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November 25, 2003

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

Re: **File No. SR-NASD-2003-157 Relating to Permanent Approval of Fees for the Trade Reporting and Compliance Engine (TRACE)**

Dear Mr. Katz:

The Bond Market Association ("Association")¹ is pleased to submit this comment letter to the Securities and Exchange Commission ("SEC" or "Commission") in connection with the proposal by the National Association of Securities Dealers, Inc. ("NASD") to amend Rule 7010(k) relating to fees for the TRACE system, and to establish a permanent TRACE fee structure prior to the expiration of the pilot program for fees on January 31, 2004 (the "Permanent Fee Proposal").²

The Permanent Fee Proposal is required by Exchange Act Section 15A(b)(5) to provide for the "equitable allocation of reasonable dues, fees and other charges among members and other persons" using the TRACE system, which the NASD operates and controls.

We submit that, in order to determine whether the proposed fees are "reasonable" and "equitably allocated," it is first necessary to understand and establish as reasonable the underlying costs giving rise to the fees. To our knowledge, NASD has never provided any financial information disclosing its developmental and operating costs for the TRACE system, nor the revenues generated by TRACE fees under the pilot program, to the Commission or to the industry. Without this detail:

- it is impossible to establish that the costs, and therefore the fee structure that supports those costs, are reasonable; and
- it is impossible to determine if the fees equitably allocate the expenses among persons using TRACE.

¹ The Association represents securities firms and banks that underwrite, distribute and trade in fixed income 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, Investment Grade, High Yield, Distressed Debt, Legal Advisory and Operations Committees.

² Exchange Act Release No. 34-48714 (October 29, 2003), 68 FR 62483 (November 4, 2003), File No. SR-NASD-2003-157 (the "Proposing Release").

We therefore urge the Commission not to approve the Permanent Fee Proposal until the NASD provides the Commission and the industry with a detailed accounting of developmental and operating expenses for the TRACE system and revenues generated from TRACE fees to date. The absence of this disclosure on costs and revenues effectively prevents the industry – and the Commission itself – from making an informed decision.³

I. The NASD Has Not Provided Any Disclosure Substantiating the Reasonableness of the Costs That Give Rise To the Fee Structure

To our knowledge, the NASD has not provided any public disclosure substantiating the reasonableness of the costs to develop and operate the TRACE system, which have escalated to amounts significantly above its original estimates. The NASD's original TRACE fee proposal filed with the Commission in May 2002 stated that its developmental costs to date for the TRACE system were approximately \$7.2 million and the total annual operating expenses for TRACE were estimated to be \$6.0 million.⁴ The Permanent Fee Proposal states that for the first twelve months of operation of the TRACE system (the period from July 1, 2002 through June 30, 2003), the NASD's expenses have totaled approximately \$12.4 million.⁵

The Permanent Fee Proposal states that the \$12.4 million includes "partial recovery" of the original investment made in the development of TRACE, and that NASD's "original investment costs" will be "recovered over a 48-month period," without giving any further detail as to the total amount of the original investment costs or the estimated dollar amounts scheduled to be recovered in each year.⁶ The Permanent Fee Proposal also states that the costs of \$12.4 million include expenses incurred since the launch of TRACE to enhance software, conduct routine monitoring of transaction data, and to surveil the corporate debt market, with no further financial detail or breakdown of these costs provided.⁷

This lack of meaningful disclosure leaves members with no ability to gauge the reasonableness of the expenses for the first twelve months of TRACE, nor how far above original estimates actual expenses have escalated. For example, assuming that the NASD's original investment was approximately \$7.2 million and that approximately \$2 million of the costs for the twelve month period ending June 30, 2003 is the amortized portion of the NASD's original investment costs, the NASD's costs for the first year of TRACE would be approximately 70% higher than its original estimate.

³ The recommendations set forth in the "Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change" dated September 14, 2001 (the "Seligman Report") included "full transparency of fees, contractual terms and conditions, business requirements and administrative procedures related to the provision and use of market data." Seligman Report, page 63. We submit that these standards have not been met by the Permanent Fee Proposal.

⁴ Exchange Act Release 34-45960 (May 17, 2002), 67 Fed. Reg. 36654 (May 24, 2002), File No. SR-NASD-2002-63.

⁵ Proposing Release at page 62487.

⁶ Id.

⁷ Id.

Because these costs are directly borne by its members largely through transaction reporting and system fees as described below, some level of disclosure regarding costs and the benchmarking of such costs is a reasonable request. We submit that the NASD should provide transparent financial disclosure of its costs to date for the TRACE system, including a breakdown of all developmental costs, an amortization schedule for those costs, and all costs incurred with respect to enhancements to the TRACE system, support of TRACE by NASD staff and through outsourcing, and market surveillance activities.

II. The NASD Has Not Established That the Proposed TRACE Fees Are Reasonable and Equitably Allocated

Exchange Act Section 15A(b)(5) requires the NASD to establish reasonable fees for the use of its facilities. As stated above, we believe it is necessary to understand and establish as reasonable the underlying costs giving rise to the fees in order to determine whether the proposed fees are reasonable. Another measure of the reasonableness of fees is a determination that revenues reasonably match expenses. In the absence of any detailed disclosure concerning the revenue streams generated by TRACE fees during the pilot program, it is impossible to assess whether those revenues are reasonably matched to expenses. The Permanent Fee Proposal states only that for the first twelve months of operation, TRACE expenses have totaled \$12.4 million and TRACE revenues have totaled \$12.4 million, without providing any further significant breakdown or detail.

A second and related requirement under Section 15A(b)(5) is that fees should be equitably allocated among users. The proposed TRACE fee structure, as well as the current structure, contains three categories of fees: system related fees, transaction reporting fees and market data fees. The first two categories of fees only apply to broker-dealers that are responsible for reporting transactions in eligible corporate bonds. The third category of fees applies to professional users of market data, which includes member firms as well as other users. The Commission has stated that it believes purchasers of consolidated TRACE data are users of the TRACE facility for purposes of considering whether the fees are consistent with the requirements of Exchange Act Section 15A(b)(5).⁸

The Permanent Fee Proposal states that for the first twelve months of operation, TRACE generated revenues of approximately \$12.4 million reflecting approximately \$2.0 million, \$8.9 million and \$1.5 million for system fees, transaction reporting fees, and market data fees, respectively. Clearly the vast majority of the fees—\$10.9 million—were generated by registered broker-dealers through system and transaction reporting fees.⁹ Without a breakdown of the expenses required to develop and operate the various components of the TRACE system, there is no basis to determine whether this allocation is fair. Many broker-dealers feel that it is not a fair allocation and that the fees they currently pay are

⁸ Exchange Act Release No. 34-43873 (January 23, 2001), 66 FR 8131 (January 29, 2001) at 8138, File No. SR-NASD-99-65 (“TRACE Approval Release”).

⁹ Proposing Release at page 62487.

excessive, in some cases (particularly inter-broker dealers) reaching totals of over \$100,000 annually.

The issue of allocation is important not only as a statutory matter, as the Commission noted in the TRACE Approval Release, but is also critical to the question of how to calculate net revenues from the sale of market data fees. As explained at greater length below, the NASD has agreed in principle that net revenues from the sale of real-time TRACE data are to be allocated to broker-dealers.

The Permanent Fee Proposal states that NASD believes the fee structure is “equitable” and the fees are “reasonably related to the costs of developing the facility and to meeting the estimated operating expenses of the TRACE system” *because* trade reporting fees are based on a sliding scale and system and market data fees allow participants to select from several different options depending on a participant’s needs.¹⁰ However, these features of the fee structure do not go to the crux of the issue—the total costs which are the underlying basis for the fee structure and the fees. It is not possible to know if the fees are “reasonably related to the costs” of development and operating costs without knowing what those costs are and how they match to current revenues.

III. The TRACE Fees Should Not Be Made Permanent Until Disclosure Regarding Expenses and Revenues Has Been Made Publicly Available

Any approval of the NASD’s request to make the amended TRACE fee structure permanent should not take place until a full accounting of costs and revenues has been made publicly available. We submit that the Commission should wait to approve the Permanent Fee Proposal pending meaningful and substantive disclosure by the NASD of its costs and revenues for the TRACE system to date. The absence of this disclosure on costs and revenues effectively prevents the industry – and the Commission itself – from making an informed decision on the fairness and equitable allocation of the TRACE fees.

IV. Broker-Dealers Have an Economic Interest in Net Revenues from the Sale of TRACE Data

In the course of discussions between the Association and the NASD concerning the development of the TRACE Rule, an important principle agreed upon between the two organizations was that broker-dealers have an economic interest in the net revenues (the excess of revenues over expenses) from the sale of TRACE data. In connection with those discussions, the NASD proposed that it share 50% of the net revenues from the sale of TRACE data with those firms that have trades reported through TRACE.¹¹

¹⁰ Proposing Release at page 62489.

¹¹ Letter from Richard Ketchum to Micah Green, May 17, 2000, page 2 “[W]e reiterate our belief that revenues should be shared with the industry after deducting related technology and regulatory costs. Once those costs are deducted from the revenues earned from the sale of TRACE data, the NASD proposes that it share 50% of the remaining revenue with those firms that have trades reported through TRACE to the NASD.”

Because broker-dealers have an economic interest in net revenues from the sale of TRACE data, a reasonable and fair level of expenses allocable to market data should be established, and those expenses, together with the revenue streams from the sale of market data, should be publicly disclosed. To the extent that disclosure shows there are net revenues from the sale of TRACE data, those net revenues should be shared with the broker-dealers.

V. The NASD Should Not Make a Profit On the System and Reporting Fees of the TRACE System

A presentation recently given by a member of NASD staff stated that NASD pricing philosophy "is to recover its cost of development and operations and a very modest return on its investment."¹² We are troubled by the concept of the NASD making a profit on the system and reporting fee revenue of the TRACE system. The goals of the TRACE system are "increased price transparency and enhanced market surveillance in the corporate bond market,"¹³ not the creation of a commercial enterprise. System and transaction reporting fees should be based on amounts sufficient to cover the reasonable expenses of operating and maintaining the TRACE system, not to result in a profit or return to the NASD. To the extent there are net revenues on the sale of TRACE data, at least 50% of those net revenues should be shared by the broker-dealers.

VI. Conclusion

The Permanent Fee Proposal provides a wholly insufficient basis for commenters and the Commission to assess whether the fees as proposed are reasonable and equitably allocated. Without a detailed accounting of TRACE developmental and operating expenses, as well as revenues, to date, it is not possible to objectively determine whether the fees proposed in the Permanent Fee Proposal are reasonable and equitably allocated among users.

We believe that the NASD should disclose the nature of its costs, the revenues generated by TRACE, and the basis for allocation of fees. The requested disclosures are particularly important to broker-dealers due to their economic interest in the net revenues resulting from the distribution of TRACE data. Although the Association recognizes the NASD's commitment to reassess fees, we believe that this commitment is not a substitute for the necessary disclosure by the NASD. In this time of heightened market scrutiny, full cooperation and disclosure from the NASD is vital.

¹² Presentation by Elliot Levine at the Association's 11th Annual Fixed Income Operations Conference, November 6, 2003.

¹³ TRACE Approval Release at 8138.

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 at 646-637-9220.

Sincerely,

/s/ *Michele C. David*

Michele C. David
Vice President and Assistant General Counsel

cc: ***Securities and Exchange Commission***
 William H. Donaldson, Chairman
 Cynthia A. Glassman, Commissioner
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