: File No. SR-NASD-2004-22 Proposed Rule Change by the
National Association of Securities Dealers, Inc. Relating to the
Corporate Financing Rule and Shelf Offerings of Securities

Dear Mr. Katz:

The Capital Markets Committee (“Committee”) of the Securities Industry Association (“SIA”)¹ appreciates the opportunity to comment on the above-referenced rule proposal (the “Proposal”), which the Commission published for Comment on December 7, 2004 in accordance with Sections 19(b)(1) of the Securities Exchange Act of 1934 and Rule 19b-4 thereunder.

I. BASIC PRINCIPLES FOR REVISION OF THE CORPORATE FINANCING RULES IN RESPECT OF SHELF OFFERINGS

In July 2001, the Board of Directors of the National Association of Securities Dealers, Inc. (“NASD”) approved publication of NASD Notice to Members 01-59 and authorized the filing of the rule change with the Commission. On December 21, 2001, the Committee responded to NASD’s request for comment to the proposed rule change, applauding NASD for recognizing the practical problems of the application of NASD Rules 2710, 2720 and 2810 (the “Corporate Financing Rules” or the “Rules”) in the shelf offering context, and generally concluding that “the goal of simplifying the shelf offering process for seasoned issuers [had] not been met.” The Committee recommended the redrafting of the Proposal with the goal of simplifying the application of the Rules to the shelf offering process.

In February 2004, NASD republished the rule change with the Commission, and since that time amended the proposed rule on three occasions prior to its recent publication for comment by the Commission in the Federal Register.

¹

The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry employs 790,600 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated \$213 billion in domestic revenue and an estimated \$283 billion in global revenues. (More information about SIA is available at: www.sia.com.)

The Committee continues to applaud NASD's attempt to simplify the Corporate Financing Rules in respect of offerings by established issuers. In this regard, the Committee is guided by three basic principles:

- i. That the Rules are designed to seek issuer protection, and confront underwriter overreaching, in the context of the distributions of securities, and must not in that design interfere with ordinary course trading.
- ii. That offerings of securities on Forms S-3 and F-3 do not raise the concerns of issuer protection or underwriter overreaching.
- iii. That the substantive application of the Rules to shelf offerings, alone, fully balances the need for (a) regulatory protection, (b) market efficiency, and (c) appropriate apportionment of NASD's resources.

In this light, the Committee has reviewed the revised Proposal and the three amendments thereto. Generally, the Committee has come to the view that NASD's proposed rule change further complicates the shelf process at a time when the Commission's direction trends towards simplification.

Specifically, the Committee is concerned that the Proposal (i) extends the scope and reach of the Rules beyond their intended or useful function, and (ii) introduces changes to shelf offering compliance that may yield unforeseen impediments. Each of these concerns is detailed below.

The Committee believes that the Proposal should be revised, and would welcome the opportunity to convene a working group with NASD in order to design changes to the Corporate Financing Rules that will simplify the shelf offering process while preserving the regulatory goals of the Corporate Financing Rules.

II. THE COMMITTEE'S GENERAL CONCERN IS THAT THE PROPOSAL FURTHER COMPLICATES THE RULES AT A TIME WHEN THE COMMISSION'S DIRECTION TRENDS TOWARDS THE SIMPLIFICATION AND AUTOMATION OF THE SHELF OFFERING PROCESS

The purpose of the Rules is the protection of issuers from abusive practices by underwriters during the distribution of their securities. Among other things, Conduct Rule 2710 requires the review of underwriting terms and conditions by NASD prior to the commencement of certain public offerings. Owing in part to the limited ability of underwriters to set unusual or onerous terms when acting as underwriter in distributions of securities of established issuers, Rule 2710 exempts some public offerings from the filing requirement. Though exempted from the filing requirements of the Rules, such offerings remain subject to their substantive provisions.

The Proposal increases the complexity and difficulty of compliance with the Rules in the context of shelf offerings, and increases the burden on NASD members in respect of classes of offerings that have no demonstrable history of underwriter abuse. In addition, the Proposal may require the filing with NASD of shelf offering transactions that are currently not required to be filed.

The Committee notes that at the same time that NASD is proposing to substantially increase the Rules' complexity as they relate to shelf offerings, the Commission has proposed simplifications of the shelf offering process. SEC Release 34-50624 (November 3, 2004), relating to Securities Act Reform, proposes, among other things, (a) liberalization of requirements under Securities Act Rule 415 (including (i) elimination of the two year limitation for registered securities for a delayed offering, (ii) elimination of the "at-the-market" offering restrictions, (iii) elimination of the prohibition against immediate takedowns off shelf registration statements; and (iv) similar liberalization of Securities Act Rule 424 regarding the filing of prospectus supplements), (b) amendments to Forms S-3 and F-3 to expand the categories of majority-owned subsidiaries that would be eligible to register non-convertible securities or guarantees under those forms, and (c) comprehensive changes that will permit automatic shelf registration for certain well-known, seasoned issuers that meet certain proposed criteria. The Commission's proposals would modernize and liberalize the shelf offering process, yet the proposed NASD rules would negate the benefits of these proposals for many issuers, and well-known seasoned issuers (WKSI's) in particular.

The Committee recommends a redrafting of the Proposal. The stated goal of that redrafting should be the broad exemption of shelf and other short-form offerings from the Rules, and the harmonization of NASD and Commission regulation.

III. CONCERNS AND RECOMMENDATIONS REGARDING THE PROPOSAL

3.1 The Proposal represents a major expansion of the scope and reach of the Rules beyond their intended or useful function.

The Proposal extends the scope of the Rules through two amendments to the definitions found at Rule 2710. Specifically, NASD proposes a very broad definition of what constitutes "participation in a public offering", and proposes a circular definition of "underwriter or related person".

3.1.1 NASD proposes to use the Rules to regulate virtually all shelf offerings through its definition of "participation in a public offering".

Conduct Rule 2710 applies when an underwriter or related person "participates" in a public offering. NASD proposes to amend the definition of "participation in a public offering" as follows (new text is in [brackets]):

"Participation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, [principal, agency] or any other basis, [participation in a shelf takedown that does not satisfy the requirements of the market transactions exemption] ..."

NASD thus proposes to expand the reach of the Rule to any shelf offering that does not meet its narrow market transactions exemption. This definition will require substantive compliance with the Rules for virtually all shelf offerings, and will subject a host of offerings to NASD's filing requirement that were never intended to be covered by the Rules.

NASD Notice to Members 93-88 (addressing the application of the Corporation Financing Rules to shelf offerings) stated that the Rules were meant to apply to “any primary or secondary *distribution* of securities made pursuant to a registration statement or offering circular.” (Emphasis added.) In this context, the use of the word distribution constitutes a reference to Rule 10b-6 and to its successor rule, Regulation M. That term has since the 1960s been interpreted by the Commission and the Courts to refer to an offering of securities that is distinguished from ordinary trading transactions by the magnitude of the offering, the presence of special selling efforts, or the payment of compensation greater than that normally paid in connection with ordinary trading transactions, all of which are elements that are central to the Rules.²

As currently drafted, the Rules’ reach makes logical sense: NASD regulates distributions of securities, which are marked by special selling efforts and compensation, under the Rules, and regulates ordinary trading commissions and mark-ups under Rule 2440. In overturning this longstanding balance, the Proposal constitutes an unnecessary sea change for the regulation of securities transactions. For example, NASD may now require the filing and review of a resale shelf established by an issuer, without identification of a specific broker-dealer, on behalf of selling securityholders from which securities are sold from time to time at the prevailing market price and without special selling efforts. Such resale shelf offerings are not currently subject to the NASD’s filing requirement; to subject them to filing and review would create an unnecessary burden for selling securityholders and issuers, and would create significant unexpected timing delays for selling shareholders.

NASD has presented no evidence that such a radical change is warranted, or that any regulatory concern exists to which this expansion would respond.

The Committee recommends that the Proposal be redrafted to clarify that, for purposes of the Rules, “participation in a public offering” constitutes participation in any primary or secondary distribution of securities made pursuant to a registration statement or offering circular.

3.1.2 NASD proposes to define “underwriter or related person” circularly.

Conduct Rule 2710 applies when an “underwriter or related person” participates in a public offering. NASD proposes to amend the definition of “underwriter or related person” as follows (new text is in [brackets]; deleted text is in {braces}):

“Consists of underwriter’s counsel, financial consultants and advisors, finders, any participating member, and any other persons {related to any participating member} [that receive any item of value that would be considered underwriting compensation].”

As proposed, “underwriter and related persons” will include any “persons that receive any item of value that would be considered underwriting compensation.” However, underwriting compensation is defined in Rule 2710(d)(1) as the receipt of any item of value by an

² See, e.g., *Bruns, Nordeman & Company*, 40 S.E.C. 652 (1961)

“underwriter or related person” within 180 days immediately preceding the required filing date of the public offering. Under the Rules as proposed, therefore, an “underwriter” will be any person that receives “compensation”, while “compensation” will be any item of value received by an “underwriter”.

NASD must correct this circularity because it may permit the treatment as underwriting compensation of amounts received from an issuer that are wholly unrelated to the transaction under review. However, merely finding a less circular means of drawing inappropriate persons under the Rules’ scope is unsatisfactory. The Rules are intended to curtail overreaching by underwriters and their affiliates in respect of total underwriters’ compensation in connection with distributions of securities, and the definition of “underwriter or related person” should be so tailored.

The Committee therefore recommends that the definition of “underwriter or related person” be clearly limited to NASD members acting as underwriters, their affiliates (as that term is defined in NASD Rule 2720), and their associated persons (as defined in NASD’s By-Laws). No evidence has been presented warranting a broader definition. That underwriters’ counsel, underwriters’ financial consultants, and finders are added to the definition is unnecessarily overbroad, but has generally had little effect in the application of the Rule.

3.2 Committee Recommendations regarding the modernization of the Rules’ filing exemptions in respect of shelf offerings

3.2.1 Committee Recommendation: Modernization of the Rules’ filing exemptions.

The Proposal represents an opportunity to allow the Department to focus its resources on the offerings that most require the review and comment of the Department, and to exclude from the filing requirements of the Corporate Financing Rules those offerings for which there is no evidence of issuer abuse or underwriter overreaching.

To that end, the Committee recommends that NASD amend the Proposal in order to exclude from the filing requirements of the Rules:

1. All offerings of securities that meet the standards set forth by the Commission for Forms S-3 and F-3, as such offerings by definition meet the Commission’s standards of seasoning required to be eligible to conduct short form transactions;
2. In the alternative, all shelf offerings of securities that meet the standards set forth by the Commission for Forms S-3 and F-3, and not merely those that meet the standards set forth by the Commission prior to 1992;
3. All offerings that are exempt from Commission review by virtue of being eligible for filing under the multi-jurisdictional disclosure system; and
4. All offerings issued or guaranteed by sovereign entities.

That such offerings will remain subject to the substance of the Rule will permit NASD to initiate investigations or examinations in respect of such offerings as necessary in order to determine compliance with the Rules.

Additionally, the Committee recommends that NASD take immediate steps to harmonize the Proposal with the Commission's Securities Act Reform proposals, including exemption from the Rules' filing requirements for any well-known, seasoned issuer.

3.2.2 Committee recommendation regarding the availability of shelf filing exemptions for distributions of securities by underwriters' affiliates.

The Rules permit an exemption from the NASD's filing requirements for shelf offerings of securities registered with the Commission on Forms S-3 or F-3, as those forms existed prior to October 21, 1992. However, no offering "subject to Rule 2720" may qualify for this filing exemption.

Rule 2720 requires certain special measures in connection with the distribution of securities of an issuer that controls, is controlled by, or is under common control with, an underwriter in such distribution, or of an issuer that is more than 10% owned by an underwriter and/or its parent and affiliate entities.

In practice, this formulation requires NASD review and clearance of offerings by many of the world's largest financial institutions. NASD insists on the review of such shelf offerings without any evidence of underwriter overreaching or issuer abuse in respect of offerings by NASD members and their affiliates.

For this reason, the Committee recommends that NASD amend the Proposal to exempt NASD members from filing any otherwise exempt shelf offerings where the issuer is the parent entity or the majority-owned subsidiary of such NASD member.

That such offerings would remain subject to the substance of the Rule will permit NASD to initiate investigations or examinations in respect of such offerings as necessary in order to determine compliance with the Rules.

3.2.3 The Proposal eliminates the existing filing exemption for subsidiary transactions on Forms S-3 or F-3, which exemption should be preserved.

Under the Rules, an exemption from the NASD's filing requirement is available for offerings of "*securities* registered with the SEC on Form S-3 or F-3, pursuant to the standards for those forms prior to October 21, 1992, and offered pursuant to SEC Rule 415 ..." (emphasis added). Under the Proposal, however, an exemption from filing will exist solely for *issuers* meeting the applicable standards. This is narrower than the language of the current rule, which permits an exemption covering securities of certain subsidiaries and other related companies that qualify for Form S-3 or F-3.

The Committee is of the view that no reason exists to eliminate the filing exemption for subsidiary transactions on Forms S-3 or F-3 that meet the required criteria, and consequently

recommends that NASD redraft the proposed filing exemption to ensure the availability of such exemption for offerings of securities registered on Forms S-3 or F-3.

In addition, the Committee notes that the Commission's Securities Act Reform proposals will permit additional access to Forms S-3 and F-3 for subsidiary transactions, and, as above, recommends the immediate harmonization of the Rules with the Securities Act Reform proposals in order to ensure that the Rules do not further diverge from market and Commission practice.

IV. THE MECHANICS OF THE RULE CHANGE PROPOSAL ARE UNDULY COMPLEX AND MAY YIELD UNINTENDED IMPEDIMENTS TO THE SHELF OFFERING PROCESS.

4.1 The proposed "Market Transactions Exemption" is far too narrow.

As noted above, NASD would apply the Rules' filing requirement to any shelf offering that does not meet NASD's proposed Market Transactions Exemption ("MTE"). Unfortunately, the MTE is far too narrowly drafted to be regularly relied upon.

Though the Committee principally recommends the elimination of the MTE in favor of a clear statement that the Rules apply only to distributions of securities, the Committee is concerned that the specific criteria of the MTE, if adopted, will subject too many ordinary market transactions to the Rules. Specifically:

- That transactions must be "unsolicited" in order to meet the MTE is inappropriate. The solicitation of securities transactions in absence of special selling efforts is the routine and regulated business of broker-dealers and does not, in and of itself, raise a requirement for NASD review and clearance.
- That the MTE is limited to transactions below a certain size (the greater of (a) 2% of the average daily trading volume (ADTV) on the dates of the transactions or (b) 10,000 shares, or securities convertible or exercisable into such number of shares) ignores the institutional nature of today's markets, and suggests that ordinary block trades without special selling efforts should be subject to NASD review. Further, if any maximum transaction size is adopted as a criterion of the MTE, that maximum should be substantially higher than is currently proposed.
- It is unnecessary to restrict the MTE to NASD members that have not entered into any agreement whatsoever with the issuer (or any selling securityholder) with respect to the sale of the securities offered. The suggestion by NASD that any agreement relating to the sale of securities outside the distribution context requires regulatory review is itself awkward, and may discourage parties from seeking the certainty of written agreements in a business setting.
- That the MTE will be reserved to NASD members that have not acquired any "item of value" – which term can include fairly priced derivatives – in connection with its participation in the shelf offering may limit the MTE,

for example by foreclosing the MTE to ordinary course sale transactions that are part of a series of transactions not involving any distribution.

- That the MTE may not be available to NASD members that are affiliates of the issuer, or that have a conflict of interest with the issuer under Rule 2720 would, if adopted, continue the unnecessary application of regulatory review to ordinary course transactions conducted outside the distribution context by many of the largest and most closely-watched issuers. Ordinary course market transactions should be exempt from the Rules' filing requirement.

4.2 The proposed filing requirements for shelf offerings may serve as an impediment to the offering process.

The Committee is concerned that the proposed filing requirements, if adopted, will add substantial complexity to the shelf offering process, will give rise to a host of unintended and unforeseeable consequences, and will be unknown and inaccessible to all but a handful of specialists in the securities and legal services industry. Specifically:

- The information that is required to be filed on NASD's WebCOBRA system requires substantial pre-filing diligence by underwriters and their counsel, and is an unnecessary impediment to a shelf offering in a setting where the concerns raised by the rule are nonexistent.
- The requirement that each underwriter must be individually reviewed prior to the issuance of a "no objections" opinion by NASD may reduce the ability of an issuer to seek to conduct offerings on a short time frame, especially if the proposed offering is the first takedown from a base prospectus, or if a new underwriter is proposed.

The Committee therefore specifically recommends that, if any filing is to be required in respect of shelf offerings conducted pursuant to Forms S-3 and F-3, then a notice filing of the takedown by the electronic submission of the prospectus and related supplement, as filed on EDGAR, will provide NASD with ample opportunity to review the terms and conditions of the underwriting and to examine or investigate any irregularities.

4.3 The proposed mechanism of determining the compensation received in principal transactions not governed by any agreement is unnecessary.

As noted above, the Committee is of the view that the regulation of securities transactions that are not distributions under the Rule is an unnecessary expansion of the Rule. That complex decision trees of formulae are proposed in order to determine "underwriting compensation" in market transaction settings – where no underwriting exists – speaks to the inadvisability of this aspect of the Proposal.

If the proposal moves forward with current (proposed) Rule 2710(c)(2)(F) governing the calculation of compensation in connection with market transactions, then the Committee would recommend that the criteria for both subclauses (1) and (2) of Rule 2710(c)(2)(F)(iii)(b) should be redrafted to provide that the bona fide attempt to sell at least 50% (or, in the case of subclause (2), at least 25%) of the securities at the initial resale price (or at lower prices) would permit the member to elect the initial resale price for purposes of calculation of compensation. Adding this language would be consistent with the analysis that NASD member firms undertake prior to changing the price in a fixed-price offering.

Finally, NASD gives no indication in the Proposal of what compensation will be acceptable in market settings, other than by reference to NASD Rule 2440, under which such transactions are rightly and currently regulated.

V. CONCLUSION

In 2001, the Committee expressed a concern that tensions would arise as increasingly complex NASD regulation met with securities reform efforts. Notwithstanding present Securities Act Reform proposals, NASD now proposes sweeping expansion of the scope of the Rules into ordinary market transactions outside the distribution context, and unduly complex and narrow methods for exemption from the review process.

The Committee recommends that the Rule be clarified with a clear statement of its application only to securities distributions, and that the Rule be modernized through the exemption of offerings that have no history of issuer abuse or underwriter overreaching. To that end, the Committee³ would welcome the opportunity to work with NASD in order to revise the Proposal to meet these goals.

The Committee appreciates very much this opportunity to present our views. Should you have any questions, please feel free to communicate with our SIA staff advisor Scott Kursman, Vice President & Associate General Counsel of SIA, at (212) 618-0508, or with our counsel for NASD Corporation Financing Rules, Charles Gittleman and Russell Sacks, at Shearman & Sterling, at 212-848-7317. We would be happy to arrange a meeting between the Staff and members of the Capital Markets Committee to explain our views more thoroughly.

Very truly yours,

John Faulkner
Chair, SIA Capital Markets Committee

³ The NASD member firms represented on the Committee are: ABN Amro Incorporated, Banc of America Securities LLC, Bear, Stearns & Co., Inc., CIBC World Markets Corp., Citigroup Global Markets Inc., Credit Suisse First Boston LLC, Deutsche Bank Securities Inc., Goldman, Sachs & Co., J. P. Morgan Securities Inc., Legg Mason Wood Walker, Incorporated, Lehman Brothers Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co., Incorporated, Piper Jaffray & Co., RBC Capital Markets Corporation, Ryan Beck & Co., and UBS Securities LLC.

Cc's: Annette L. Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Larry E. Bergmann, Associate Director, Division of Market Regulation
James Brigagliano, Assistant Director, Trading Practices, Division of Market Regulation
Katherine A England, Assistant Director, Division of Market Regulation

Thomas Selman, Senior Vice President, Corporate Financing, NASD
Joseph E. Price, Vice President, Corporate Financing, NASD