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February 9, 2000

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

Re: Creation of a Corporate Bond Trade Reporting and Transaction Dissemination
Facility-File No. SR-NASD-99-65

Dear Mr. Katz:

The Bond Market Association ("Association")¹ welcomes the opportunity to comment on the National Association of Securities Dealers, Inc. ("NASD") proposal to create a system for collecting and disseminating debt market transaction information. In brief, the Association supports the goal of enhanced debt market transparency. We believe, however, that this goal must be implemented in a manner consistent with two equally important objectives. First, investors should continue to have access to liquid markets for their securities. Second, the provision of trade reporting, dissemination and matching services for the debt markets should remain competitive. As described below, we believe the goal of enhanced transparency can be achieved without sacrificing either investor liquidity or marketplace competition.

I. Executive Summary

The Association supports the goal of enhancing price transparency in the debt markets. We have worked with members of the industry, securities regulators and Congress on a wide range of price transparency initiatives that have contributed meaningfully toward this goal. We support current efforts to improve corporate bond price transparency, to the extent that these efforts would reasonably facilitate regulatory surveillance of the market, and meaningfully assist investors, dealers and other market participants in the price discovery process.

The Association believes it essential, however, that the mechanisms employed to enhance corporate bond price transparency not adversely affect market liquidity. The NASD's proposals could have adverse liquidity effects on certain corporate bonds.² In that regard, we are concerned that an automatic roll-out, inevitably sweeping in all products, could have serious irreversible adverse effects on the bond market.

The Association believes that the NASD's proposals should be modified to better address liquidity concerns. We recommend an alternative framework for the public dissemination of corporate bond transaction information on an incremental, phased-in basis.³ The mechanism we suggest is for the NASD to set forth specific analysis and findings, with

required input from a "market transparency committee" consisting of investor and dealer representatives, to ensure that each incremental step of this proposed phase-in will not adversely affect the markets.

Moreover, as a practical matter, implementing the NASD's proposed TRACE system by the spring 2000 deadline set forth in the proposals, or even within the year 2000, would be extremely daunting if not impossible. The Association believes that any attempt to implement the TRACE system (which encompasses both transaction reporting/dissemination and trade processing functions) within this timetable would frustrate the goal of enhancing price transparency this year, and would be incompatible with broader industry initiatives that are underway to develop and introduce operations systems and processes that will support straight-through processing and trade date plus-one settlement functions.

The development and introduction of real-time trade matching systems, while desirable, are not required to achieve regulatory price transparency goals. Accordingly, the Association recommends that the trade matching and trade processing elements of the NASD's proposals be decoupled from those elements of the proposals that relate to enhancing price transparency.

In today's rapidly evolving technological environment, the systems employed to meet regulatory price transparency goals and trade processing needs are best determined by industry participants themselves. Decisions concerning the development and usage of these systems should be made in an open, competitive marketplace on the basis of cost, efficiency and similar economic and business criteria. The regulatory process should not mandate the exclusive use of one single system or sponsor for delivering these services. Instead, regulators should establish common standards and requirements that can be met by a variety of competitive systems and sponsors. The NASD's proposals do not meet this standard because they would establish Nasdaq's TRACE system as the exclusive system for corporate bond reporting, dissemination and trade matching services. We firmly reject that approach.

Finally, the Association believes that the NASD's proposals constitute an unwarranted use of the regulatory process, by conferring a potentially valuable corporate bond market data and trade processing business monopoly to Nasdaq-soon to be a for-profit, privately owned enterprise that exists in competition with other profit-oriented entities in the securities markets.

As suggested by the foregoing Executive Summary, there are several key principles that members of the Association regard as fundamental to any regulatory price transparency initiative in the corporate bond markets. These principles, set forth below, suggest specific areas in which the NASD's proposals require modification prior to their adoption.

First, the dissemination of corporate bond transaction information must be implemented quickly, but conducted in a manner that does not adversely and unnecessarily affect market liquidity.

Second, the development and implementation of systems and facilities to support corporate bond transaction reporting, dissemination and processing functions must proceed according to realistic timetables and within reasonable cost parameters. In addition, such mechanisms must be designed to be compatible and interoperable with other systems (whether now in existence or to be developed in the future) that deliver the same or complementary functions and services.

Third, the contributors of corporate bond transaction data should be the principal beneficiaries of any economic value associated with the commercial use and distribution of that data.

Fourth, the role of regulators should be limited to proposing, adopting and enforcing necessary and appropriate price transparency rules, based upon demonstrated need and subject to a comprehensive and rigorous analysis of benefits, costs and competitive impacts. Standards established for this purpose should be capable of being met by a variety of potential systems and sponsors. Regulators should not stifle competition by mandating the exclusive use of any particular price transparency or trade processing system or sponsor.

II. Interests and Prior Involvement of the Association in Price Transparency Issues and Initiatives in the Bond Markets

The Association has a substantial and credible track record in responding to the needs of Congress, regulators and industry participants to enhance price transparency in the bond markets. In the government securities markets, the Association was instrumental in the creation of the GovPX system for U.S. Treasury securities. Since its inception, the GovPX system has continued to expand the range of services it offers to meet the demands of market participants for useful price data and related information. 4

In the municipal securities market, the Association strongly supported the Municipal Securities Rulemaking Board ("MSRB") in developing a transaction reporting system that provides relevant pricing data to investors and other market participants. In late 1998, the Association, in coordination with Standard & Poor's J.J. Kenny, began posting the MSRB's price and volume data--enhanced by the Association's provision of yield, credit rating, call dates and other useful information--on our public investor website, InvestingInBonds.com. This user-friendly service enables investors and other interested parties to obtain end-of-day pricing information on actual municipal bond transactions, based on the previous trading day, free of charge.

In the corporate bond market, the Association has taken the lead in developing and introducing an industry-based system to enhance price transparency. Within a six-month period after Chairman Levitt announced as a regulatory goal the implementation of an "immediate" transaction reporting and dissemination mechanism for the corporate bond

markets 5, the Association, working with its members and other industry participants, designed, developed and introduced a voluntary, industry-directed initiative that responds to this goal. Under the name Corporate Trades I, the Association and GovPX established a joint venture that collects price data on publicly-issued, investment grade corporate bonds as voluntarily reported by participating dealers and interdealer brokers pursuant to contractual arrangements with the Association. Data collected by Corporate Trades I is made available to the public on an end-of-day basis through data vendors as well as directly through the Association's investinginbonds.com website. Corporate Trades I is the only mechanism presently available in the marketplace that captures and reports actual price and other trade details for over-the-counter corporate bond transactions. 6

Throughout each of these initiatives, the Association consistently has articulated and acted upon a basic theme: that the nature of price transparency initiatives applied to the various bond markets must recognize and reflect the unique characteristics of each different market. Such initiatives must not only address characteristics that distinguish the debt markets from the equity markets, but also characteristics that distinguish the various debt markets from each other.

III. Transaction Reporting: Market Surveillance and Regulatory Oversight

The Association is in favor of bond transaction reporting and supports the goal of developing a database of corporate bond transaction information to facilitate necessary regulatory surveillance of that market. As a general matter, we support NASD's recommended reporting fields and procedures for reporting price, capacity and volume. We agree in particular that reported bond prices should include any mark-up or mark-down, as we believe that such an "all-in" price is the most meaningful from a regulatory as well as an investor price transparency perspective.

However, the Association believes it unnecessary and undesirable to prescribe a single mechanism-Nasdaq's proposed TRACE system-as the only means for regulatory reporting of corporate bond transaction data. Numerous other systems are either presently available or may be developed in the future that may be used for this purpose, and which are capable of satisfying regulatory standards relating to integrity, reliability and capacity. Dealers should retain the flexibility to choose which system(s) they wish to use, based on their assessment of cost and efficiency.

As long as common system requirements, trade reporting standards, data fields and formats are established, transaction data that is initially reported into a particular system can be transmitted to and aggregated within a single regulatory repository, thus facilitating the creation of a comprehensive regulatory database that achieves market surveillance and oversight goals. Similarly, original transaction data that is reported into one of several competing reporting systems can be made available to still other systems to facilitate trade matching and other trade processing, clearance and settlement functions. The creation and mandated use of a single system is anti-competitive and is not necessary to achieve the basic goal of transaction reporting, or, as discussed below, to support the additional objective of real-time trade matching.

IV. Public Dissemination of Transaction Data: Liquidity Concerns

A. Overview of Association's Liquidity Concerns and Recommendations Regarding the NASD's Proposal

As noted above, the Association supports the goal of enhanced price transparency in the corporate bond markets. The public dissemination of price and other essential details of individual corporate bond transactions, however, must be subject to implementing appropriate safeguards to avoid potential harm to market liquidity.⁷

The Association believes that there are a number of more actively traded corporate bonds, comprising a significant percentage of total trading activity, for which relatively immediate public dissemination of price information and other trade details would serve a useful price discovery function in a manner that does not harm liquidity. We are gravely concerned, however, that relatively immediate public dissemination of such information for less actively traded and less liquid corporate bonds could damage the liquidity of those instruments.

The NASD's proposal offers no analysis, justification or support for implicitly concluding that market liquidity would not be negatively affected by the public dissemination of transaction information, within 15 minutes of trade execution, for virtually all reported securities. Although such public dissemination is scheduled to begin automatically, the precise impact of immediate public dissemination on the liquidity of all types of corporate bonds cannot be predicted with certainty. This impact may well be salutary for some sectors of the corporate bond market. However, we believe it extremely imprudent to risk significant, long-term damage to that market by implementing a pre-ordained timetable for comprehensive, immediate public dissemination of trade details, with no meaningful prior evaluation or analysis of the potential impact.

The Association believes that a more measured and incremental approach, which allows for adjustment and refinement based on actual experience, is highly preferable to the implementation plan set forth in the NASD's proposal.

B. The Nature and Importance of Liquidity in the Corporate Bond Market

Liquidity is a compelling factor in the decision of a dealer or investor to trade securities. If a dealer or investor believes that the liquidity of bond trading has been reduced, this perception will be a critical factor in their determination of whether to participate in the market, and if so, the price that they are willing to pay or accept in purchasing or selling an individual bond. Liquidity not only affects secondary market trading, but also impacts greatly the initial price offered to public or private investors (and hence the cost to issuers of raising debt capital).

The term "liquidity" is perhaps most simply defined as the relative ease and speed with which a given security can be purchased or sold at a price that is reasonably related to its

actual market value. To the degree that these characteristics are present, a security is more liquid, and to the degree that these characteristics are absent, a security is less liquid. Dealers and investors in the debt markets commit significant amounts of their capital to assume risk positions in various types of securities, based upon an expectation that those positions may subsequently be traded or unwound efficiently, at reasonable market levels.

The relatively immediate dissemination of transaction information for certain types of thinly traded corporate bonds, which are already relatively illiquid, could further impair their liquidity. This would reduce the willingness of dealers and their customers to commit capital, and to assume risk positions, in these securities.⁸ If all market participants have immediate access to proprietary information concerning the trading patterns and intentions of other market participants, as revealed by actual transaction information, it may become more difficult to conduct further trades at acceptable prices.⁹ For example, given the non-continuous trading character of the bond markets, a market participant attempting to unwind a large position through a series of smaller trades would be disadvantaged by the posting of individual transactions before the entire position was fully liquidated.

Clearly, a prolonged or pronounced reduction in market liquidity would have serious consequences for the corporate bond markets and the economy as a whole. The Association believes that the result could be a decline in demand and corresponding increase in required yield for certain types of corporate bonds, which would raise the overall cost of capital and lessen the efficiency of the capital formation process. In general, we believe this effect would be more pronounced for smaller, less well-known and less creditworthy issuers. Their securities are already less actively traded, and would be disproportionately affected by any further diminution in liquidity.

C. Examples of Existing Regulatory Frameworks that Seek to Balance Transparency and Liquidity

Securities regulators, academics and market participants have recognized the potential negative liquidity impact on less actively traded securities that may be produced by overly expansive transparency requirements. They also have recognized differences between highly liquid markets and less liquid markets when crafting rules and practices relating to the timeliness and content of public dissemination of transaction information. We believe no less caution is warranted in applying transparency concepts and mechanisms to the corporate bond market.

The distinctive characteristics of the corporate debt markets present unique challenges that must be met by systems and mechanisms that would seek to distribute meaningful price data to investors. First, there are a large number of individual corporate bonds outstanding-over 300,000 separate CUSIPs. In excess of 95% of these bonds, as measured by dollar volume, are held by institutional investors. The vast majority of corporate bonds trade very infrequently. Unlike the equity markets, where most issues trade daily, it is not unusual for weeks--or months--to pass between trades involving a

particular corporate bond. For example, in 1996, of all corporate bonds outstanding, only 4% traded at least once during the year. 10

In most of the equities markets, price transparency has been equated with real-time, last sale reporting. While this regulatory model is generally applied to registered equity securities, transparency for some unregistered equities ("restricted securities") is quite different. For example, trade data for registered equities must be reported to the NASD within 90 seconds of trade execution via the Automated Confirmation System (ACT), which automatically disseminates trade information to the public. However, trades for restricted securities are reported to the NASD, if at all, pursuant to the PORTAL rules, and are not ever reported to the public.

Similarly, when the SEC introduced real-time transaction reporting in the over-the-counter ("OTC") market, it proceeded in a measured manner. The SEC started by requiring last sale reporting for approximately 40 securities. Over a period of years the Commission, working with the NASD and the industry, carefully expanded trade reporting. Eventually, real-time trade reporting was expanded to encompass most OTC securities, but only in a manner which avoided disrupting market liquidity. 11

In 1991, the NASD created the FIPS system to improve transparency in the high yield corporate bond market. In the letter that accompanied his report to Congress, then SEC Chairman Richard Breeden acknowledged the difficulty and possible harm that mandating increased price transparency for the entire high yield market could cause:

It may be possible and desirable to substantially improve transparency...for much of the high yield bond market. However, mandating increased transparency for the large segment of the market that is illiquid could further reduce dealer participation in that segment of the market, and is therefore only practical where a "critical mass" of market participants exists. 12 In May 1999, the central banks of Canada, Italy, Japan, the United Kingdom, the United States and the Bank for International Settlements prepared a joint research report examining the determinants of market liquidity, and how central banks and other regulatory bodies influence those determinants, focusing on the government bond markets. The conclusions of this report included the following observation: "The relationship between transparency and market efficiency is non-linear: transparency may improve efficiency up to a point, but full transparency appears to be sub-optimal." 13 These conclusions suggest that at a minimum, liquidity issues should be carefully analyzed and that one should not automatically equate greater market transparency with greater efficiency.

We believe that the above conclusions are equally relevant for those segments of the corporate bond markets that are characterized by low trading volumes and relatively low levels of liquidity, and must be factored into the NASD's proposals.

D. Specific Recommendations for an Incremental Phase-In of Public Dissemination of Corporate Bond Transaction Information

We believe the next steps toward greater debt market transparency should follow three principles.

First, for those securities for which there is common agreement that enhanced transparency is useful, transaction information for such securities should be publicly disseminated as soon as practicable.

Second, for those securities for which there are concerns regarding how immediate dissemination will impact liquidity, an incremental, carefully measured and monitored dissemination mechanism should be established.

Third, a regular and rigorous methodology should be created, including the views of market participants, in evaluating whether to expand or contract the scope and timing of public dissemination of transaction information.

Our first principle is simple. There is common agreement that for actively traded debt instruments—which account for the vast majority of trading—immediate dissemination should begin as soon as practicable. Transaction data relating to these securities need not be held hostage to concerns about other, less-actively traded securities.

Second, we believe the phased expansion of immediate public dissemination of transaction information should occur in a manner which ensures the regular and continuous evaluation of the market effects of such expansion. Such a phase-in approach is in the tradition of the Commission's previous approach to transaction reporting. In addition, such an approach allows for the consideration not only of further expansion, but also contraction, if unintended adverse liquidity consequences emerge from prior decisions.

Our proposal recognizes there is relatively active trading and relatively high liquidity in large, publicly-offered investment grade corporate bonds. For this reason, the Association believes that the immediate public dissemination of transaction details for this segment of the market can begin even sooner than the timetable proposed by the NASD (pursuant to one or more competitive reporting/dissemination mechanisms other than TRACE), and that doing so would deliver more immediate price transparency for a meaningful portion of the corporate bond marketplace. 15

Accordingly, as soon as technologically practicable, the Association recommends the immediate public dissemination of transaction information for publicly-offered, investment grade corporate bonds having an initial issuance size of \$1 billion or greater. 16

Thereafter, we urge that public dissemination be phased in incrementally, with an industry group examining and evaluating at each step whether and how to proceed to the next step, based upon the observed impact on liquidity, if any, resulting from the

immediate public dissemination of transaction information that has previously occurred. The Association has developed the following general framework and implementation schedule to illustrate one possible way to effect such a phase-in:

Upon initial implementation of our alternative proposed framework, regulatory reporting of corporate bond transaction data would be required within one hour of trade execution. Beginning two months after such regulatory reporting begins, however, the data collected for all individually-reported transactions would be publicly disseminated on a one-month delayed basis. Consistent with the NASD proposal, we are recommending regulatory reporting within one hour of trade execution for the first six months, to ensure technological readiness and systems integrity prior to moving to 15-minute reporting at the end of that period. During this initial six month period, however, and unlike the NASD proposal, we are recommending that all reported transaction data be disseminated to the public, at a minimum, on a one-month delayed basis. Moreover, within this time period, as discussed below, we believe that immediate dissemination for large, public investment grade issues can begin.

As soon as technologically practicable after regulatory reporting begins, transaction information for trades involving publicly-offered, investment grade corporate bonds having an initial issuance size of \$1 billion or more would be immediately disseminated to the public. Trade details for all other categories of corporate bonds would continue to be publicly released on a one-month delayed basis.

At the end of six months after the commencement of regulatory reporting, the NASD would be obligated to issue a rule proposal, with an accelerated public notice and comment period, identifying the specific additional types of corporate bonds that would become subject to immediate (i.e., 15-minute) public dissemination upon adoption of the rule (as proposed, for public investment grade issues of \$500 million or more, and high yield issues of \$1 billion or more). The proposals contained in this rule filing would be required to be based upon an analysis of the corporate bond transaction data that was previously reported and publicly disseminated (on an immediate basis with respect to large, publicly-offered investment-grade issues, and on a one-month delayed basis for all other issues), and the impact on market liquidity, if any, resulting from dissemination.

This rule filing also would be required to incorporate views and recommendations obtained from a corporate bond "market transparency committee," whose members would be appointed by the NASD. The membership of this committee would consist, at a minimum, of representatives of the corporate bond dealer and institutional investor community. In its proposals, the NASD, consistent with legislative requirements governing regulation of the securities markets, 17 would be specifically obligated to set forth analysis and findings to the effect that, based upon its review of trading data for the subset of corporate bond transactions for which immediate public dissemination is already taking place and the recommendations of the market transparency committee, the introduction of immediate public dissemination for the proposed category of corporate bonds would not adversely affect market liquidity. 18 Data related to all other reported

corporate bond transactions that is not approved for dissemination on a more immediate basis would continue to be released to the public on a one-month delayed basis.

Upon the passage of three additional months (nine months after regulatory reporting begins) the NASD would be obligated to submit another rule filing (again with an accelerated public notice and comment period) proposing a further, incremental expansion of the categories of reported corporate bond transactions for which immediate public dissemination of trade details would be made. This next phase, as proposed, would deal with public investment grade issues of \$250 million or more, and high-yield issues of \$500 million or more. This rule proposal would be subject to the same requirements to analyze previously reported and disseminated transaction data, to consult with and obtain the recommendations of the industry "market transparency committee," and to set forth specific findings supporting the NASD's view that market liquidity would not be negatively impacted by such an expansion.

This process would be followed with successive, incremental rule filings every three months (as described below) thereafter, until the point is reached at which either (1) all corporate bond transactions have been approved through this process for immediate public dissemination, or (2) substantially all, or at a minimum, a significant portion of corporate bond transactions have been approved for immediate public dissemination, with the remainder disseminated on a delayed basis. In either case, the decisions reached at each incremental stage along the way will have the benefit of an increasingly robust database of corporate bond trading activity, and longer experience of regulators and market participants in evaluating the effects of public dissemination on liquidity.

As suggested by this proposed framework, we believe original issue size and credit rating are the most practical and useful proxies for assessing the relative liquidity of a given corporate bond. Accordingly, we are proposing that these factors should determine which issues should be the first additional types of corporate bonds that would become subject to immediate public dissemination. Corporate bonds added in succeeding increments of this phase-in plan would be linked to gradual reductions in the size and credit rating of the issue, ultimately encompassing smaller-sized and high-yield issues, as set forth in the following chart.

TIME FRAME (Number of Months After Regulatory Reporting Begins)

CORPORATE BOND CATEGORY

REGULATORY REPORTING/ DISSEMINATION TIMEFRAME

As soon as practicable after regulatory reporting begins

Public, investment-grade issues of \$1 billion or more

One-hour reporting; immediate dissemination for this segment

1 - 6

All reportable corporate bonds (except above \$1 billion-plus segment)

One-hour reporting; rolling one-month dissemination delay

7 - 9

Public, investment-grade issues of \$500 million or more; high-yield issues of \$1 billion or more

15-minute reporting for all transactions; if approved by market transparency committee, immediate dissemination for this segment; one month delay for all others

10 - 12

Public, investment-grade issues of \$250 million or more; high-yield issues of \$500 million or more

15 minute reporting for all transactions; if approved by market transparency committee, immediate dissemination for this segment; one month delay for all others

13 - 15

Public, investment grade issues of \$100 million or more; high-yield issues of \$250 million or more

15 minute reporting for all transactions; if approved by market transparency committee, immediate dissemination for this segment; one month delay for all others

16 - 18

All public, investment-grade issues; high-yield issues of \$100 million or more

15-minute reporting for all transactions; if approved by market transparency committee, immediate dissemination for this segment; one month delay for all others

Thereafter

All reportable public and private corporate bond transactions

15-minute reporting for all transactions; if approved by market transparency committee, immediate dissemination

The Association believes that the framework set forth above offers a number of distinct advantages over the NASD's proposals, consistent with statutory requirements. 19

First, the Association's proposal would result in the more immediate and widespread public dissemination of corporate bond transaction data within the early stages of implementation of regulatory transaction reporting requirements. Transaction reporting for regulatory purposes would begin immediately. Data for all reported transactions (other than 144A issues) would be released to the public on a rolling, one-month delayed basis, and data for the most actively traded, largest, publicly-offered corporate bonds would be publicly disseminated as soon as technologically practicable after the commencement of regulatory reporting requirements. This contrasts with the NASD's proposal, in which no transaction data -- other than for the 50 FIPS issues -- would be disseminated until six months after initial implementation. The early and meaningful public dissemination of data proposed by the Association would provide an analytical and empirical basis for assessing the desired scope, and potential liquidity impact, of the initial roll-out of immediate dissemination of transaction information in the corporate bond markets.

Second, the Association's proposal would provide an ongoing empirical and analytical basis, useful to regulators and market participants alike, for determining the appropriate scope and timing of successive, incremental phase-ins of immediate public dissemination of corporate bond transaction data, and the resulting impact on market liquidity from each successive phase.

Third, the Association's proposal would provide the NASD with the benefit of input from a representative group of both buy-side and sell-side participants in determining, on an ongoing basis, the desired scope of the next phase of corporate bonds that would be immediately disseminated to the public. The NASD would be required to set forth its specific analysis and findings, prior to implementing each successive phase and subject to public notice and comment, that no adverse liquidity impacts would result, greatly assisting market participants' understanding of and preparation for each phase.

Fourth, the Association's proposal would provide the NASD with the flexibility to revisit and refine dissemination parameters if it determines, based on its analysis and the evaluation and recommendation of the market transparency committee, that the prior phase of dissemination yielded unexpected or unanticipated liquidity results. Such results could provide the basis for slowing or accelerating the timetable for phasing in immediate dissemination for additional segments of the corporate bond market, extending or contracting the time period applicable to public dissemination of transaction information, or such other changes as it may deem appropriate.

Finally, this phase-in approach would be consistent with other regulatory initiatives that the Commission and NASD have readily recognized as having a substantial impact on the market place, and on firm trading systems and SRO systems. For example, Commission Rule 11Acl-4, the "Display Rule" 20 contained a phase-in period for the rule's application to Nasdaq securities, with the most liquid securities phased in first. Based on industry

response, including from the NASD 21, the Commission agreed to a more gradual phase-in period. In a letter dated November 22, 1996 to Richard Grasso of the NYSE, then Division Director of Market Regulation Richard Lindsey noted that, "... because the Commission has recognized that the display of customer limit orders is a significant change for the OTC market, the Commission has determined that a more gradual phase-in of the Order Display Rule for Nasdaq securities is necessary." On January 20, 1997 the first 50 stocks were phased-in. 22 Over approximately the next year, the remainder of Nasdaq securities (approximately 2,000 in all) were phased in under this rule.

Even with numerous economic studies of the Nasdaq market and years of public comment with regard to the displaying of limit orders, the Commission saw fit to phase-in the Display Rule. Given the significant change in market practice and legitimate liquidity concerns among market participants associated with the immediate dissemination of transaction information, we strongly believe that the corporate bond markets would be equally well served by a phase-in approach. 23

V. Implementation Issues Associated with the Proposed TRACE System

The NASD's proposals would establish a system for the regulatory reporting and public dissemination of corporate bond transaction data, thus seeking to advance price transparency policy objectives. However, these proposals would also establish a corporate bond trade matching facility within the TRACE system, thus simultaneously advancing certain trade processing system objectives believed necessary, in part, to support the industry's migration to straight-through processing and "T plus-one," settlement.

Although both of these objectives are laudable, the Association believes that the inclusion of proposals relating to trade matching and securities processing are not necessary to achieve regulatory price transparency goals. Also, because the NASD's TRACE proposal integrates price transparency with trade matching functions and sets forth an unrealistic and unachievable implementation timetable, it actually frustrates near-term enhancements to price transparency in the corporate bond markets, which is the primary regulatory goal motivating the issuance of the NASD's proposals. Accordingly, we believe that the price transparency elements of the NASD's proposals should be decoupled from those portions that would establish a corporate bond trade matching facility through the proposed Nasdaq TRACE system.

From an operational and practical perspective, implementation of the NASD proposals by "Spring 2000"--in other words, at the latest, by the third week of June of this year--is a virtual impossibility. 24 The NASD's proposals contain no technical implementation specifications of any kind. Such specifications are a prerequisite to identifying, planning and conducting the necessary analysis, testing, programming and other system changes and reconfigurations that would need to be accomplished prior to implementing TRACE. Moreover, all of this activity would need to be conducted in the midst of massive industry efforts being devoted to other major operational issues and challenges, including the completion of Y2K efforts, all systems changes backlogged in 1999 by Y2K efforts,

decimalization and, as discussed below in greater detail, straight-through processing and T plus-one settlement initiatives. Based upon all of these factors, senior operations and technology professionals at the Association's member firms have categorically indicated that they cannot realistically implement the conversion to the TRACE system by the spring of 2000, and in all likelihood (again, pending the issuance of detailed technical specifications by the NASD), not any time during the year 2000.

The Association's members recognize and support the need to establish broadly integrated and interoperable trade matching and clearing facilities to support the industry's migration to straight-through processing and T plus-one settlement. However, as with other major trade processing and technological challenges that the industry has successfully confronted in the past or is now confronting (such as Y2K and decimalization), the Association believes that the design of systems to support this goal, and the timing of their development and implementation, should rely principally upon directions established by industry participants themselves. Members of the industry are already responding to the straight-through processing and T plus-one challenge in a comprehensive and globally coordinated fashion. The NASD's proposed TRACE system would need to be implemented in isolation from this broader and more integrated effort, and according to a different timetable. The result is that the NASD's proposed TRACE system presents the undesirable prospect of requiring conflicting and inefficient operational and trade processing efforts on the part of industry participants.

To the extent that the NASD's proposals reflect a regulatory judgment that Nasdaq's TRACE system is uniquely capable of meeting the industry's need for a corporate bond transaction reporting, dissemination and trade matching facility, we believe that such a judgment is erroneous. An ever-increasing range of alternative price transparency and transaction reporting systems and mechanisms is available to meet these and other technological challenges. We believe that many of these systems would be capable of providing the same--if not superior--functions as TRACE, potentially with greater efficiency and at lower cost. 25

Moreover, as relates to trade processing, the Association believes that in the future environment of straight-through processing and T plus-one settlement, advancements in technology will make it possible for a variety of systems to accept both dealer and customer trade inputs, and that such systems will be capable of being integrated with each other to facilitate real-time trade matching and other critical operational and trade processing functions. In the current trade processing environment, dealers, customers and other market participants increasingly demand an open architecture that facilitates interoperability across disparate and competing technological platforms. We believe it is imperative that such systems be allowed to develop freely in a competitive environment, and selected on the basis of their efficiency and cost. The Association strongly believes that the regulatory process should facilitate and encourage the competitive development and introduction of such technologies, rather than locking the industry into a single, designated system.

VI. Competitive Issues Associated with Selecting Nasdaq as the Owner and Operator of the Proposed TRACE System

Finally, the Association believes that there are important competitive and economic issues that are implicated by the NASD's proposals. In particular, in certain key areas, we believe that these proposals constitute an unwarranted and undesirable use of the regulatory process that would produce anti-competitive outcomes, inconsistent with requirements under the Exchange Act. 26

The NASD's proposals would have the effect of designating TRACE as the exclusive, regulatorily-mandated system for certain corporate bond reporting, dissemination and trade processing functions. As the owner and operator of the TRACE system, Nasdaq would be the principal economic beneficiary of any revenues and profits generated by this system.

The Association believes that Nasdaq should not be designated as the sole and exclusive facility for these purposes. Doing so constitutes an unwarranted use of the regulatory process, and creates an inherent conflict of interest. The Association believes that the role of regulators should be limited to proposing and enforcing necessary and appropriate rules and standards that are capable of being met by a variety of potential providers, rather than conferring what may be a valuable business franchise--in effect, a monopoly--to any single provider or system sponsor.

The Association regards the designation of Nasdaq as the sole provider of corporate bond price transparency and trade matching services as particularly inappropriate, given that Nasdaq has already begun a process of converting its organizational structure from a mutual ownership base to one in which equity interests in the enterprise are held by private (and soon, perhaps, public) shareholders. Even more so than in its prior capacity, a for-profit, shareholder-owned Nasdaq is regarded by the Association as a direct competitor with the wide variety and large number of organizations that provide services to the securities industry, including dealers, information vendors and processors, industry utilities and clearing corporations, and other entities. Under these circumstances, it is wholly inappropriate for NASD to use the regulatory process to confer a potentially valuable business franchise to Nasdaq in the areas of corporate bond transaction reporting, dissemination and trade matching.

In the Association's view, data contributors should be the principal beneficiaries of any economic value that is associated with the commercial use and redistribution of that data. Moreover, we believe that dealers should retain the flexibility to choose among competitive providers of trade matching and other corporate bond transaction processing services, including such proprietary or third-party systems as they may choose. Preserving such an environment would not prevent Nasdaq from developing its own version of these or other services, nor would it inhibit dealers from choosing to use Nasdaq's systems or products for these or other purposes. However, these determinations would appropriately be based upon economic and competitive factors, rather than being dictated by the operation of the regulatory process.

With respect to economic benefits accruing from the commercial use and distribution of corporate bond transaction data, the Association is aware of the SEC's recently issued concept release on this subject. 27 We expect to respond separately to the issues raised in that document. The concept release touches upon, among other things, the appropriate determination and allocation of costs and fees associated with the provision of market data, and the role of revenues derived from market data fees in funding the operation and regulatory oversight of the securities markets. In the present context, the Association notes that corporate bond transaction data relates to a segment of the over-the-counter debt markets that is distinct in both structure and operation from the exchange-based equity markets that are the principal focus of the SEC's concept release. Accordingly, the Association believes that the regulatory standards that govern the determination of appropriate market data fees and costs, the nature of regulatory market operation and oversight functions, and the degree to which market information fees should be used to subsidize these regulatory functions in the corporate bond markets, should be established with these differences in mind.

* * *

VII. Conclusion

As suggested in the foregoing sections of this letter, the Association would welcome an opportunity to comment on a repropose NASD rule that:

More carefully analyzes the potentially harmful consequences of relatively immediate public dissemination of price information on less liquid corporate bonds;

Sets forth an incremental phase-in plan that incorporates actual market information as well as the continuing input of directly affected market participants;

Provides realistic implementation timetables whose elements are appropriately integrated with other critical industry systems, technology and trade processing initiatives;

Decouples regulatory price transparency from industry trade processing goals;

Limits the role of regulators to developing, proposing, adopting and enforcing necessary and appropriate rules, whose standards and requirements are capable of being met by a variety of system sponsors and providers in an open, competitive environment;

Expressly recognizes data contributors' economic interests in any corporate bond transaction information; and

Refrains from conferring one or more potentially valuable business franchises to any individual system sponsor or service provider, by mandating its use to the exclusion of other existing or potential sponsors or providers.

Because of the fundamental policy issues associated with the NASD proposal, the Association has limited its response in this letter to those matters. However, in the near future, we will supplement this letter with an additional submission raising questions and concerns on specific technical issues regarding the NASD proposal.

We look forward to a continuing dialogue with both the NASD and SEC on this important matter, and remain committed to achieving improvements to corporate bond price transparency in a manner that is consistent with the principles, views and recommendations set forth herein.

Should you have any questions or desire any clarification or additional information regarding any of the matters discussed in this letter, please do not hesitate to contact the undersigned, or George Miller, Senior Vice President and Deputy General Counsel of the Association, at 212.440.9400.

Sincerely,

William H. James, III Lazard, Frères & Co. LLC 1999 Chairman, Corporate Bond Division of The Bond Market Association

Vincent P. Murray ABN AMRO Incorporated 2000 Chairman, Corporate Bond Division of The Bond Market Association

Ferdinand Masucci Morgan Stanley Dean Witter & Co., Inc. 2000 Vice Chairman, Corporate Bond Division of The Bond Market Association

cc: Securities and Exchange Commission
The Hon. Arthur Levitt, Chairman
The Hon. Norman S. Johnson, Commissioner
The Hon. Isaac C. Hunt, Commissioner
The Hon. Paul R. Carey, Commissioner
The Hon. Laura S. Unger, Commissioner
Annette L. Nazareth, Director, Division of Market Regulation
Robert L. Colby, Deputy Director, Division of Market Regulation
Stephen L. Williams, Special Advisor to the Director, National Association of Securities
Dealers Regulation, Inc.
Mary L. Schapiro, President
Elisse B. Walter, Chief Operating Officer
Mary Alice Brophy, Executive Vice President
R. Clark Hooper, Executive Vice President
Alden S. Adkins, General Counsel

Notes

The Association is the bond market 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 Internet home page at <http://www.bondmarkets.com>. This letter was prepared in consultation with the Association's Board of Directors and the Price Transparency Steering Committee, High Yield Debt Committee and Legal Advisory Committee of the Association's Corporate Bond Division.

The NASD's proposals present no data, analysis or justification for concluding that the public dissemination of trade details, including price, within 15 minutes of trade execution for virtually all types of investment grade and high yield corporate bond transactions would not harm market liquidity.

Unlike the NASD's proposal, our recommendations would (1) produce earlier and more widespread public dissemination of corporate bond transaction data; (2) link regulatory decision-making concerning the appropriate scope of public dissemination of transaction information with observations and data relating to actual corporate bond trading patterns, thus providing an empirical basis for assessing the impact of progressively wider and more immediate dissemination of such information on market liquidity; and (3) incorporate in a systematic fashion the views and recommendations of corporate bond market participants, including both bond dealers and investors, in determining the appropriate scope and timing of public dissemination of transaction information.

Today, GovPX is recognized as a leading provider of real-time price and volume information, and is widely credited with introducing significant improvements to price transparency in the government securities markets. In addition to providing real-time

price and volume data for U.S. Treasury Securities, the GovPX system has been expanded and now includes SwapPX, a widely distributed service delivering 24-hour real-time rates, data and analytics for the worldwide interest rate swaps market, as well as a repo index, which provides a comprehensive source of overnight repo rates weighted by volume for on-the-run U.S. Treasuries and general collateral.

Arthur Levitt, The Importance of Transparency in America's Debt Market, Address at the Media Studies Center, New York, New York (Sept. 9, 1998) (transcript available at <http://www.sec.gov/news/speech/speecharchive/1998/spch218.htm>).

The potential of this initiative to deliver useful and meaningful corporate bond price information has been recognized by other private sector entities, who have approached GovPX and the Association to propose the expanded use of corporate bond transaction data collected by Corporate Trades I to support the development of broader and more robust evaluated pricing services for the corporate bond markets. The Association believes that such inquiries, which are presently under consideration, demonstrate the potential commercial viability of the Corporate Trades I concept. They also highlight the fact that last-sale reporting of price data alone may not effectively respond to the market's need for enhanced corporate bond price transparency, given (as discussed in greater detail below) the infrequency of trading that characterizes the majority of corporate bond issues.

We are generally in agreement with the parameters proposed for transaction information that would be disseminated to the public. In particular, we support the dissemination of high-yield transactions over \$1 million, and investment grade transactions over \$5 million, as "1MM+" and "5MM+," respectively, as we believe that these volume limits may be helpful in preserving the anonymity of the parties in certain transactions. However, as discussed below, we do not believe that these limits are sufficient to address our broader concerns about adverse liquidity impacts, since the immediate dissemination of price data for certain bond transactions, no matter their size, may nevertheless reveal the identity and trading strategy of one or both transaction participants.

Some have suggested that any reduction in dealers' commitment of capital to the corporate bond market occasioned by their perception of reduced liquidity will be offset by a corresponding increase in capital commitments by other participants-including both institutional and retail investors-that will result from a more transparent and efficient marketplace. Although it is impossible to predict these outcomes in advance, the Association would note that prior market events and dislocations, such as the broad liquidity crisis experienced in the late summer and early fall of 1998, have amply demonstrated the central and unique role that dealers have historically played in providing large-scale liquidity to the debt markets. Moreover, unlike the situation with less well-known equity securities, we have no reason to believe that debt securities have been less likely to be traded because of their relative lack of transparency.

Often, a small number of institutions, or even a single institution, may hold very large blocks or the entirety of an individual corporate bond issue, so that the identity of the

party engaging in any transaction in that issue would be obvious to other market participants.

Data quoted in this paragraph are estimates of The Bond Market Association, derived in part from information obtained from the CUSIP Service Bureau.

Designation of National Market System Securities, Exchange Act Release No. 34-17549 22 S.E.C. Docket 22 (Feb. 17, 1981).

Senate Comm. On Banking, Housing and Urban Affairs, Report by the Division of Market Regulation on Transparency for High-Yield Debt Securities, (Sept. 6, 1991).

Committee on the Global Financial System of the Central Banks of the Group of Ten Countries, Bank for International Settlements, Market Liquidity: Research Findings and Selected Policy Implications, 20, (May 3, 1999) <http://www.bis.org/publ/index.htm>.

We consciously chose the language "regular and continuous" because we expect the Commission would be willing to hold itself to the same standards it demands of broker-dealers. Order Execution Obligations, Exchange Act Release No. 34-37619, 62 S.E.C. Docket (Aug. 29, 1996).

We acknowledge that the NASD's proposal provides for the immediate dissemination of the FIPS 50 bonds during the first phase of implementation of the TRACE system. However, we question whether dissemination of transaction data for the 50 most liquid high-yield bonds would provide insights on the impact of immediate dissemination on all investment grade and other high yield bonds, some of which are extremely illiquid.

The Association is not aware of any comprehensive data source that would allow for a determination of the total percentage of corporate bond trading activity that would be covered by this segment of the corporate bond market. Qualitatively, however, Association members report that a significant majority of corporate bond trading activity is concentrated among relatively large, publicly offered investment grade issues (and particularly, during the time period immediately following their issuance). In any event, as discussed below, the Association is proposing an alternative framework in which regulatory decision-making concerning the implementation of immediate dissemination requirements for all public and private investment grade and high yield corporate bonds would occur relatively quickly-within eighteen months-from the commencement of regulatory transaction reporting requirements.

Congress has established a number of specific requirements that must be meaningfully addressed in a rulemaking initiative of this type, which promises significant effects on investors, dealers, liquidity and the competitive landscape for the corporate bond markets. Section 3(f) of the Exchange Act requires the SEC, when it is engaged in a direct rulemaking or the review of a rule of a self-regulatory organization, to consider whether the proposed rule is in the public interest, protects investors, and promotes efficiency, competition and capital formation. 15 U.S.C. § 78c(f)(1999). Section 15A(b)(9) of the

Exchange Act requires that the rules of any national securities association not impose any burden on competition that are not necessary or appropriate in furtherance of the purposes of the Act. 15 U.S.C. § 78o-3(b)(9)(1999). Section 23(a)(2) of the Exchange Act requires that in all rulemaking activities, the SEC must consider the effects the proposed rule would have on competition, and disallows the adoption of any rule that would impose an unnecessary or inappropriate burden on competition. This section further requires the SEC to state its reasons for believing that any such burden on competition is necessary or appropriate. 15 U.S.C. §78w(a)(2)(1999).

The Commission should be familiar and comfortable with concept of establishing an industry committee to monitor the impact of an incrementally phased-in rulemaking. For example, with regard to its phased-in implementation of Rule 11Ac1-4, the Commission acknowledged the formation of an industry committee which included integrated, wholesale and regional firms to "observe the operation of the Limit Order Display Rule during the phase-in period, and provide their views regarding whether the current schedule may need further modification." See letter from Alfred Berkeley, III, President, Nasdaq, to Richard R. Lindsey, Director, Division of Market Regulation, Securities and Exchange Commission, December 18, 1996.

See supra footnote 17.

17 CFR § 240.11Ac1-4 (1996); Exchange Act Release No. 34-37619A 62 S.E.C. Docket 2083 (Sept. 6, 1996).

See supra footnote 18.

See Nasdaq Head Trader Alert #1997-5 - January 9, 1997.

The Association understands that the Commission is also considering a phase-in approach for its decimalization initiative.

Furthermore, we foresee practical and operational challenges that need to be addressed in implementing 15 minute reporting requirements throughout the corporate bond markets.

In particular, the Association believes that alternative industry price transparency initiatives and mechanisms--including but not limited to the Association's Corporate Trades I product--are capable of being expanded in the near term to provide more comprehensive coverage of transactional activity in the corporate bond markets. Unlike the NASD's proposed TRACE system, these mechanisms are capable of meeting both regulatory and industry goals of enhancing corporate bond price transparency in the year 2000.

See supra footnote 17.

Regulation of Market Information Fees and Revenues, Exchange Act Release No. 34-42208, 64 Fed. Reg. 70,613 (December 17, 1999).

