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Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Attention: Mr. Jonathan G. Katz
Secretary

RE: Proposed Interpretation of the Application of the NASD's Mark-Up Policy to Transactions in Government and Other Debt Securities;
File No. SR-NASD-97-61

Ladies and Gentlemen:

The Bond Market Association (the "Association") [1] welcomes the opportunity to comment on the interpretation proposed by the National Association of Securities Dealers, Inc. ("NASD") concerning the application of its mark-up policy to transactions in U.S. government and other debt securities (the "Proposed Interpretation").[2] The Proposed Interpretation was recently published for comment by the Securities and Exchange Commission ("Commission" or "SEC").[3]

I. INTRODUCTION

The Association has long advocated the need to tailor regulatory policy to the distinctive features of debt securities and to the fixed-income markets in which these securities are issued and traded. [4] Accordingly, we agree with the NASD that specialized guidance is needed concerning the application of the NASD's mark-up policy to debt securities, given their unique characteristics, and the important differences that exist between the debt and equity markets. In that regard, we acknowledge and appreciate the longstanding efforts of the NASD and the Commission, beginning with the first published version of a mark-up interpretation in 1994, [5] to develop and implement meaningful mark-up guidance for the fixed-income markets. The Association recognizes the complexity and difficulty inherent in this undertaking given the laudable regulatory objectives of investor protection and fair pricing. There are no easy solutions.

In any event, the Association believes that the utility of the Proposed Interpretation should be judged on the basis of how well it achieves its basic goal: to clarify the application of the NASD's existing mark-up policy to debt securities transactions. [6] Subject to several important changes described herein, the Association believes that the Proposed Interpretation does provide market participants with useful guidance. Nevertheless, the length of time it has taken to reach even this point in the regulatory process perhaps serves to illustrate some of the problems inherent in mark-up policy generally which, as we discuss below, should be revisited as it applies to debt securities.

Specifically, in reviewing the evolution of the NASD's work leading to the recent publication of the Proposed Interpretation, the Association is very concerned by what we perceive to be an increasing attempt to fashion mark-up guidance for debt securities that relies heavily—and in our view, inappropriately—on equity market concepts and definitions as its starting point. As discussed in the balance of this letter, many of the concepts and definitions outlined in the Proposed Interpretation are poorly-suited to debt securities, and would produce illogical and inequitable results if adopted as proposed. As discussed at greater length in the body of this letter, the Association has grave concerns that the application of a "contemporaneous cost" standard for determining the prevailing market price of a debt security, coupled with the Proposed Interpretation's definition of a debt securities "market maker," could severely impact the willingness of dealers to commit their capital to facilitate customer trades in certain markets or securities, thereby materially affecting the liquidity of the fixed-income markets, especially for less liquid securities. 7 Accordingly, the Association wishes to offer comments and recommendations that we believe are needed to clarify several key areas of the Proposed Interpretation, and that will give better effect to its intended purpose and function in the context of the debt securities markets.

EXECUTIVE SUMMARY

In summary, our comments address not only the appropriateness of the NASD's mark-up policy in general as applied to debt securities but also the reasons the Association favors or opposes specific provisions of the Proposed Interpretation. The Association:

Supports the NASD's effort to lend further guidance and clarification to the application of the existing NASD mark-up policy to debt securities transactions.

Strongly disapproves of the regulation of dealer profit inherent in current NASD mark-up policy and the Proposed Interpretation, which we believe is unnecessary and inconsistent with the dictates of the Securities Exchange Act of 1934.

Agrees with the Proposed Interpretation's acknowledgment that the determination of whether a mark-up is excessive rests on an analysis of all the relevant facts and circumstances associated with a particular debt securities transaction. Hence, the Association agrees that the Proposed Interpretation's scope should be limited to the methodology used to calculate the prevailing market price, upon which a mark-up or mark-down may be based.

Strongly objects to the Proposed Interpretation's assertion that the NASD and SEC "have made clear that the appropriate mark-up or mark-down from the prevailing market price for most types of government and other debt securities is usually substantially less than 5 percent" [emphasis added] because it fails to accurately reflect current law and regulatory policy. The Association requests that this language be withdrawn or modified before the Proposed Interpretation is approved.

Disagrees with the Proposed Interpretation's premise that the best evidence of prevailing market price is the dealer's contemporaneous cost of acquiring the securities. Believes that the Proposed Interpretation would, as a practical matter, particularly during the course of compliance examinations, establish a costly, unfair and largely unworkable evidentiary burden for dealers to overcome the general presumption that acquisition cost ordinarily offers the "best evidence" of prevailing market price. The Association suggests that factors other than the contemporaneous cost of acquiring debt securities be given at least equal evidentiary weight, such as a debt security's pricing relationship to benchmark securities, or to other debt securities that have similar credit, yield and maturity characteristics. In particular, the Association believes that contemporaneous sales of similar securities to sophisticated institutional investors, and purchases from such investors, are

highly reliable indicators of prevailing market price and should be recognized as a probative factor in the Proposed Interpretation.

Commends the NASD for recognizing that acquisition cost may not accurately reflect the prevailing market price in certain specific situations, such as the presence of intervening market events or where securities are purchased from knowledgeable customers at levels below the prevailing market price. We also suggest that the presence of intervening credit or issuer events be expressly recognized as a factor in overcoming the presumption that a dealer's acquisition cost is "contemporaneous."

Believes that the Proposed Interpretation's concept of a "market maker" is not well-suited for the debt markets. The Association recommends that the Proposed Interpretation de-emphasize or redefine the concept of a market maker for the debt markets, and focus instead on whether a dealer routinely places its capital at risk, to determine whether the reference point for establishing prevailing market price should be the "offered" side of the market (in the case of a sale to a customer) or the "bid" side (in the case of a purchase from the customer).

Recommends that the definition of "riskless principal" transaction be clarified, so that it is not applied in situations where fixed-income securities dealers in fact assume market risk in committing their capital to trades.

Believes that, unlike the equity market concept of domination and control, the opportunity to exercise undue control over the supply and demand characteristics of any given debt security is far more limited since other debt securities having similar performance characteristics are almost always readily available.

Seeks clarification that high-yield securities will not be routinely classified as securities that possess "significant equity-like characteristics" since most high-yield securities share fundamentally similar credit, yield and maturity characteristics with other debt securities.

Urges the harmonization of mark-up guidance applicable to taxable and municipal debt securities.

III. GENERAL COMMENTS CONCERNING REGULATORY MARK-UP POLICY

A. The Association's views concerning the Proposed Interpretation should not be construed as support for mark-up regulation. The Association believes that mark-up regulatory policy for fixed-income securities should be revisited in its entirety.

The current approach embodied in NASD's mark-up policy, reduced to its core, is nothing less than profit regulation. Government price regulation is a policy that is not often pursued, and that is generally disfavored, in competitive markets. 8 Given the inherent definitional ambiguities that presently exist (even if current law is clarified through the approval of the Proposed Interpretation), a 5 percent mark-up guideline essentially establishes an up-side "ceiling" on the amount of profit that a dealer can make on a particular trade. Yet, governmental policy offers no down-side "floor" to protect dealers in the event of adverse price movements that may diminish the value of securities they hold in inventory. Recent events remind us that these down-side risks are both real and significant throughout the debt securities markets. The Association believes that the current regulatory approach, which indirectly regulates dealer compensation, as opposed to an approach which focuses on the fairness of prices, is fundamentally flawed and deserving of wholesale revisitation.

Moreover, as the Association has stated on many previous occasions, the amount of dealer mark-up is not material to a determination of fair price. What is relevant to investors is the effective yield to maturity (or call date) of a debt security, which is readily apparent to customers and is disclosed on the confirmation for each transaction. The debt markets are extremely competitive markets characterized by a significant institutional investor component and fungibility among securities within most fixed-income sectors. Customers are generally quite capable of comparing and choosing among investment alternatives on the basis of yield. Under these circumstances, mark-up regulatory policy should not emulate rules that have been established for the equity markets. We believe that judgments about fair prices for fixed-income securities in a competitive, transparent market are determinations that are best left to market participants to resolve through commercial interaction.

B. The Association agrees that whether a particular mark-up is excessive is a facts-and-circumstances determination that is properly left unaddressed by the Proposed Interpretation. However, the Proposed Interpretation would inappropriately establish new, substantive mark-up policy in one important respect. The Association strongly objects to the Proposed Interpretation's characterization of current law regarding appropriate mark-up levels

The Proposed Interpretation generally limits its focus to the methodology that may be used to calculate the "prevailing market price," the definitional terminology used as the benchmark price upon which a mark-up or mark-down is based. The Association believes that this limited focus is appropriate in the context of a proposed interpretation of existing regulatory policy. For purposes of this letter, accepting the existence of the NASD's mark-up policy as a given, the Association agrees with the Proposed Interpretation that whether the amount of mark-up charged is excessive depends on an analysis of all the relevant facts and circumstances associated with a particular debt securities transaction.

Although the Proposed Interpretation purports not to provide additional guidance with respect to the NASD's mark-up policy per se, it would inappropriately establish new, substantive mark-up policy in one important respect. The Proposed Interpretation states that the NASD and SEC "have made clear that the appropriate mark-up or mark-down from the prevailing market price for most types of government and other debt securities is usually substantially less than 5 percent [emphasis added]." 9 The Association strongly objects to the inclusion of this statement in the Proposed Interpretation, and disagrees that it accurately summarizes current law.

This statement directly conflicts with the Proposed Interpretation's assertion that whether a mark-up is excessive depends on the facts and circumstances associated with a particular debt securities transaction. Here, instead, a reasonable mark-up level for "most types" of debt securities would be artificially established at a level "substantially less than 5 percent." This statement also inappropriately groups most types of debt securities together in a homogeneous, undifferentiated matter. In fact, the bond markets are a diverse group of markets that encompass a wide variety of securities and financial products. There are significant differences among the debt securities markets, as well as among individual debt securities (particularly with respect to the liquidity of such markets and securities), that readily justify differences in appropriate mark-up levels under the NASD's existing policy. In some cases where particular debt securities or markets are less liquid than equity markets, reasonable mark-up levels for debt securities may justifiably exceed "typical" mark-up levels for most equity securities. For example, permissible mark-ups for relatively illiquid, thinly-traded fixed-income securities which may not trade on a daily, or even weekly, basis (including, but not necessarily limited to certain types of high-yield, emerging markets and structured debt instruments) should certainly not, as a general matter, be expected to be "substantially less" than 5 percent.

The NASD's historical policy guidance, as presently embodied in NASD Conduct Rule IM-2440, is that mark-ups in excess of 5 percent above the prevailing market price would generally be deemed to be unreasonable. 10 The SEC has previously indicated that mark-ups on debt securities are "generally…expected to be lower than mark-ups on equity securities," 11 not "substantially lower," nor "substantially less than 5 percent." The Association is aware of no judicial finding of excessive mark-ups at levels below 4 percent, and no administrative penalty for mark-ups at levels below 3.5 percent. 12 In short, neither the NASD nor the SEC has ever previously established as a matter of governmental policy, either through regulatory pronouncement or adjudication, that debt securities mark-ups should be "substantially" below 5 percent. It is highly inappropriate to do so in the context of the Proposed Interpretation (especially without any factual or legal support for this stated proposition), which purports to be limited to providing guidance on how to calculate the prevailing market price, rather than establishing new, substantive mark-up policy. The Association therefore requests that this statement either be withdrawn or appropriately modified before commission approval of the Proposed Interpretation.

IV. SPECIFIC COMMENTS

A. Contemporaneous Cost/Contemporaneous Transactions

1. Contemporaneous cost should not constitute the default standard for determining the prevailing market price of a debt security

The Proposed Interpretation generally states that, absent countervailing evidence, the best evidence of prevailing market price is the dealer's "contemporaneous cost" of acquiring the securities. 13 The Proposed Interpretation defines a transaction as "contemporaneous" if it occurs close enough in time to a later transaction that it would reasonably be expected to reflect the current market price for the security. Conversely, a transaction would not be contemporaneous if it is followed by intervening changes in interest rates or other market events that reasonably would be expected to affect the market price. 14 Even though this definition appears to provide some flexibility in departing from the dealer's "acquisition cost," as a practical matter, a risk exists that examiners will use the cost of acquiring the security as the starting point for determining the "prevailing market price" thus establishing a rebuttable presumption that acquisition cost should generally be used as the basis for calculating a mark-up or mark-down on a particular debt security. The Association does not believe that contemporaneous cost as currently defined should constitute the default standard for determining prevailing market price. 15 Factors other than contemporaneous cost should be given at least equal evidentiary weight.

In this regard, the Association believes that the Proposed Interpretation would constitute a significant retrenchment from current NASD mark-up policy and from previously published interpretive guidance proposed by the NASD. For example, in NASD Notice to Members 94-62, the NASD noted that "imposing a contemporaneous cost standard would not be appropriate without first considering other relevant factors." 16 Such factors would have included the same considerations suggested in the Proposed Interpretation for determining whether a security is "similar." The Association continues to believe that this element of NTM 94-62 constitutes a more logical approach. We are not suggesting that contemporaneous cost is irrelevant, but only that it should not be determinative of prevailing market price, except in certain limited circumstances.

In economic terms, a dealer's contemporaneous cost will often not reflect the prevailing market price for a debt security, even one that is held for a relatively short period of time, since the value of that security is subject to very real risks of intra-day movements in interest rates, changes in credit quality and other market variables that will affect its price. Moreover, it is unnecessary to rely on contemporaneous cost as a general default standard for establishing the prevailing market price. Unlike equity securities, the vast majority of debt securities bear a fundamental pricing relationship to benchmark securities, or to other debt securities that have similar credit, yield and maturity characteristics. Quantitative information about the prices and yields of benchmark securities, and other comparable securities, is readily available. Price and yield levels for virtually any given debt security may therefore be established on a current basis, without the need to resort to the "contemporaneous" acquisition cost of that security.

At a minimum, the Association believes it essential that "contemporaneous" not be measured in practice solely by reference to an arbitrary, temporal standard, such as a fixed number of days within which one transaction is deemed to be "contemporaneous" with another. Similarly, the Association believes that a dealer's burden of demonstrating that a single transaction price does not establish the prevailing market price in connection with a subsequent transaction should decline as the period of time between the two transactions increases. The farther removed one transaction is from another, the less likely is it to be a reliable source of the prevailing market price, and less evidentiary weight should be accorded to it for this purpose. Indeed, at some point in time, a dealer's acquisition cost should be completely disregarded as relevant evidence of prevailing market price. Otherwise, "contemporaneous" may be given an unduly expansive regulatory interpretation. 17

2. The Proposed Interpretation would establish a costly, inequitable and largely unworkable evidentiary burden to overcome the presumption that contemporaneous cost offers the best evidence of prevailing market price

In addition to our general concerns about the relevance and necessity of "contemporaneous" acquisition cost as a proxy for the prevailing market price, the Association believes that the Proposed Interpretation would establish a costly, unfair and largely unworkable evidentiary burden to overcome the general presumption that contemporaneous cost ordinarily offers the "best evidence" of prevailing market price. The Proposed Interpretation acknowledges that a transaction would not be contemporaneous if it were followed by intervening changes in interest rates or other market events that reasonably would be expected to affect the market price. We strongly recommend that the factors identified as counterbalancing "acquisition" cost should also be expanded to expressly recognize the probative value of events relating to the credit quality of the issuer of the securities, which also in certain classes of debt securities exerts an influence on price. However, to establish the influence on price of these intervening market or company events, the Proposed Interpretation states that a dealer must be "prepared to provide evidence that is sufficient to overcome the presumption that contemporaneous cost provides the best measure of the prevailing market price." 18

The requirement to produce evidence to overcome the presumption created by contemporaneous cost could well impose a de facto books and records obligation for virtually every debt securities transaction where any degree of subjective valuation was present. At a minimum, in situations in which general market information is not relevant or cannot be easily obtained or reconstructed (e.g., from market data vendors and other sources), such a requirement would effectively require dealers to document and record their basis for valuing securities at any level other than their own acquisition cost. This requirement is highly burdensome and impractical in light of the high volume and rapid pace of fixed-income trading, and would be extremely costly to implement. Moreover, such a requirement is inequitable. It would place dealers at a tremendous disadvantage in the context of a compliance examination, inspection or enforcement proceeding, by requiring them to adduce documentary and other evidence needed to reconstruct general market conditions, and their decision-making processes regarding securities pricing, at a time that is likely to be well after a particular trade occurs.

The presumption that contemporaneous cost offers the best evidence of prevailing market price also operates to shift the burden of proof that normally attaches to alleged violations of securities regulations. The Association believes that regulators should instead bear the burden of demonstrating that mark-ups are unfair and unreasonable, based upon the specific facts and circumstances of a particular debt securities transaction. Nevertheless, if the burden of proof remains with the dealer to overcome this presumption, the Association believes that significant consideration should be given to whether an individual transaction, or several isolated transactions are at issue (in which case a lesser burden should be imposed), or whether a wider pattern of transactions is involved (in which case the dealer's burden of proof would appropriately be greater).

3. The Proposed Interpretation appropriately recognizes that contemporaneous cost may not accurately reflect the prevailing market price in certain specific situations, such as when securities are purchased from knowledgeable customers below the prevailing market price

The Association commends the NASD for recognizing that contemporaneous cost may not accurately reflect the prevailing market price in certain specific situations, such as where securities are purchased from knowledgeable customers at levels below the prevailing market price. Such situations can and do arise in "distress" sales, or other circumstances in which it may become necessary for a counterparty rapidly, efficiently and/or anonymously to liquidate large or relatively illiquid debt securities positions. Dealers who stand ready to commit their capital in these situations provide an important source of liquidity to the fixed-income markets. However, dealers should not be required to satisfy burdensome, unrealistic, after-the-fact evidentiary standards to demonstrate that such purchases were effected at levels below the prevailing market price, and the circumstances surrounding such purchases.

As a general proposition, the fact that securities purchased from (or sold to) a knowledgeable institutional customer are subsequently sold to (or purchased from) another knowledgeable institutional customer at a higher (or lower) level should be regarded as prima facie evidence that the dealer's contemporaneous cost does not reflect the prevailing market price for those securities. In the institutional debt markets, where counterparties have ready access to the same informational sources as dealers, and where such customers are, because of their access to many individual dealers, often in a better position than the dealers themselves to determine the prevailing market price of securities, we believe there is no valid regulatory purpose to be served by enforcing contemporaneous cost as the presumptive standard for determining the prevailing market price.

B. Market Maker Status

1. The proposed definition of "market maker," while modified somewhat from the definition established for equity market makers, is nevertheless poorly suited to the debt securities markets. The attributes set forth in the Proposed Interpretation that would qualify a dealer as a "market maker" in debt securities are unduly limited, and would generally operate to deny dealers the benefit of a bid-ask spread in calculating mark-ups. This result is unwarranted and undesirable since it significantly diminishes the incentive for dealers to provide liquidity to those segments of the debt markets that need it most

The Proposed Interpretation proposes to define a "market maker" in debt securities as a dealer who, with respect to a particular security, furnishes bona fide competitive bid and offer quotations upon request and is ready, willing and able to effect transactions in reasonable quantities at his or her quoted prices with other brokers or dealers. 19 The consequences of "market maker" status are significant. The Proposed Interpretation indicates that "integrated dealers"—dealers that not only sell to retail customers, but also act as wholesale market makers in active, competitive markets—are permitted to calculate their mark-ups from their contemporaneous sales prices to other dealers. As a preliminary matter, however, the derivation, meaning and purpose of this definition of "integrated dealer" are not clear. Whether a dealer is active in both the retail and wholesale markets should not affect the analysis of whether that dealer provides "market maker" functions (e.g., providing market liquidity by assuming at-risk positions to facilitate customer transactions). Many dealers provide such functions exclusively to the institutional debt securities markets. Such dealers should be equally entitled as "integrated dealers" to calculate the mark-up using the "offered" side of the market as the reference point for determining prevailing market price. 20

As noted above, the Proposed Interpretation suggests that an integrated dealer 21 may calculate mark-ups from its contemporaneous sales prices to other dealers. Although the intent of this language is apparently to enable integrated dealers to avoid the requirement to use contemporaneous cost as the baseline measure of prevailing market price, in practice for most debt securities, perhaps other than U.S. government securities, it would not accomplish this result. It appears from the Proposed Interpretation that contemporaneous inter-dealer transactions in the same security would be required to establish the "offered" side of the market for a particular security. Since inter-dealer transactions in the same security may be rare or non-existent for any given debt security, this formulation would be of little practical utility. The Proposed Interpretation is also unclear regarding the relevance of a dealer’s market maker status in a situation where no contemporaneous transactions in the same security exist. We suggest that the Proposed Interpretation be revised to recognize that a market maker’s contemporaneous sales to institutional customers, in addition to interdealer sales, may establish a basis for determining the prevailing market price. Additionally, the Association recommends that the Proposed Interpretation be modified to recognize explicitly the ability of a dealer that routinely commits capital to classes of categories of debt securities to calculate its mark-up from a bona fide "offered" quotation, as long as that quotation is not demonstrated to be unreasonable. The reasonableness of dealer quotations for debt securities can therefore be readily established and verified through independently available sources of pricing information—in effect, by employing the same factors suggested elsewhere in the Proposed Interpretation for determining whether a given debt security is "similar" to another.22

The Proposed Interpretation would produce the inappropriate result that, if a debt security is widely traded among dealers, then a dealer can receive both the spread and a mark-up, whereas if (as is typically the case) the security does not trade in this fashion, then the dealer is limited to a mark-up over its contemporaneous cost. This result is illogical given the greater risks of dealing in more thinly-traded and illiquid securities. If dealers cannot receive the benefit of the bid-ask spread as compensation for assuming these greater risks, their willingness to commit capital and provide liquidity to the fixed-income markets, particularly among less liquid securities, will be significantly diminished.

Moreover, the definition of market maker in the Proposed Interpretation is too limiting to the extent that it requires this determination to be made with respect to a particular security. We believe that this definition would produce continuing uncertainty and confusion over whether a particular dealer, at a particular time, is or is not a "market maker" with respect to a particular debt security or class of debt securities. Such a definition reflects the difficulty of applying the equity "market maker" standard to debt securities, where there are a far greater number of individual securities, and for which there is broad comparability among debt securities having similar credit and yield characteristics. A dealer in debt securities may provide what amounts to "market making" functions for a wide range of similar securities, without necessarily providing quotations or effecting transactions in any particular security within that broader category. The text accompanying the Proposed Interpretation is more helpful, in that it suggests that dealers in debt markets may effectively act as market makers in a group of securities without publishing continuous two-sided quotations for each security within the group. The text of the Proposed Interpretation itself should be expanded and clarified accordingly.

2. The NASD should abandon its effort to define the activities of debt securities "market makers," and should instead establish a standard for calculating mark-ups that is based on whether a dealer routinely assumes principal risk in particular categories or classes of debt securities

On balance, however, and even if the foregoing recommendations are adopted, the Association believes that the attempt to define and categorize the activities of debt securities "market makers" in the manner suggested by the Proposed Interpretation is grossly misplaced. The equity markets typically have market makers that quote two-sided markets. The fixed-income markets in this regard operate in a manner quite different from the stock markets. At least in less liquid fixed-income products or sectors that are not characterized by active and continuous trading, dealers do not routinely quote two-sided markets, even privately. In such circumstances dealers typically quote securities on request, and solicit buyers and sellers on an individual, negotiated basis.

As a result of these and other factors, the fixed-income markets do not function in a manner similar to the equity markets, and it is generally a misnomer to refer to "market makers" in fixed-income securities. The reality of the fixed-income markets is that, with respect to any particular debt security at any time, some dealers will perform only riskless principal or agency trades, while other dealers are prepared to put their capital at risk. Those dealers who assume principal risk may do so for a relatively brief or extended periods of time, by positioning securities (usually involving long positions, but sometimes short positions) to facilitate transactions with customers.

In the fixed-income markets, a spread exists between the price or prices at which a capital-committing dealer is prepared to buy a security and the price or prices at which the dealer is prepared to sell the security. Those prices are influenced by the dealer's own perception of the risk (in the case of the dealer's bid) of accepting the market risk of holding the particular security for what may be an extended period of time and (in the case of the dealer's offer) the dealer's degree of eagerness to dispose of that risk. A dealer willing to commit its capital to facilitate customer transactions should be compensated through this spread, in a manner analogous to the compensation available to an equity market maker, for assuming the market risk in committing to a position. Unlike the equity market maker's spread, however, that compensation does not depend on the dealer's willingness to quote a two-sided market, but is instead determined by the dealer's willingness to routinely commit capital to facilitate trading activity.

Moreover, in the fixed-income markets, the dealer's willingness to commit capital to facilitate its trading activity in particular categories or classes of debt securities is closely analogous to the equity market maker's willingness to commit capital to its market-making activities for a particular equity security. The Commission has long recognized that requiring equity market makers to use their contemporaneous cost as the base price against which the fairness of mark-ups or mark-downs would be judged might deter market makers "from taking the risk of maintaining market making positions." 23 The same principle applies to denying the spread to a fixed-income dealer that in fact assumes the risk of taking proprietary positions in the course of its dealer activities. Denying the capital-committing dealer the spread would interfere with its very willingness to commit capital to such customer-facilitation transactions, and would diminish market liquidity.

The Association believes that the NASD is mistaken in its effort to force the fixed-income markets into the mold established by the equity markets. The determination of whether a dealer should be entitled to calculate the mark-up using the "offered" side of the market as the reference point for determining prevailing market price (in the case of sales to customers) should be based not on whether the dealer's conduct sufficiently replicates the conduct of an equity market maker. Instead, we believe that this determination should be based on whether the dealer in fact is prepared to commit its capital, by buying securities or selling them short without having an identified counterparty to relieve it of the risk. The objective fact that a firm from time to time maintains an inventory (short or long) in classes of fixed income securities offers readily verifiable evidence that a dealer is prepared to commit capital and should be expressly recognized as a highly probative, if not determinative, factor in the Proposed Interpretation.

As discussed below in greater detail, the Commission's confirmation rule, Rule 10b-10 under the Securities Exchange Act of 1934, sets forth a usable framework for defining a "riskless" principal transaction in equities that could be used to define the circumstances in which a fixed-income dealer should be limited to a mark-up or mark-down above its acquisition cost. 24 By employing that concept, rather than the misplaced and misapplied equities concept of a "market-maker," the NASD's rule would appropriately define and limit, in the Association's view, situations in which a dealer would be permitted to benefit from the bid/offer spread in addition to a mark-up or mark-down.

The Commission itself has recognized that the concept of market maker has only limited application in the debt markets. In its most recent proposal to require disclosure of the mark-up or mark-down in a "riskless" principal transaction, the Commission stated:

Unlike current disclosure requirements for riskless principal transactions in equity securities, the proposed amendment and Rule 15c2-13 do not include an exclusion for market makers. This exclusion is omitted because market makers have a much more limited function in the debt markets.25

The Commission has also provided no-action guidance, in the context of recent amendments to Rule 10b-10, to the effect that a customer confirmation for a debt securities transaction need not disclose whether the dealer was acting as a market maker, in view of the difficulty of applying this concept to transactions in debt securities. 26

The Commission has concluded in the Waide case, in the context of judging the fairness of pricing to customers, that riskless principal transactions do not justify any compensation above a mark-up or mark-down. In reaching that conclusion, however, the Commission looked not to whether the dealer was acting as a market maker, but to whether the dealer in question was providing liquidity by putting its capital at risk. It concluded that dealers engaging exclusively in riskless principal trades do not add any liquidity: 27

In the respects relevant here, a trade on a riskless principal basis should be treated similarly to an agency transaction, in which a firm may retain no more than a commission computed on the basis of its cost. As we have noted, a riskless principal transaction is the economic equivalent of an agency trade. Like an agent, a firm engaging in such trades has no market making function, buys only to fill orders already in hand, and immediately "books" the shares it buys to its customers. Essentially, the firm serves as an intermediary for others who have assumed the market risk. The firm in these circumstances provides no liquidity to the inter-dealer market. For this limited role, a firm is adequately compensated by a markup over its cost.

. . . .

Moreover, in a riskless principal capacity, the dealer is neither risking its capital in an effort to profit from the rise and fall of the market nor providing liquidity to the inter-dealer market. Instead, the broker-dealer is merely performing a service for customers. Measuring the dealer's markup on the basis of the price it pays in the routine process of acquiring customers' shares appropriately recognizes this relationship by allocating any additional benefit to the customer. 28

In the Proposed Interpretation, the NASD cites Waide for the proposition that a riskless principal trade is to be treated as an agency trade, but it does not do justice to the Commission's rationale. The Commission's reasoning in Waide was that the true commitment of capital in buying or selling securities for a dealer's proprietary account is to be distinguished from agency or riskless principal trades, where the customer and not the dealer assumes the market risk. 29 The proper conclusion from the Commission's Waide analysis is that it is the commitment of capital, not whether the dealer is a "market maker," that should control whether the dealer can calculate the mark-up using the "offered" side of the market as the reference point for determining prevailing market price (in the case of a sale to a customer).

For the foregoing reasons, the Association believes that the NASD does not give due weight to the Commission's analysis and, in the context of the fixed-income markets, the Proposed Interpretation in this regard does not accord with either the needs of the marketplace or the policies that underlie the Commission's long-standing positions concerning dealer compensation. Accordingly, the Association recommends that the Commission require the NASD to abandon its effort to distinguish between "market makers" and others in determining the base price against which the mark-up or mark-down is to be measured for a fixed-income security. Instead, the Association recommends that the NASD draw this distinction on the basis of whether the dealer routinely assumes principal risk in particular classes or categories of debt securities. If the dealer routinely acts as an agent or a riskless principal, it should be entitled only to an agent's commission or mark-up, relying on contemporaneous cost as the determinative reference point for determining prevailing market price. On the other hand, if the dealer routinely commits capital to position a security, either long or short, before trading with the customer, or if the dealer facilitates the customer's trade by taking the other side without having a counterparty to accept the market risk, the dealer is entitled to a spread, and the reasonableness of the dealer's mark-up should be measured with reference to the dealer’s offered side of the market (in the case of a sale to a customer) and the dealer’s bid side of the market (in the case of a purchase from a customer), rather than acquisition cost. If a dealer routinely commits capital to a particular class or category of debt securities, but the particular transaction is a riskless principal transaction, then the Association believes it would be appropriate to look to contemporaneous cost as presumptively (not determinatively) the best evidence of prevailing market price. Therefore, even if the particular transaction is a riskless principal trade, the capital committing dealer would be able to rebut the presumption by introducing countervailing evidence.

C. Riskless Principal Transactions

The definition of "riskless principal" transaction requires additional interpretive clarification so that it is not applied in circumstances in which debt securities dealers assume principal market risk in committing their capital to trades.

The Proposed Interpretation cites SEC precedent to the effect that when a dealer that is not a market maker effects a riskless principal transaction, contemporaneous cost must always be used as the basis on which to calculate a mark-up. The SEC has previously held, however, that market makers in equity securities are not subject to this analysis, on the basis that an equity market maker provides important liquidity functions and should not be limited to a mark-up above its cost. For precisely the same rationale, if the NASD declines to abandon the market-maker concept as recommended above, there is no reason that the same exclusion should not apply to dealers who routinely commit capital to trades in a particular class or category of debt security and provide the liquidity necessary for the fixed income markets to function.

The Proposed Interpretation does not specifically define "riskless" principal transaction. However, to give the term its ordinary meaning, a riskless principal transaction should be regarded as the functional equivalent of an agency trade, in which (by definition) no principal risk attaches to the dealer effecting the transaction. It is particularly important that risk transactions not be regarded as "riskless" solely because of their timing, or definitional ambiguities about what constitutes an "order" in the debt securities markets. 30 Dealers often acquire debt securities in the expectation that they will meet known or anticipated customer interest, and customer transactions involving those securities may be executed shortly after a dealer acquires a position. However, such expectations or expressions of customer interest are not "orders," and until the security is sold, the dealer is entirely at risk.

D. Similar Securities

The Association strongly supports the use of "similar securities" as a means of establishing the prevailing market price. However, the factors suggested in the Proposed Interpretation that do not involve comparisons drawn from similar securities are likely to be of little practical benefit in determining prevailing market price, given the dynamics of trading in the debt securities markets.

The Proposed Interpretation suggests a number of factors that may be taken into consideration when a debt securities dealer determines a mark-up or mark-down on a basis other than its own contemporaneous cost. In general, the Association strongly supports this concept, which relies on valuations derived from "similar securities." The first two factors are theoretically helpful, but in practice are likely to be of little benefit because they rely either on actual dealer-customer transactions, or on contemporaneous inter-dealer quotations involving the same security, which in less actively traded fixed-income products are likely to be rare or non-existent. These factors include prices of dealer transactions in the same security with institutional accounts with which a dealer regularly effects transactions in the same or a similar security, and contemporaneous inter-dealer quotations in the same security made through an inter-dealer quotation mechanism through which transactions do in fact occur in that security at prices that are reasonably related to the displayed quotations. 31

In contrast, yields calculated from the price levels of "similar securities" should be helpful in establishing the prevailing market price of other debt instruments, and the Association strongly supports this concept. Several important refinements are needed in the definition of this term, however, and the indicia of pricing that may be derived from "similar" debt securities. The Proposed Interpretation suggests that a dealer may calculate debt securities yields on the basis of either actual inter-dealer transaction prices, or dealer-institutional customer transaction prices involving "similar" securities. In practice, the Association believes that actual dealer-institutional customer transaction prices are likely to be more prevalent than inter-dealer transaction prices.

The Proposed Interpretation also suggests that such yields may be calculated from validated inter-dealer quotations in "similar" securities. However, a requirement for "validated" inter-dealer quotations essentially replicates the above-mentioned factors that rely upon actual inter-dealer transaction prices or contemporaneous inter-dealer quotations. To be helpful in allowing dealers to use similar securities to establish evidence of the prevailing market price for another debt security, a dealer routinely commits capital to a debt securities positions should be allowed to use its own offered quotations to provide such evidence, as long as such quotations are not demonstrated to be unreasonable. The reasonableness of such quotations may be verified in the manner described earlier in this letter. Accordingly, the Association suggests that the Proposed Interpretation be clarified to provide that such quotations need not be continuously "displayed" in order to be "validated."

Finally, the Association generally agrees with the factors set forth in the Proposed Interpretation for determining the degree to which a security is "similar." However, we believe that regulators and examiners will require specific additional guidance and training to prevent unreasonable or unsupported challenges to dealers’ assessments of securities that are "similar" for pricing purposes.

V. SCOPE OF THE PROPOSED INTERPRETATION

The Interpretation proposes to exclude "dominated and controlled" securities, securities with "equity-like characteristics," and municipal securities from its scope. The Association believes that each of these proposed exclusions require additional elaboration and refinement before the Commission approves the Proposed Interpretation.

A. Dominated and Controlled Securities

The Proposed Interpretation states that it does not address the application of the mark-up policy to transactions involving the domination and control of the market for a particular security, and that when a dealer dominates and controls the market for a particular security, the dealer’s contemporaneous cost is the best evidence of prevailing market price.

The Association believes that the circumstances in which a dealer may be found to "dominate and control" the market for a debt security will be quite limited. The concept of domination and control is predominately an equity markets phenomenon, where a dealer can theoretically exercise undue control over the supply and demand characteristics of a singular instrument that is uniquely linked to the future economic prospects of an issuer, and where the dominating dealer’s quotations are subject to little if any independent valuation. 32 The opportunity to exercise such control over the supply and demand characteristics of any given debt security is far more limited since other debt securities having similar performance characteristics are almost always readily available. This is true even in situations where there may be only a single dealer interested in buying or selling a specific debt security.

The Proposed Interpretation also indicates that the analysis of whether the market for any particular security is dominated or controlled should take into account the extent to which the security is "fungible" with other similar securities. Fungibility, which could be interpreted to require that one security be capable of substituting completely for another, is an inappropriately stringent standard. Instead, the Proposed Interpretation should take into account the extent to which the pricing of a given debt security is regarded as being closely related to a benchmark security, or to other debt securities having similar characteristics. In this context, the same factors proposed to be used for establishing whether a security is "similar" to others, described above, should be employed for purposes of establishing whether a given debt security is capable of being dominated and controlled.

B. Securities with "Equity-Like Characteristics"

The Proposed Interpretation states that in the case of those debt securities that trade with significant equity-like characteristics, the use of comparisons with similar securities of unrelated companies will generally not be relevant. Although the range of securities having "significant equity-like characteristics" is not defined in the Proposed Interpretation, 33 it is important that this statement not be interpreted generally to prevent the prevailing market price of high-yield securities to be established by reference to the prices of other, similar high-yield securities. Notwithstanding their distinctive characteristics, high-yield securities are still debt instruments, and share fundamentally similar credit, yield and maturity characteristics. Prices of many high-yield securities are in fact determined primarily with reference to interest rate spreads applicable to other high-yield securities within the same industry sector. Other generic market factors in addition to interest rate spreads may be used to determine the price of high-yield securities, rendering the use of similar securities for pricing purposes meaningful.

C. Municipal Securities

Finally, the exclusion of municipal securities from the scope of the Proposed Interpretation represents a potential source of confusion for market participants. MSRB Rule G-30, which governs permissible mark-ups for municipal securities, is essentially a fair pricing rule. As such, that rule establishes a different conceptual framework for evaluating the reasonableness of mark-ups in comparison with prevailing NASDR mark-up policy, which focuses on the percentage amount of mark-up. In practice, however, the Association believes that MSRB mark-up investigations and enforcement actions will continue to be informed by prevailing NASD and SEC mark-up policies, as may be augmented by adoption of the Proposed Interpretation. The Association believes that the issuance of the Proposed Interpretation offers regulators in the taxable and municipal fixed-income markets an opportunity to harmonize their mark-up practices and policies, and at a minimum, for municipal securities regulators to adopt more explicit mark-up guidance consistent with the suggestions set forth in this letter. Given certain fundamental similarities of taxable and municipal debt securities, we see no reason to perpetuate different regulatory standards, interpretive guidance and potential marketplace confusion concerning the mark-up analysis that should be applied to each type of instrument.

CONCLUSION

Again, the Association appreciates the opportunity to provide its comments on the Proposed Interpretation. Should you require any additional information or clarification of the matters discussed in this letter, please contact either of the undersigned at 212.440.9400.

Sincerely,

PAUL SALTZMAN
Senior Vice President and General Counsel

GEORGE P. MILLER
Vice President and Deputy General Counsel

cc:
Securities and Exchange Commission
The Honorable Arthur Levitt, Chairman
The Honorable Norman S. Johnson, Commissioner
The Honorable Isaac C. Hunt, Jr., Commissioner
The Honorable Paul R. Carey, Commissioner
The Honorable Laura S. Unger, Commissioner
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The Bond Market Association
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FOOTNOTES

1 1">The Bond Market Association represents securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. The Association's member firms account for in excess of 95 percent of all primary issuance and secondary trading activity in the domestic debt capital markets. More information about the Association can be obtained from our website at www.bondmarkets.com. This letter was prepared with input from a broad range of Association members and committees, reflecting the diverse range of different debt securities products and markets. In particular, the preparation of this letter was overseen by the Association's Board of Directors, various divisional Executive Committees, the Regional Advisory Committee, and the Legal and Compliance Committee.

2 Proposed NASD Rule IM-2440-2 (September 30, 1998).

3 Securities Exchange Act Release No. 40511, 63 Fed. Reg. 54169 (October 8, 1998), (hereinafter, the "Release").

4 See generally "Bond Markets 2000: A Conceptual Framework for Efficient Regulation of the Fixed-Income Markets," The Bond Market Association Member Exposure Draft (October 21, 1998).

5 NASD Notice to Members 94-62 (August, 1994).

6 The Interpretation and the NASD's mark-up policy address mark-up and mark-down practices for debt securities, and thus deal with situations in which a dealer acts either as a seller or buyer of securities. For convenience, and unless the context clearly indicates otherwise, references and commentary throughout this letter that relate solely to "mark-up" rules, policies and practices may be assumed to apply equally to corresponding rules, policies and practices relating to "mark-downs."

7 With respect to this fundamental issue, the Association questions whether the current filing by the NASD gives the Commission a reference point to sustain its statutory burden

of finding that the Proposed Interpretation does not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Securities Exchange Act of 1934. See, Item 4 of Form 19b-4.

8 See Raymond James & Assoc., Inc., Securities Exchange Act Release No. 38893, 1997 WL 429578, 6 (SEC) (Aug. 1, 1997) (concurrence of Commissioner Wallman) (stating that guidelines such as the NASD's 5 percent markup policy "have the potential to set floors for pricing or to preclude or otherwise limit competition or innovation, thereby discouraging investors.")

9 Release at 54170.

10 NASD Conduct Rule IM-2440.

11 Securities Exchange Act Release No. 24368, 52 Fed. Reg. 15575 at 15576 (April 21, 1987).

12 See, e.g., District Bus. Conduct Comm. v. MMAR Group, Inc., 1996 NASD Discip. LEXIS 66 (NASD Nat'l. Bus. Conduct Comm., October 22, 1996); In re Lehman Bros., Inc., 62 SEC Doc. 2195, 1996 WL 519914 (1996). Also see Securities and Exchange Commission v. Rauscher Pierce Refsnes, Inc. (amicus curiae brief of The Bond Market Association), filed June 18, 1998 (discussion at pp. 5-10).

13 The Association understands the Proposed Interpretation to suggest that "contemporaneous cost" must be used as the basis for determining prevailing market price in the context of a riskless principal transaction or in the event the transaction is consummated in a market controlled or dominated by the dealer. This suggestion is extremely confusing because it appears that the ability to introduce "countervailing evidence," rebutting the presumption of acquisition cost as the benchmark price, is included within the definition of "contemporaneous," (i.e., intervening market events that make acquisition cost not a probative indicator of prevailing market price). The Proposed Interpretation thus creates a circular analysis that is inconsistent with the rigid requirement to default to "contemporaneous" cost suggested by the NASD.

14 It appears that language was inadvertently dropped from the definition of "contemporaneous" set forth in the Federal Register version of the proposed Interpretation (63 Fed. Reg. 54170, in the first full paragraph in the middle column). The text accompanying the proposed Interpretation appears to include the intended description of this term. Since the Federal Register supplies the official version of the NASD's proposed rule change, the Association suggests that the SEC issue a corrected release at or before approving the Proposed Interpretation.

15 As suggested in the text below, the Association agrees that acquisition cost is an appropriate determinative default standard in the context of a riskless principal transaction, but only when the dealer involved does not routinely commit capital to trading in the given class of debt securities the particular security falls within. In a

riskless principal transaction, where the dealer does routinely commit capital acquisition cost should be viewed only presumptively as the best evidence of prevailing market price. Outside the context of a riskless principal transaction, acquisition cost should simply be one of several factors in determining prevailing market price.

16 NASD Notice to Members 94-62 at 389 (August, 1994).

17 See, for example, In re Howe, Solomon & Hall, Securities Exchange Act Release No. 40038 (May 28, 1998) at n.3, 1998 SEC LEXIS 1028, in which cost was deemed to represent market value of a debt security fully 38 days after acquisition.

18 Release at 54170.

19 Release at 54170.

20 The ambiguity perhaps could be resolved by defining "retail" as non-dealer, so that transactions with institutional customers would clearly be included.

21 As discussed above, the distinction made in the Proposed Interpretation between "integrated dealers" and "market makers" is not clear since it suggests that a dealer must sell to retail customers and act as a wholesale market maker in order to receive a spread as well as a mark-up.

22 Concerns previously cited in equity market enforcement actions (e.g., Alstead, Dempsey &Co., 47 SEC 1034 (1984)), where a dealer's "quotations" for equity securities in which it alone made a market were suspect, are not generally present in the debt markets where, as discussed above, securities are generally priced in relation to benchmark securities or other similar securities.

23 General Investing Corporation, 41 S.E.C. 952, 954-955 (1964), 1964 SEC LEXIS 503.

24 See 17 C.F.R. 240.10b-10(a)(2)(ii)(A).

25 Securities Exchange Act Release No. 33743 (March 4, 1994), 1994 SEC LEXIS 732.

26 SEC No-action Letter, Public Securities Association (available March 30, 1995).

27 Even in a riskless principal transactions, and notwithstanding the SEC's analysis in Waide, the Association believes that fixed income dealers provide liquidity by facilitating customer purchase and sale transactions. They simply do not incur principal risk.

28 Kevin B. Waide, Securities Exchange Act Release No. 30561 (April 7, 1992), 1992 SEC LEXIS 827, in text at nn. 12-15 [emphasis added, footnotes omitted].

29 The counterparty risk in a fixed-income "riskless" principal trade often is greater than the counterparty risk in an equity riskless principal trade, since the amounts of money

involved often are much greater and, in the case of trades for delayed settlement, the risk extends for what may be a considerably greater period of time. Those factors should be taken into account in judging the fairness of the riskless principal dealer's mark-up or mark-down.

30 For example, the above-cited definition of "riskless" principal transaction drawn from Exchange Act Rule 10b-10 would encompass transactions in which a dealer, after having received an order to buy from a customer, purchases the security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, sells the security to another person to offset a contemporaneous purchase from such customer. The key element in establishing whether such a transaction is "riskless" is not whether the dealer's offsetting customer sale or purchase is contemporaneous, but whether the dealer was in fact exposed to any principal market risk associated with holding a long or short position in the security. The essential distinction is whether a dealer has both sides of a transaction in hand, in which case the transaction may properly be regarded as "riskless" for this purpose. See Waide, quoted supra. See also, Buys-MacGregor, MacNaughton, Greenawalt & Co., SEC No-action Letter (February 1, 1980) 1980 SEC No-Act LEXIS 2851.

31 Release at 54170. The Association suggests that the qualification, "with which any dealer regularly effects transactions in the same or a similar security" should be deleted. The Association believes that all institutional customers should be presumed to be sophisticated enough to determine the reasonableness of the price of fixed income securities. No similar qualifier is used in clause (4) with respect to transactions with institutional accounts in "similar" securities, and there is no reason why it is acceptable to use prices with any institutional customer in similar securities, but only some institutional customers in the same securities.

32 See General Investing Corporation, supra, where the Commission concluded, with respect to retail markets in equity securities where a single market maker is dominant: "In such cases, concentration of sales on the retail level and domination of the market by maintaining or increasing a bid would provide a dealer unrestricted latitude in setting its inside offer and therefore the retail prices. A determination on the basis of the firm's own inside offer that the mark-ups realized by it in retail sales were not excessive when other firms are offering at wholesale prices lower than the firm's inside offer would make a sham of the protection intended by the NASD proscription that a member shall not charge unfair prices in principal transactions with customers." Id. in text following n. 6. Notably, that 1964 case dealt with an equity security in which retail customers would have no readily available indices of value, other than the dealer's own quotation against which to evaluate the appropriateness of the dealer's quoted prices. Given the ready availability of other similar securities and of the prices of "benchmark" securities, the concerns that prompted the Commission to rule as it did in that case, and the subsequent domination cases such as Alstead Dempsey, supra, are not pertinent to the debt markets.

33 If the intent of this provision is to target any particular type of security the Association recommends that the Interpretation be modified to do so explicitly. In addition, to the

extent that it can be demonstrated that a debt security has "significant equity-like characteristics," then appropriate mark-up levels should be judged with reference to other equity, rather than debt, securities