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December 13, 2005

Mr. Elliot Levine, Chief Counsel
Transparency Services, Markets, Services, and Information
Ms. Sharon Zackula, Associate General Counsel
Office of General Counsel, Regulatory Policy and Oversight
National Association of Securities Dealers, Inc.
1735 K St NW
Washington, DC 20006

Re: TRACE and Notice to Members 05-77

Dear Mr. Levine and Ms. Zackula:

The Bond Market Association (“Association”)¹ is writing this letter in response to the publication on November 9, 2005, by the National Association of Securities Dealers, Inc. (“NASD”) of Notice to Members 05-77 (“NTM”), relating to the NASD’s Trade Reporting and Compliance Engine (“TRACE”). We continue to applaud the NASD’s ongoing efforts to create a workable and fair rule governing the reporting and dissemination of secondary market trade information for corporate bonds. The Association’s comments on the NTM are offered in the spirit of the ongoing and constructive dialogue that the Association has had with the NASD concerning corporate bond price transparency and the continued evolution of the TRACE rule. We would appreciate the opportunity to meet with you to discuss the issues raised by this letter.

I. Introduction

A. The NTM

In the NTM, the NASD provides interpretive guidance under Rule 6230, stating that members must report to the NASD transactions in TRACE-eligible securities executed in connection with: (1) the exercise or settlement of options; and (2) the termination or settlement of swaps, including credit default swaps (“CDS”) or similar instruments (collectively, “Triggered Deliveries”).

¹ The Association is the trade association representing securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. More information about the Association is available on its website at <http://www.bondmarkets.com>. This comment letter was prepared in consultation with the Association’s Corporate Credit Markets Division Executive, Legal Advisory, and Operations Committees.

B. The Instruments at Issue

The instruments at issue are over-the-counter (“OTC”) options on TRACE-eligible securities², CDS referencing TRACE-eligible securities, and similar products. The OTC options are agreements in which the party that is long the option has the right to either buy (with a call) or sell (with a put) an underlying TRACE-eligible security at a fixed price at a fixed date (European style) or over a fixed period of time (American style). The fixed price negotiated between the parties at the outset of the option is known as the strike price. When the option is “in the money” the party that is long the option can compel the party that is short the option to deliver (or receive) a security at the strike price. A call is “in the money” when the current market price exceeds the strike price. A put is “in the money” when the strike price exceeds the current market price. When the option is exercised, the parties exchange a security for cash at the strike price. The strike price is unrelated to the market price at the time of delivery, having been negotiated by the parties at the time of the negotiation of the option contract.³

The NASD provides a description of a CDS transaction in footnote 1 of the NTM. In short, one party to the contract pays a fee to the other party in exchange for risk protection in the event a credit event impacts the issuer of the TRACE-eligible security. Unlike an option on a security, a CDS that references a security is not itself a security.⁴ As with options, if a triggering credit event occurs, the parties deliver securities versus cash at a price unrelated to the current market.

For the reasons outlined below, the Association respectfully contends that the Triggered Deliveries should not be reportable to TRACE. Further, the Association is of the view that the NASD should not disseminate these reports. Last, should the NASD mandate reporting in this context, NASD should address its members’ interpretive issues surrounding such reporting and address certain logistical issues firms have encountered in their attempts to report the Triggered Deliveries, which should be resolved before such reporting is mandated.

II. Discussion

² See NASD Rule 6210(a) (defining TRACE-eligible security).

³ For example, parties may enter into a call option contract on September 1, 2005, for \$10 million principal amount of bonds at a strike price of 90, exercisable until December 1, 2005. If on November 1, 2005, the bonds are trading at par (100), they will be in the money. The party that is long the call can compel the party that is short the call to sell it \$10 million principal amount of bonds at 90, which it can then resell at par (100), earning 10 points (less expenses).

⁴ See Section 3A(b) of the Securities Exchange Act of 1934 (“Exchange Act”) (“the definition of ‘security’ in section 3(a)(10) of [the Exchange Act] does not include any security-based swap agreement. . . .”). Note that the anti fraud provisions of Section 10(b) of the Exchange Act apply to securities-based swap agreements.

A. Reporting of Triggered Deliveries Should Not Be Required

The Association believes that the NASD should not require the Triggered Deliveries to be reported to TRACE because the TRACE reports serve no investor protection or other regulatory purpose or significance, the Triggered Deliveries are not secondary market transactions and the requirement is inconsistent with other NASD trade reporting rules which do not require trade reporting in similar situations.

1. No Investor Protection Significance to the Reported Prices

The two primary purposes of TRACE, as articulated in the adopting release⁵ are: (1) to permit the NASD to “take a proactive role in supervising the corporate debt market . . . to better detect fraud and foster investor confidence in the fairness of the corporate debt market”⁶ and (2) to increase transparency in the debt markets.⁷ Requiring members to report the Triggered Deliveries furthers neither of these purposes.

As the NASD acknowledged in the NTM, “the price of the later occurring transaction in TRACE-eligible securities does not reflect then current market price for those securities.” While this is undeniably true, it does not go far enough. Not only do these trades not reflect the current market, they reflect an execution price negotiated and agreed to at a prior point in time. Because the prices are completely unrelated to the current market for the security at issue, trade reports will not assist the NASD in identifying any potential regulatory violation in connection with trading in TRACE eligible securities, such as violations of the NASD’s fair pricing or mark-up guidelines. Accordingly, these trade reports will not, as is the stated purpose of TRACE, enable NASD “to take a more proactive role in supervising the corporate debt market.”⁸ Further, reports related to the Triggered Deliveries add nothing to corporate bond price transparency. The prices do not reflect prices at which customers may buy or sell bonds and do not reflect price points at which any market participant (dealer or customer) would be willing to provide liquidity. Accordingly, the purposes for which TRACE was implemented do not support the NASD’s view that the Triggered Deliveries should be reported and the Association believes that the NASD should not, in fact, require such reporting.

2. The Triggered Deliveries are Not Secondary Market Transactions

⁵ Exchange Act Rel. No. 43873 (Jan. 31, 2001) (“Adopting Release”).

⁶ Adopting Release at 1.

⁷ Adopting Release, text accompanying footnote 50.

⁸ Adopting Release at 2 and 3.

Rule 6210(c) defines “reportable TRACE transaction” to mean “any secondary market transaction in a TRACE-eligible security” The Association believes, however, that the Triggered Deliveries are not properly viewed as secondary market transactions. In this regard, at the time of the Triggered Deliveries, the broker-dealer is not involved in any price negotiation or price discovery and no agreement is reached by the parties as to price; rather, the Triggered Delivery represents the completion of a prior commitment at a pre-determined price. As the pre-determined price has nothing to do with current trading in the security, the Triggered Delivery is not a transaction that is occurring in the secondary market and thus should not be TRACE-reportable. Further, at the time of the Triggered Delivery, the broker-dealer’s involvement is quite minimal. In this regard, the broker-dealer delivers (or receives) securities versus cash based on a triggered event in a previously negotiated contract. This is more akin to settlement of a transaction based on a pre-existing price than entering into a new transaction based on the current market for the security. As TRACE reporting is triggered by secondary market transactions at currently negotiated prices, the Association does not believe that TRACE reporting should be required in connection with the Triggered Deliveries. Note that to the extent the firm receiving the security then sells it, that sale will be reported under existing TRACE rules and interpretations.

This view is consistent with guidance the NASD has previously supplied on the need to report (or not report) certain types of transactions involving TRACE-eligible securities. The NASD has stated that repurchase agreements in TRACE-eligible securities “are not viewed as transactions in the secondary market for the purchase and sale of corporate bonds, but, rather, as financing transactions for members.”⁹ By contrast, the NASD has required reporting of issuers’ open market repurchases of TRACE-eligible securities even though such repurchases may occur at off market prices and at abnormal volumes, in part based on the fact that “in such purchases and sales, market participants negotiate the price and other terms of the transaction . . . based on investment, commercial or trading considerations Even where an issuer, or a market participant on behalf of an issuer, determines to price and purchase a significant amount of a debt security, the price established for the transaction is determined with substantial reference to the current market price of the security and current market conditions. . . .”¹⁰ However, with OTC options and CDS, the price of the Triggered Delivery has nothing to do with current market conditions.

As such, the NASD has excluded the delivery and receipt of TRACE-eligible securities in connection with repurchase agreements from reporting because they are not

⁹ See TRACE FAQ Rules & Compliance (“Are repurchase agreements (‘Repos’) reportable to TRACE if the securities involved are TRACE-eligible? For purposes of TRACE reporting, bona fide properly documented repo transactions are not viewed as transactions in the secondary market for the purchase and sale of corporate bonds, but, rather, as financing transactions for members.”)

¹⁰ Letter from Sharon Zackula to Dennis C. Hensley (Nov. 13, 2002) (focusing on the NASD Rule 6230(e) exception for securities at trades “at a price substantially unrelated to the current market”).

viewed as secondary market transactions, and has required reporting in the context of an issuer repurchase because the repurchases are based on current price negotiations. Consistent with this guidance, the Association believes that the Triggered Deliveries should be viewed as occurring outside the secondary market for the securities because the prices are not based on current negotiations and thus transaction reporting should be not be required.

We would also note that certain Association members have a recollection of being advised by the NASD verbally, at approximately the time that TRACE was initially implemented, that transactions resulting from the exercise of an option would not be TRACE reportable. As such, many Association members view the NTM as promulgating a new interpretation that is inconsistent with prior guidance.

3. NASD Trade Reporting Rules for Equities Do Not Require Trade Reporting in Similar Situations

The trade reporting rules for equity securities, including the NASD's own equity trade reporting rules, have long excluded reporting of trades on the exercise of options and similar transactions.¹¹ These equity trade reporting rules have the identical purpose of TRACE – to provide transparency to investors and to enhance oversight by regulators.¹² As the rationale underlying equity trade reporting tracks the rationale underlying debt trade reporting, it is not clear to the Association why the NASD would make different policy choices, in this limited context, for trade reporting in the equity and debt markets. Further, we are not aware of any differences between the debt and equity markets, in this limited context, that would require different policy choices in this area. We believe that the NASD should strive for consistency in this area, to avoid both dealer and customer confusion. Inconsistency leads to confusion and unnecessarily increases compliance complexity for broker-dealers, who need to track two different requirements for the same

¹¹ See Consolidated Tape Association Plan, Second Restatement, 1995 at 22-23 (“the following types of transactions are not to be reported for inclusion on the consolidated tape . . . (vii) purchases or sales of securities effected upon the exercise of an option pursuant to the terms thereof or the exercise of any other right to acquire securities at a pre-established consideration unrelated to the current m market. . . .” NASD trade reporting rules for equity securities reflect this exclusion. See e.g., NASD rule 4630(e)(6).

¹² When equity trade reporting rules were initially proposed in 1972, the Securities and Exchange Commission (“SEC”) stated, that “an essential step toward formation of . . . a central market system is to make information on prices, volume and quotes for all securities in all markets available to all investors and their broker-dealers, to help assure that every investor may receive the best possible execution of his order.” Exchange Act Release No. 9530 (Mar. 8, 1972). Further, in 1981, when equity trade reporting was expanded to equities traded in the OTC market, the SEC stated that “[I]n the securities markets, as in most other active markets, it is critical for those who trade to have access to accurate, up-to-the-second information as to the prices at which transactions in particular securities are taking place (i.e., last sale reports)” Exchange Act Rel. No. 17549 (Feb. 25, 1981) (text accompanying fn. 48). The SEC also stated that “transaction information also will assist the Commission’s and NASD’s oversight responsibilities with respect to the OTC market generally.” Exchange Act Rel. No. 17549 (Feb. 25, 1981) (text following fn. 52).

issue under two sets of trade reporting rules issued by the same self-regulatory organization. It also leads to confusion among investors, who need to accommodate themselves to different practices in different markets, in situations where there does not seem to be a justification for the different practices. The Association believes that absent a compelling justification, the NASD should avoid inconsistencies of this nature.¹³

Further, the Association has in the past looked to trade reporting requirements for equity securities in analyzing TRACE reporting requirements. In connection with the exchange of TRACE-eligible securities for a creation unit of an exchange traded fund, the NASD, referencing equity trade reporting rules, concluded that such exchanges are not required to be reported to TRACE.¹⁴ We believe that the NASD should similarly look to the equity trade reporting rules for guidance in this area and not require reporting of Triggered Deliveries.

B. Dissemination of these Reports Risks Confusing Investors

The Association strongly believes that reports of Triggered Deliveries should not be disseminated, as disseminating them serves no useful purpose and in fact may be harmful to the extent it causes confusion among investors and dealers. As more fully explained below, these reports will confuse investors both as to the pricing and liquidity in a security.

The NASD previously has made clear that where the reported yield would provide inaccurate or misleading information concerning the price of, or trading in, the security, reporting of that yield would not be required.¹⁵ Similarly, we believe that disseminating the Triggered Deliveries provides inaccurate and misleading information. We believe that the information is inaccurate, in that it suggests to investors that trades are being executed at prices that are away from the prevailing market. We do not believe that the special price indicator, by itself, is sufficient to explain these transactions to many investors, especially when a significant number of reports in a given day represent Triggered Deliveries, which may be typical if a credit event impacts a large issuer of TRACE-eligible securities.

Until now, the special price indicator has been used to indicate the existence of a special trade condition that impacted the execution price, such as trading a bond flat or

¹³ The Association often takes the position that rules designed for the equity markets are not appropriate for the fixed income markets, due to the different nature and characteristics of the debt markets. However, in this limited instance, the Association believes that consistency is warranted.

¹⁴ See Letter from Sharon K. Zackula, NASD, to Alice Yau, Vice President, Compliance, J.P. Morgan Securities, Inc. (Mar. 18, 2003).

¹⁵ See NTM 02-76 (November 2002) at 818.

with accrued interest against market convention¹⁶ or a trade price that reflects a due bill or warrant.¹⁷ These are trades that occur in the context of the current market and represent a current investment decision (and thus provide information about current liquidity), but at prices that do not imply standard market conventions. In contrast, the Triggered Deliveries occur at prices wholly unrelated to the current market and do not reflect any current investment decisions or say anything whatsoever about current liquidity. Using the special price flag for these multiple purposes also may raise investor confusion, as investors will not understand what the special price may represent. Further, trades reported with the special price indicator are not incorporated into the day's high, low and last price for the security.¹⁸ Where many trades are reported with the special price indicator, this too could cause confusion.

Second, we believe that the information is misleading in the sense that it suggests greater market liquidity than actually exists, as the Triggered Deliveries do not represent current investment decisions at prevailing market prices.

By way of example, we have attached a printout of transactions in Delphi bonds, printed from www.investinginbonds.com on November 17, 2005. These printouts show a jumble of trades executed in the range of 50 percent of par and 100 percent of par on the same day, all inter-mingled. While the trade reports are accompanied by an asterix (*) to indicate they were executed at a "special price" there is no context for an investor looking at this information to know what that means. The bonds disseminated at par could cause confusion for some investors, who may wonder why they may not be able to sell their own bonds at par. We cannot discern any purpose behind disseminating these trade reports, and indeed we believe that dissemination may be harmful to the extent it risks misleading or confusing investors, in particular, retail investors. Even a quick glance at the attached pricing data, in both graphic and tabular form, shows how the dissemination of Triggered Deliveries causes a confusing and possibly misleading jumble of trade reporting information.

Given that one of the main purposes of TRACE is to provide transparency for investors, trade reports that may confuse investors, particularly retail investors, should be avoided as inconsistent with the NASD's investor protection goal.

C. Interpretive Issue

The NASD needs to address certain interpretive issues in connection with the reporting of the Triggered Deliveries. First, it is not clear what date and time the

¹⁶ TRACE User Guide Version 1.07 at 18.

¹⁷ TRACE User Guide Version 1.07 at 61.

¹⁸ TRACE User Guide Version 1.07 at 61.

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Triggered Delivery occurs, or, consequently, when the transaction report is required. When an obligation triggers under a CDS, one party sends a notice of physical settlement to the other, requiring a bond to be delivered within a certain number of days. It is not clear if the trade reporting obligation is triggered by the delivery of the notice of physical settlement or at actual settlement. Complicating this is that many CDS agreements permit a range of securities to be delivered, and the parties may not know, until delivery, what security will be used to fulfill an obligation under a CDS. This makes reporting on notification date quite cumbersome because the actual bond at issue is unknown, and would require a report, possibly followed by a cancellation and a replacement. Members of the Association are concerned that if they report one transaction, then cancel that initial report and report another transaction, the NASD may seek to sanction them for providing late or incorrect trade reports. We would suggest that the NASD provide guidance with respect to this matter.

D. Logistical Issues

We understand that the NASD is experiencing significant systems constraints that cause dealers operational difficulties in reporting Triggered Deliveries. For example, when trades are executed outside of a range from the prior trade, TRACE rejects the report. The dealer is thus required to call TRACE to re-set the range to allow the trade report to go through. Once the range is re-set, however, the next dealer executing a normal secondary market trade will have its trade rejected as out of range, and thus must call the NASD to re-set the range again. This also results in dealers submitting reports outside the 15 minute reporting window, due to NASD's systems constraints. Members of the Association are concerned that the NASD will seek to sanction members for late trade reporting in this scenario, even where any such late trade reports result from constraints in the NASD's systems. We respectfully request that the NASD modify its systems to permit trades with special price modifiers to be reported without regard to the range restrictions. The logistical issues would cause increasing difficulties were a significant credit event to occur with respect to a large bond issuer.

Sincerely,

/s/ Michele C. David

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Vice President and
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cc: **NASD**

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