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# Report of the Corporate Debt Market Panel





# Corporate Debt Market Panel Members-2004

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## Executive Summary

The launch of NASD's Trade Reporting and Compliance Engine (TRACE) on July 1, 2002 and the subsequent availability of a consolidated view into the U.S. corporate bond market have surfaced a number of trends that have implications for the regulatory framework and structure of this market. In order to ensure that it is proactively monitoring shifting market dynamics, NASD convened a panel of twelve prominent experts representing a cross-section of the marketplace – the Corporate Debt Market Panel ("Panel"). The objective of the Panel was to review and make recommendations to the NASD Board of Governors regarding how to best ensure market integrity and investor protection in the corporate bond market.

The Panel discussed both individual and institutional investor aspects of the market and concluded that the higher sophistication levels of and resources available to institutional investors make this segment a lower priority for any immediate action, and individual investors often do not understand some key aspects of bonds and would benefit from additional guidance and information disclosure. The Panel recognizes that some recommendations may flow over into the institutional market.

The Panel provided the NASD with specific recommendations and general guidance to help investors better navigate the corporate bond market.

The Panel recommendations include:

**A. Specific guidance on general disclosures and information for individual investors:**

**1. Improved information for individual investors prior to, and at the time of, buying or selling corporate bonds:**

- At the time of indicating interest in corporate bonds, investors should be provided with basic information about bonds, including types of bonds, pricing, payment terms, risks, marketability, and how broker-dealers are compensated for bond transactions.
- Immediately prior to buying or selling a bond, investors should be provided with more specific information, including the features of the bond(s) under consideration, indicators of marketability, yield after brokerage remuneration, credit rating (and “outlook”, if available), where recent transaction information can be located for this or similar bonds, whether this will be a new issue or secondary market transaction, and the broker-dealer’s intended capacity (“agent” or “principal”).

**2. Straightforward language and increased disclosures on post-trade corporate bond confirmations, supplementing existing disclosure requirements:<sup>1</sup>**

- A simple method (i.e. a symbol) for individual investors to identify a corporate bond;
- A text field plainly describing that “a payment to your brokerage firm” may have been deducted from or incorporated into the price if the broker-dealer acted as principal in the transaction;
- A credit rating from a nationally recognized statistical rating organization;
- Cash flow information; and
- Yield to worst.

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1 It should be noted that the Panel believes the current disclosure requirements on trade confirmations such as dollar price, yield, quantity, trade date, broker-dealer capacity, commission (if agent), etc. are necessary and will be further enhanced by these recommended additions.



**B. Other guidance to improve investor access to information about bonds:**

- The Panel urged NASD and the brokerage community to intensify their efforts to achieve wider distribution of bond information through various media channels. The Panel recommended that NASD continue its effort to increase the distribution and availability of TRACE information as a cornerstone of a broader effort to better educate individual investors about the bond market.
- The Panel believed it would be very helpful for investors to be able to compare the price and yield they receive for a bond against industry benchmarks and that NASD should work to determine if benchmarks could be developed for use by individual investors.

The Panel recommendations were presented to the NASD Board of Governors and referred to NASD staff and Board Committees for the formulation of specific actions. The Panel will reconvene in nine months to discuss progress regarding improved access to information about bonds.

# I. Introduction

The corporate bond market has traditionally been seen as the almost exclusive province of institutional investors, such as pension funds, investment companies and hedge funds. With older baby-boomers nearing retirement age, however, individual investors are increasingly participating in this market. Information gleaned from NASD's Trade Reporting and Compliance Engine, or TRACE, shows that about two thirds of corporate bond transactions reported to TRACE are in quantities of \$100,000 or less in value, a size widely viewed as representative of individual investor activity.

Yet, individual investors by and large know very little about how the bond markets work. Recent NASD surveys, for example, showed only 40 percent of investors understood that bond prices fall as interest rates rise. Thirty-four percent either thought: (a) there was no fee for buying or selling a bond or (b) they did not know whether or not they were paying a fee.

In order to review how institutional and individual investors are navigating through this increasingly important market, NASD convened the Corporate Debt Market Panel and charged it with making recommendations to NASD's Board of Governors regarding how best to ensure the integrity of the market and protect investors.

The Panel consisted of twelve members knowledgeable about the interests of individual investors, institutional investors, broker-dealers and others.

The discussions were limited to TRACE-eligible securities that trade in the U.S. secondary corporate bond market, including investment grade, high-yield and convertible bonds. The Panel reviewed transaction methods, current regulation and recent market dynamics and found that this market is:

- Overwhelmingly an over the counter market, with 99.9 percent of business transacted off-exchange.
- Larger than either the U.S. Treasury or municipal bond market, with approximately \$4.3 trillion outstanding as of the third quarter of 2003.

- Important to individual investors, with TRACE data showing that 65 percent of transactions are for quantities of \$100,000 or less.
- Predominantly traded as “principal”, where the broker-dealer buys or sells for its own inventory, rather than “agent”, where the broker-dealer facilitates trades between the buyer and seller; with 92 percent of TRACE trades reported by dealers acting as principal.
- Increasingly transparent as NASD phases in disclosure of more transaction information to cover all publicly-traded TRACE-eligible corporate bonds, including investment-grade and high-yield, with this market being one of the first U.S. fixed income sectors to have mandated intraday price transparency.
- Increasingly interacting with, and influenced by, the credit derivatives market, especially credit default swaps.

The inception of the Corporate Debt Market Panel followed the July 2002 launch of TRACE, which has brought unprecedented transparency to the corporate debt market. Before TRACE went online, investors had ready access to transaction information in the equities markets, but not in the corporate debt markets. Today, more than 23,000 publicly traded corporate debt securities are subject to TRACE reporting requirements (“TRACE-eligible”). All TRACE-eligible corporate bond trades executed by NASD-registered firms must be reported to TRACE within 45 minutes of execution. The reporting window will narrow to 30 minutes on October 1, 2004, and to 15 minutes on July 1, 2005.

NASD also plans to broaden the universe of TRACE transaction data that is made available publicly from about 4,600 corporate bonds at present to the full 23,000 by early 2005. That number will include all TRACE-eligible publicly-traded corporate bonds across investment-grade and high-yield credit qualities.

This report presents the Corporate Debt Market Panel’s findings and recommendations. NASD continues to work with the securities industry and the Securities and Exchange Commission (SEC) to bring even more transparency and integrity to the corporate bond market and protect its investors.

## II. Discussion of Issues

Out of their review of market dynamics, the Panel confirmed the areas to be discussed. Given the evidence of increased individual investor activity, the discussions were divided along two broader topic areas: institutional investor related topics and individual investor related topics. The topics were categorized as follows:

- **Institutional Investor topics**
  - Capital commitment and the role of “riskless principal” trading
  - Issues of overlap between the corporate bond and credit default swap markets and the differences in transparency and non-public information availability in the credit derivative vs. corporate bond markets
- **Individual Investor topics**
  - Execution quality
  - Broker-dealer compensation disclosure

### A. Institutional Investor Topics

#### **Capital Commitment and the Role of Riskless Principal Trading**

NASD conducted a survey<sup>2</sup> of institutional investors that indicated a concern about the increasing concentration of assets among institutional investors and the consolidation of dealers and their reduced appetite for facilitating customer transactions by employing capital. With the pace of broker-dealer mergers, there was general concern that although the balance sheet of the newly combined entity would be larger than the individual predecessor firm's, the new aggregate balance sheet was committing less capital overall to the market than the sum of the individual firms prior to the merger. In part, the view that there was more risk aversion from the broker-dealers may have been driven by overall market volatility and resulted in the view that more principal activity was being executed on a “riskless” basis rather than through traditional capital commitment. As part of these discussions, SEC Rule 10b-10 (“Trade Confirmation Rule”) was discussed as it relates to broker-dealers disclosing trading capacity.

### **Credit Default Swaps (CDS)**

During interviews with institutional investor and broker-dealer professionals<sup>2</sup>, the increasing influence of the CDS market on the corporate bond market was frequently mentioned as an important new development. Market participants noted the significant growth and size of the CDS market, and that those participants involved in both CDS and bonds may have had additional information available to them that could unfairly inform their trading decisions. In part, the concern was that some market participants are not allowed (typically by charter) to participate in the CDS market and that information availability in CDS might make those transacting primarily in the bond market “blind” to these external forces dictating price movement. With these influences in mind, the Panel reviewed the issues surrounding the barriers in place to prohibit misuse of non-public information in CDS and the differences in transparency levels between the CDS and corporate bond markets.

### **Conclusions**

There was general agreement that although some market participants may have been initially concerned that there was less capital commitment and significant risks from the “spill-over” effects of CDS into the corporate bond market, that these concerns largely impacted the sophisticated institutional market. More importantly, supported by the material and presentations discussed at the meetings, the view was that market forces were already improving the initial areas of concern.

**Consensus:** The Panel believed higher sophistication levels of and resources available to institutional investors make this segment a lower priority for any immediate action and current efforts should be focused on individual investors.

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2 The survey included a series of interviews with 21 institutional investor and broker-dealer participants completed in October 2003.

## B. Individual Investor Topics

### Execution Quality

The quality of trade execution received by individual investors was discussed in detail. Significant concerns were raised regarding whether individual investors understood the differences between the ways the debt and equity markets operated and if sufficient information was available to individual investors to assess the quality of their execution.

The Panel discussed NASD Rule 2320 (“Best Execution Rule”) and the appropriate metrics for measuring the relative price an investor receives from their brokerage firm. Yield (inclusive of any charges from the brokerage firm) was deemed to be a good measure of overall “price” paid for a given bond and one that could be compared to the broader market to gauge the competitiveness of the price and quality of execution.

Ultimately, the Panel determined that the tools for individual investors to assess the quality of their trade execution are increasingly available through public sources such as TRACE, but the extent of their use to date is very limited.

### Broker-Dealer Compensation Disclosure

The discussions regarding compensation disclosure covered the requirements when the broker-dealer is acting as “agent” versus when the broker-dealer is acting as “principal”. With agent transactions, the Panel concluded that the payment/compensation to the broker-dealer was self-evident with the dollar amount disclosed on the trade confirmation as “commission”.

For principal transactions there is no indication on a confirmation statement that the dealer or sales person has received any compensation for conducting the trade. In fact, as indicated in an NASD survey<sup>3</sup>, 34 percent of individuals do not believe they are paying the dealer anything for executing the trade. However, the

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3 The research was conducted by an independent 3rd party market research firm in February 2004 and surveyed 150 individual investors that were screened to have primary or shared household decision-making responsibility for investments, and to have invested directly in corporate bonds (excluding investments made through mutual funds).

payment/compensation the dealer takes is more difficult to measure (in part because the bonds could have been in inventory for some time and, therefore, the dealer incurred market risk) and is not disclosed.

The Panel believed that investors were entitled to know that these trades were not conducted “for free.” But how, what and when compensation should be indicated was thoroughly debated. As part of these discussions, SEC Rule 10b-10 (“Trade Confirmation Rule”) was reviewed as it relates to broker-dealer disclosures.

### **Conclusions**

The Panel concluded that a concerted effort to better inform and educate individual investors on corporate bonds was necessary. Because the Panel believed that investors learn the most at the time of actually investing in an instrument, the Panel recommended that their broker-dealer provide better information to investors. As a cornerstone of this information and education, the Panel believed individual investors require complete and straightforward information disclosure from their brokerage firm – with minimal jargon and “Wall Street” terminology.

The Panel recognized that some broker-dealers already provide excellent disclosure to customers, and the desire of the Panel was to bring all broker-dealers up to high-quality disclosure. The Panel concluded that certain key pieces of information disclosed both before trading and after execution (e.g. on the trade confirmation) would significantly increase the ability for individual investors to understand the detail of their investment choices, risks and return. An important component of this effort is the ability to link aspects of recent improvements in transparency with actual transactions so that individual investors can determine the quality of execution they receive from their brokers.

In addition, the Panel believed that although bonds, like equities, are an important component of individual investors’ portfolios, little information is available through popular media outlets to advance individual investors’ knowledge of the bond markets. As a result, the Panel urged NASD and the brokerage community to intensify their efforts to achieve wider distribution of bond information (including TRACE) through various media channels.

In a related effort, the Panel believed that investors would benefit from broadly established “retail-friendly” benchmarks (such as indices) and that NASD should consider further investigation in this area.

**Consensus:** The Panel believed that individual investors’ increased participation in corporate bonds and improved access and use of information technology make additional guidance and information disclosure warranted and timely.



## III. Panel Recommendations

The Panel proposed a set of recommendations regarding disclosures for individual investors. The Panel will reconvene in nine months to discuss developments in this market. It should be noted that while the Panel's charter was to review issues in the corporate bond market, the Panel believed that many of its recommendations would benefit other fixed income markets, including the municipal bond market.

### A. Specific Guidance for Individual Investors

#### 1. General Disclosures and Information: Prior to Investing or Investment Decision

##### Overall Guidance

The Panel believed individual investors need more information and guidance regarding the purchase and sale of bonds. This information should allow investors to determine if these investments are appropriate for their objectives, what execution quality they receive and the bond's overall risk/return.

##### Specific Recommendations

The Panel believed there were at least two points at which individual investors needed better information: when an individual investor first indicates that he/she is considering buying corporate bonds, and at the time an individual is deciding to buy or sell a particular security.

The Panel recommended that broker-dealers ensure that individuals understand the following types of information at each of the two time intervals (note: some of this information may already be provided by broker-dealers):

- **Things an individual investor should know at the time of indicating interest in corporate bond investments:**
  - **Basic Information:** Characteristics and differences among the basic types of bonds (straight, convertible, etc.), debt structures (including use of collateral, seniority, etc.), and special features;

- **Pricing:** Price, yield to maturity and yield to call, the relationship between the price of a bond and yield, and why yield to maturity and yield to call are different;
  - **Payment Terms:** Coupon, face value, and maturity, including insurance and guarantees;
  - **Credit Risk:** Credit risk and ratings, and the differences between investment grade and high-yield categories;
  - **Other Risks:** Interest rate risk, call risk, and refunding risk<sup>4</sup>;
  - **Marketability of Bonds:** How easy they are to sell; and
  - **Compensation:** How broker-dealers are compensated for purchase and sale of bonds.
- **Security and transaction-specific information an individual investor should know immediately prior to buying or selling a corporate bond:**
    - **Basic Information:** Basics of price, maturity, coupon and yield of the bond;
    - **Indicators of Marketability:** Issue size, historic liquidity, etc.;
    - **Applicable Yield** after brokerage remuneration;
    - **Credit Rating** and “directional outlook,” if available, from a nationally recognized statistical rating organization;
    - **Call Features** and/or other unique features of the bond(s) under consideration;
    - **Sources of Comparison Data:** Where the customer can get information on recent transactions in this or similar bonds; and
    - **Transaction Type:** When a customer is going to buy a bond, whether this will be a new issue or secondary market transaction and whether the broker-dealer will sell the bond from its own inventory (i.e. as principal) or is going out to the market to find the bond (i.e. as agent).

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4 Interest rate risk is the amount that the market value of a bond will change in the event that interest rates change. Call risk is the potential amount that cash flow will be reduced in the event that a bond is called prior to maturity. Refunding risk is the possibility that an issuer will not be able to borrow funds adequate for refinancing the current bond at maturity and the resulting default creates potential losses for the investor.

### **Additional Guidance for Consideration**

During its deliberations, the Panel discussed some of the challenges of implementing these recommendations. As part of the review process within NASD, the Panel believed that employing current best practices to achieve the desired results should also be considered. Examples include:

- Use of online account click through technology to handle disclosures and deliver information to individual investors; and
- Instituting “Disclosure Obligations.”

## **2. General Disclosures and Information: Clearer Trade Confirmations**

### **Overall Guidance**

The Corporate Debt Market Panel believed trade confirmations should include straightforward and complete information regarding the nature of the service/transaction performed by brokerage firms on behalf of investors.

### **Specific Recommendations**

The Corporate Debt Market Panel recommended improving quality and quantity of information disclosed on corporate bond trade confirmations.<sup>5</sup> In addition to the current SEC Rule 10b-10 and Self Regulatory Organization requirements, the Panel recommended that the following pieces of information be included in corporate bond trade confirmations:

- **Symbol:** A simple method to identify a bond should be developed. The Panel does not believe that CUSIP is appropriate for individual investors. NASD should conduct a study to determine if its TRACE symbol has appropriate user-friendly characteristics to meet this need or whether an alternative should be developed.

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5 It should be noted that the Panel believed the current disclosure requirements on trade confirmations such as dollar price, yield, quantity, trade date, broker-dealer capacity, commission (if agent) etc. are necessary and will be further enhanced by these recommended additions.

- **Brokerage Charges:** A field labeled “Brokerage Charges” that would always have one of the following three descriptors:
  - “Commission” if the broker-dealer acted as agent (note: current rules require disclosure of commission amount);
  - “A payment to your brokerage firm may have been deducted from price you received” if the investor is selling and the broker-dealer acted as principal; or
  - “A payment to your brokerage firm may have been incorporated in price you paid” if the investor is buying and the broker-dealer acted as principal.
- **Credit Rating:** If rated, the rating and “directional outlook” from a nationally recognized statistical rating organization.
- **Cash Flow Information:** For bond purchases, the interest payments (and their periodicity) and the principal an investor should receive in U.S. dollars for this purchase if held to call and if held to maturity as well as the call and maturity date(s).
- **Yield to Worst:** The lowest yield regardless of how the transaction is effected.

## **B. Other Guidance to Improve Investor Access to Bond Information**

The Panel urged NASD and the brokerage community to intensify their efforts to achieve wider distribution of bond information through various media channels. The Panel recommended that NASD continue its effort to increase the distribution and availability of TRACE information as a cornerstone of a broader effort to better educate individual investors about the bond market.

The Panel believed that it would be very helpful for individual investors to be able to compare the price, yield, and return they receive from a bond against industry benchmarks. NASD should work to ensure that benchmarks are widely available to individual investors. NASD should encourage existing providers of benchmark (or index) data to increase their distribution. NASD should also work to determine if a set of standard “benchmarks” could be developed that are specifically geared towards individual investors.

## IV. Going Forward

NASD staff will work to organize appropriate education, possible rule filings, *Notices to Members* and other activities that are necessary to implement the recommendations of the Panel. NASD will work closely with the SEC throughout the process.



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