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June 16, 1997

Ms. Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

Re: NASD Regulation, Inc. ("NASDR") Request for Comment 97-30

Dear Ms. Conley:

PSA The Bond Market Trade Association (PSA)¹ wishes to offer its views on one of the matters raised in the above-referenced Request for Comment 97-30 ("RFC 97-30"), issued by NASDR in May 1997. RFC 97-30 generally deals with the NASD Free-Riding and Withholding Interpretation, IM-2110-1 (the "Interpretation"), and specifically, certain proposed changes to the Interpretation now being considered by NASDR.

PSA's specific comments relate to NASDR's proposal to exempt investment grade rated debt offerings from the scope of the Interpretation. For the reasons briefly outlined below, and with several suggested clarifications, PSA strongly supports such an exemption.

In general, the Interpretation is designed to protect the integrity of the public offering process by ensuring that members make a bona fide public distribution of so-called "hot issue" securities, and do not withhold such securities for their own benefit or use the securities to reward other persons who are in a position to direct future business to the member. As noted in RFC 97-30, the Interpretation has been amended over the years to ensure that there is a bona fide distribution of securities for which there is a substantial public demand.

Debt offerings are generally included in the Interpretation's definition of "public offering." NASDR proposes to delete offerings of investment grade rated debt from the scope of the Interpretation, because such offerings do not raise the same issues that are posed by offerings of equity securities. Specifically, the exception would apply to "non-convertible debt securities rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories." NASDR observes that in particular, the prices for such securities generally fluctuate based on interest rate movements, rather than on excess demand for a particular security.

PSA generally agrees with these observations, and supports NASDR's recommendation to exempt investment grade rated debt securities from the scope of the Interpretation.²

We are heartened by NASDR's recognition that in this instance, as in other situations, rules that were developed largely in the context of the equity markets should not automatically be applied to fixed income securities. Fixed-income securities generally are issued and traded primarily on the basis of yield and credit quality. These characteristics are in turn functions of market interest rates, and the maturity and rating of the particular instrument. Rather than seek a specific security of a particular issuer, investors in these securities generally seek bonds of a certain credit quality at a given spread above a benchmark Treasury security having a comparable maturity. In this sense, fixed-income securities generally-and investment grade debt securities in particular-of comparable credit quality are fungible, and largely interchangeable. This circumstance effectively negates the underlying policy concern that may have led NASD in the first instance to adopt regulations designed to curb potential sales abuses in "hot issues" of equity securities, which may be linked to the identity of a particular issuer.

In this regard, PSA believes that NASDR should consider supplementing the proposed exemption with the added language "investment grade securities that trade primarily on the basis of yield," or a similar functional standard, rather than a narrower exclusion solely for investment grade non-convertible debt securities. For example, the NASDR's proposal to limit the exemption to "non-convertible debt securities" would appear to exclude traditional preferred stock, and newer forms of capital securities (e.g., QUIPS, TOPrS, Trust Preferreds, MIPS, etc.). Although these instruments are fixed income securities that trade primarily on the basis of yield, in technical terms they may be classified as equity securities, or hybrid securities having characteristics of both debt and equity. Thus, although the fundamental policy rationale underlying the exemption for investment grade non-convertible debt securities applies equally to preferred stock and capital securities, it is not clear that such securities would be covered by the exemption as drafted.

On a related point, certain types of debt securities may be "convertible" into a security other than common stock (for example, into a preferred stock or into another class of debt security). In addition, some capital securities are convertible by the issuer into debentures of that underlying issuer. In these circumstances, PSA believes that it would be helpful for NASDR to confirm or otherwise clarify, in updating the Interpretation, that (1) the primary concern relating to conversion features of securities is that such features may affect the trading price of the security to such a degree that the instrument trades similarly to the equity securities of the issuer; and (2) if a conversion feature does not by its nature create such concerns, then that feature alone should not destroy the effectiveness of an otherwise appropriate exemption for the underlying fixed income instrument.

Again, PSA appreciates the opportunity to comment on this aspect of the Interpretation. Should you have any questions or desire clarification of the matter discussed in this letter, please do not hesitate to contact Paul Saltzman at (212) 440-9459 or George Miller at (212) 440-9403.

Sincerely,

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General Counsel

George P. Miller
Vice President,
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cc:John E. Pinto, Executive Vice President,
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1 PSA represents approximately 220 securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. PSA's member firms account for in excess of 95% of all primary issuance and secondary trading activity in the domestic debt capital markets. More information about PSA may be obtained from our website at <http://www.psa.com>.

2 PSA would urge NASDR specifically to confirm that investment grade asset-backed securities are considered "debt securities" for purposes of the Interpretation, even though they may be issued in technical terms as "equity" interests in a trust or similar vehicle. Notwithstanding this distinction, investment grade asset-backed securities possess the same essential characteristics as other types of non-convertible investment grade debt securities, in that they are issued and traded primarily on the basis of yield and credit quality.