

**SEC-REPLY-1:**

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

June 24, 1996

RESPONSE OF THE OFFICE OF THE CHIEF COUNSEL  
DIVISION OF CORPORATION FINANCE

Re: Morgan Stanley & Co., Incorporated  
Incoming letter dated May 21, 1996

Your letter requests that the Division address disclosure issues relating to registered offerings of securities that are exchangeable, on either an optional or a mandatory basis ("Exchangeable Securities"), for the equity securities (or the cash value thereof) of another issuer ("Underlying Securities"). In setting forth our views, please note that the staff may not necessarily agree with your analysis.

In the Division's view, complete financial statement and non-financial statement disclosures regarding the issuer of the Underlying Securities is material to investors at the time of both the initial sale of the Exchangeable Securities and on a continuous basis thereafter until the Underlying Securities (or the cash value thereof) have been exchanged for the Exchangeable Securities and other payment obligations on the Exchangeable Securities, if any, have been satisfied. Since an investor's return on the Exchangeable Securities depends materially on the market performance of the Underlying Securities, holders of the Exchangeable Securities should be provided with full and fair disclosure about the issuer of the Underlying Securities in addition to that provided with respect to the issuer of the Exchangeable Securities.

It also is the Division's view that this complete disclosure is not required to be set forth in the filings of the issuer of the Exchangeable Securities where there is sufficient market interest and publicly available information regarding the issuer of the Underlying Securities.

At this time, the Division has concluded that sufficient market interest and publicly available information exists where the issuer of the Underlying Securities:

1. Has a class of equity securities registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"); and
2. Is either
  - a. Eligible to use Form S-3 or F-3 under the Securities Act of 1933 (the "Securities Act") for a primary offering of non-investment grade securities pursuant to General Instruction B.1 of such forms; or
  - b. Meets the listing criteria that an issuer of the Underlying Securities would have to meet if the class of Exchangeable Securities was to be listed on a national securities exchange as equity linked securities, such as American Stock Exchange Rule 107.B.

Where there is sufficient market interest and publicly available information, as described above, the issuer of the Exchangeable Securities may include abbreviated disclosure about the issuer of and terms of the Underlying Securities in its registration statement under the Securities Act and periodic reports under the Exchange Act. The abbreviated disclosure would include at least the following information:

1. A brief discussion of the business of the issuer of the Underlying Securities;
2. Disclosure about the availability of information with respect to the issuer of the Underlying Securities similar to that

called for by Item 502(a) of Regulation S-K; and

3. Information concerning the market price of the Underlying Securities similar to that called for by Item 201(a) of Regulation S-K.

The Division's views outlined above relate only to disclosure matters and do not consider any legal issues as to whether registration of the offer and sale of the Underlying Securities is required under the Securities Act.

Because these views are based on the representations made to the Division in your letter, it should be noted that any different facts or conditions might require another conclusion.

Sincerely,

Mark W. Green  
Special Counsel

**INQUIRY-1:**

DAVIS POLK & WARDWELL

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Section 10 of the Securities  
Act of 1933, as amended

May 21, 1996

Office of Chief Counsel  
Division of Corporation Finance  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Attention: Abigail Arms,  
Associate Director

Dear Ms. Arms:

We are writing on behalf of our client, Morgan Stanley & Co. Incorporated ("Morgan Stanley"), to request interpretative advice concerning certain disclosure issues that have arisen in connection with proposed registered offerings of exchangeable securities. Specifically, we request that the Staff confirm our views that securities that are exchangeable, on either an optional or a mandatory basis, for the equity securities (or the cash value thereof) of an unaffiliated entity that does not qualify to offer its own securities on Form S-3 or Form F-3 under the Securities Act of 1933 (the "Securities Act"), may be sold pursuant to a prospectus that includes only a few items of information about the underlying equity issuer, so long as (a) the underlying equity issuer has a class of securities that are registered under Section 12 of the Exchange Act of 1934 (the "Exchange Act") (including American depositary shares), (b) the underlying equity issuer meets the criteria that an underlying issuer would have to meet if the exchangeable securities were to be listed on a national securities exchange as equity linked notes (whether or not the exchangeable securities are actually listed) and (c) the issuer of the exchangeable security does not have any material non-public information about the issuer

of the underlying equity security.

## I. Background

For the purposes of this letter, exchangeable securities are securities that are exchangeable for the equity securities (or the cash value thereof) of a different issuer. They may be optionally exchangeable or mandatorily exchangeable.

An optionally exchangeable security gives the investor the right to decide whether to exchange the security for the underlying equity security. An optionally exchangeable security typically protects the investor against a decrease in the market price of the underlying equity security between the exchangeable security's issue date and its maturity date. If the investor does not exchange the security prior to maturity or earlier redemption, the issuer is required to pay the principal amount or redemption price in cash. If the investor does exchange the security, the terms of the security may require the issuer to pay the current value of the underlying equity security in cash or may require the issuer to deliver the underlying equity security. An optionally exchangeable security may also permit the issuer or the investor to choose cash or stock settlement.

A mandatorily exchangeable security provides for an automatic exchange of the exchangeable security for the underlying equity security. A mandatorily exchangeable security typically does not confer protection against loss; rather it provides that the amount payable at maturity or upon earlier redemption is a function of the market price of the underlying security. Like an optionally exchangeable security, a mandatorily exchangeable security may require the issuer to pay the cash equivalent of the underlying equity security or may require it to deliver the underlying security. A mandatorily exchangeable security may also permit the issuer or the investor to choose cash or stock settlement.

In all of the cases addressed in this letter, the issuer of the exchangeable security is not an affiliate of the issuer of the underlying equity security. In addition, in all such cases, the issuer of the exchangeable security either owns underlying equity securities that, at the date of issuance of the exchangeable security, are eligible for sale to the public without registration under the Securities Act ("freely transferable securities") or proposes to acquire freely transferable securities over the term of the exchangeable security.

In the offerings Morgan Stanley proposes to underwrite, a company holding or intending to acquire freely transferable securities wishes to issue either an optionally or mandatorily exchangeable security that may be cash settled only or may permit or require stock settlement. Because the underlying equity securities are freely transferable, no question arises as to the registration of the equity securities under the Securities Act. But if the issuer of the underlying equity security is not eligible to offer its securities using Form S-3 or F-3, a question arises as to the information about the equity issuer that the issuer of the exchangeable security must include in its prospectus.

## II. Analysis

We understand that the Staff's position has been to draw a distinction between offerings in which the underlying equity issuer is eligible to offer its own securities on Form S-3 or F-3 and those in which it is not. Under this view, if the underlying issuer is S-3 or F-3 eligible, the issuer of the exchangeable security is required to include in its prospectus only a few items of information about the equity issuer (typically, a very brief description of the equity issuer's business, a statement that it files reports and other information under the Exchange Act and information concerning market prices of the equity securities). Conversely, if the underlying equity issuer is not eligible to offer its own securities on Form S-3 or F-3, the issuer of the exchangeable security must include in its prospectus substantially all of the information the equity issuer would have had to include if it were making a public offering of its own securities. We also understand that this distinction is based on the view that information concerning the underlying equity issuer is material to prospective purchasers of the exchangeable securities and that if the underlying issuer is not S-3 or F-3 eligible, the necessary information is not sufficiently available in the public market to permit the issuer of the exchangeable security to exclude the information from its prospectus.

During our telephone calls with you on this subject, we argued that this analogy to a primary offering by the underlying equity issuer is inappropriate and that a better analogy is to a secondary offering of freely transferable securities by a non-affiliate of the equity issuer. In such a transaction, a seller who has no material non-public information about the issuer is permitted to resell the securities without having to present the buyer with copies of the issuer's Exchange Act filings, no matter how material they may be. The secondary sale analogy is supported by the equity issuer's lack of involvement in the offering of the exchangeable security: the equity issuer does not receive any of the proceeds of the offering; it does not participate in the marketing process, and it does not provide the issuer of the exchangeable security or the underwriters for the offering with an opportunity to conduct a due diligence

review of the equity issuer's business and financial condition. In some cases, the equity issuer may not even be aware of the offering until it has been made public.

You explained that the Staff is unwilling to accept this position, in part because it does not set a sufficiently high standard as to the availability of public information about the equity issuer. While not conceding that a higher standard is required, given our view that the secondary sale analogy is the correct legal analysis, we explored with you whether criteria in addition to those that qualify an issuer to use Form S-3 or F-3 could serve as a basis for concluding that information about an underlying equity issuer is sufficiently widespread to permit its exclusion from the prospectus for an exchangeable security.

In this connection, we noted that the Options Clearing Corporation (the "OCC") issues long-term options ("LEAPS") and is in the process of obtaining permission from the Commission to issue a type of mandatorily exchangeable security ("BOUNDS") on the equity securities of underlying issuers that are not S-3 or F-3 eligible (e.g., Telecomunicacoes Brasileiras S.A. - Telebras). Offerings of LEAPS are registered under the Securities Act, but the OCC's prospectus does not contain any information about the issuer of the underlying equity security.

The LEAPS are listed for trading on the American Stock Exchange, the Pacific Stock Exchange and the Chicago Board Options Exchange pursuant to criteria approved by the Commission (e.g., AMEX Rule 915). In approving the listing criteria for LEAPS, the Commission did not use the Form S-3 eligibility criteria to determine when information about the underlying equity issuer is required to be included in the OCC's prospectus. Rather, it used criteria that measured the underlying issuer's market capitalization and trading volume to allay any concerns about the public availability of such information.

While the criteria for listing LEAPS were specifically developed for the listing of OCC options, separate and equally specific criteria have been developed for the listing of mandatorily exchangeable securities -- the criteria relating to the underlying equity issuer that must be satisfied to list equity linked notes. Mandatorily exchangeable securities may be listed on a national securities exchange only if they satisfy these criteria, which establish requirements for trading volume and market capitalization with respect to the underlying equity issuer that are more stringent than those for listing options. See, e.g., AMEX Rule 107.

These criteria, a version of which are set forth in AMEX Rule 107.B.(d), (e), (f) and (h), set standards for trading volume and market capitalization that permit high capitalization to offset low trading volume and vice versa. Paragraph (d) of the rule provides in part:

The underlying linked stock either: (i) has a minimum market capitalization of \$ 3 billion and during the 12 months preceding listing is shown to have traded at least 2.5 million shares, (ii) has a minimum market capitalization of \$ 1.5 billion and during the 12 months preceding listing is shown to have traded at least 20 million shares; or (iii) has a minimum market capitalization of \$ 500 million and during the 12 months preceding listing is shown to have traded at least 80 million shares. n1

Morgan Stanley believes that market capitalization and trading volume are good indicators of the level of market interest and that a high degree of market interest is accompanied by widespread availability of information about the company in the public market.

Accordingly, we suggest that the Staff's concerns over the availability of information about an underlying issuer that is not S-3 or F-3 eligible will be satisfied if (a) the equity issuer has a class of securities that are registered under Section 12 of the Exchange Act (including American depositary shares) and (b) meets the criteria that an underlying issuer would have to meet if the exchangeable securities were to be listed on a national securities exchange as equity linked notes. This test would not require the exchangeable securities actually to be listed as equity linked notes, since the purpose of the test is to identify issuers that, although ineligible to use Form S-3 or F-3, are sufficiently well known in the marketplace to permit the exclusion of information about them from the prospectus for the exchangeable securities. It should not matter if the exchangeable securities are equity linked notes that will be listed on a national securities exchange or are exchangeable securities that will be listed pursuant to different listing criteria, so long as in each case the underlying issuer meets the equity linked note standards. Similarly, it should not matter if the equity linked notes cannot be listed for some reason unrelated to the qualifications of the underlying issuer (e.g., the offering does not meet the applicable distribution or size requirements or the issuer of the exchangeable security does not meet the criteria applicable to it).

In addition, in order to prevent the issuer of the exchangeable security from trading on the basis of inside information concerning

the underlying equity issuer, the issuer of the exchangeable security should not have any material non-public information about the issuer of the underlying equity security when it issues the exchangeable security.

If you have any questions concerning the foregoing or require any additional information, please call the undersigned (at 212-450-4648) or my partner, Linda Simpson (at 212-450-4332).

Very truly yours,

John M. Brandow