

Notice to Members

NOVEMBER 2005

SUGGESTED ROUTING

Corporate Finance
Legal and Compliance
Operations
Senior Management
Technology
Trading and Market Making
Training

KEY TOPICS

Credit Default Swaps
Debt Securities
Operations
Options
Rule 6200 Series
TRACE Rules
Transaction Reporting

GUIDANCE

Corporate Debt Securities

Transactions in TRACE-Eligible Securities That Occur in Connection with Options, Credit Default Swaps, Other Swaps or Similar Instruments Must Be Reported to TRACE

Executive Summary

NASD provides interpretive guidance under Rule 6230 on the obligation of members to report to the Trade Reporting and Compliance Engine (TRACE) transactions in TRACE-eligible securities executed in connection with the exercise or settlement of options; the termination or settlement of (or other events triggering a transaction in TRACE-eligible securities) credit default swaps or other types of swaps; or the exercise, termination or settlement of (or other events triggering a transaction in TRACE-eligible securities) similar instruments.

Questions/Further Information

Questions concerning this *Notice* should be directed to tracefeedback@nasd.com; Elliot Levine, Chief Counsel, Transparency Services, Markets, Services, and Information, at (202) 728-8405; or Sharon K. Zackula, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8985.

Interpretive Guidance

NASD has received inquiries regarding the reporting of transactions in TRACE-eligible securities that occur as a result of the exercise or settlement of options; the termination or settlement of (or other events triggering a transaction in TRACE-eligible securities) credit default swaps (CDSs) or other types of swaps; or the exercise, termination or settlement of (or other events triggering a transaction in TRACE-eligible securities) similar instruments.¹

A member that is a party to a transaction in a TRACE-eligible security that occurs pursuant to, or in connection with an option, a CDS, another type of swap, or a similar instrument must report the transaction to TRACE under Rule 6230. In addition, when such a transaction in TRACE-eligible securities is executed at a price that does not represent current market pricing, the transaction must be reported to TRACE using the "special price" modifier (or flag), as more fully described below.

Under Rule 6230(d)(4)(A), if "a transaction is not executed at a price that reflects the current market price," the reporting member must select the "special price" modifier.² NASD interprets the term current market price as an arm's length price agreed upon by a buyer and seller after considering current pricing factors and information, such as current quotes or indications, current transaction information or a current spread to a benchmark. Even if such price is substantially different from the last price, NASD considers such a price to be a current market price.

The "special price" modifier or flag is appropriately used when a transaction is executed at a price based on arm's length negotiation and done for investment, commercial or trading considerations, but does not reflect current market pricing.³ In this regard, a transaction in TRACE-eligible securities occurring as a result of an exercise or settlement of an option or similar right generally would be reportable to TRACE with a "special price" flag because, in general, options are structured such that the price of the later occurring transaction in TRACE-eligible securities does not reflect a then current market price for those securities. Similarly, a transaction in TRACE-eligible securities occurring as a result of the termination or settlement of (or other events triggering a transaction in, TRACE-eligible securities) CDSs or other types of swaps generally would be reported with a "special price" flag for the same reason. In these instruments and the other instruments referenced above, the parties to such agreements generally determine the terms of the price and/or the price of the TRACE-eligible securities at arm's length for investment, commercial or trading purposes in a manner that will not reflect current market price as of the day and time that the transaction or transactions will occur.

Endnotes

- 1 A CDS is an agreement where one party “sells” risk (the risk-protection buyer) and the counterparty “buys” the risk (the risk-protection seller). The risk-protection buyer, who often owns the underlying security (e.g., a debt security issued by a third party), pays a periodic fee to the risk-protection seller during the life of the CDS. In return, the risk-protection seller agrees to pay the risk-protection buyer a set amount in the event that a credit event occurs during the term of the CDS (e.g., a bankruptcy, default or a credit downgrade). A CDS can expire at the end of the pre-established term of the swap, or, in the event of a triggering credit event, when it is settled and then terminates.
- 2 A transaction is reported using the special price modifier by setting the “special price” flag to “Y.”
- 3 See also *Notice to Members 02-76* (November 2002), Q&A No. 13.

For example, broker-dealer X (BD X) is contacted by an institutional client (Client M) to enter into a CDS. Client M has credit exposure to an issuer and wishes to reduce such exposure (e.g., Client M owns a large number of bonds issued by an automobile industry sector company (e.g., ABC Autos), and Client M seeks to transfer some or all of the credit risk related to owning the ABC Autos bonds without actually selling the ABC Autos bonds). BD X enters into a CDS with Client M, under which Client M agrees to pay BD X a periodic fee. In exchange for the periodic fee, BD X agrees that, in the event of a credit event relating to ABC Autos (defined in the swap and including events such as a declaration of bankruptcy or a default), BD X will pay Client M a certain predetermined amount of cash, or will buy from Client M the ABC Autos bonds at par value.

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