Comments on proposed Rule 2231

NASD has solicited comment in three areas:

I. General Approach
II. Specific Disclosure Provisions
III. Educational Materials

I. Comments on General Approach

The NASD concluded that TRACE data, which has shown larger than expected activity in trades under $100M in size, combined with other indicators of individual investor heightened interest in acquisition of individual bond issues in their portfolios, represent or confirm a trend that appears to be here to stay, and is likely to accelerate.

The Association called for an independent survey to ascertain general and specific knowledges regarding debt instruments. 150 bond investors participated.

My first comment is that while I would not challenge the conclusion that sub-$100M transactional activity means individual rather than institutional activity, it did occur to me to ask if high individual investor bond market participation is a trend, or if this is how it was before TRACE measurement was available. How was data prior to TRACE evaluated, and what did the data show. Nonetheless, new trend or old reality, if individual investor presence is this high, and knowledge level is as thin as surveys indicate, the time for 2231 has arrived.

My next comment would be that for a market representing $ 4.3 trillion outstanding float (see Debt Panel report), under what conditions would 150 human beings represent a statistically significant sampling.

I think the NASD made the right move to empanel the 12 prominent experts in 2004 to study the subject thoroughly.

The Corporate Debt Market Panel directly surveyed institutional investors. That survey indicated a concern about the increasing concentration of assets among institutional investors as well as the consolidation of dealers and their reduced appetite for facilitating customer transactions by employing capital.

My comment is that regardless of the reason for the reduced appetite, a shrinking number of dealers, combined with their increased unwillingness to take positions in bonds, may be a highly significant trend and at a minimum, threatens liquidity in the future, in particular for the individual bondholder.

Here we are discussing ways to give the individual more knowledge and better transparency, while member firms may be systematically avoiding traditional capital commitment, resorting to 'riskless' principal trades and the occasional agency transaction. It may be a good idea to ascertain if this finding by the Debt Panel, that of dealers' reduced appetite for employing capital, is a trend that is here to stay or is a temporary event, an aberration. If it's a trend, will any of the provisions of new Rule

2231 exacerbate it in any way. Equally importantly, will Rule 2231 serve to reverse this dealer trend.

The Panel stated that yield was deemed to be a good measure of overall price paid for a given bond.

My comment is that the Panel is absolutely correct. Not only is yield a 'good' measure: it may very well be THE #1 measure. I draw attention to the MSRB in its interpretations of its bond pricing rule G-30, in which the Board states that "Of the many possible relevant factors, the Board continues to be firmly of the view that the resulting yield to a customer is the most important one in determining the fairness and reasonableness of price in any given transaction. Such yield should be comparable to the yield on other securities of comparable quality, maturity, coupon rate, and block size then available in the market." This MSRB Report on Pricing, dated September 26, 1980, addresses a great many issues about which the NASD is soliciting comment regarding the 2231 proposal, and may provide historically and currently beneficial insights to decision-makers in 2005. Certain bond concepts are timeless…yield is one of them.

The Debt Panel concurred that investors learn the most at the time of actually investing in an instrument, and asserted that Member firms should be required to provide complete and straightforward information disclosure with minimal jargon and 'Wall St.' terminology. Given that the NASD has now proposed Rule 2231, it's clear the NASD agrees with the conclusions of the Panel.

My comment is that I agree with the Panel: individual investors' learning curves accelerate upward when they are about to "reach for their wallets", to use the words of Doug Shulman of the NASD at a recent Bond Market Association Legal & Compliance meeting. I agree also that if it is determined by the SROs, Member firms, and the SEC that reference to available educational materials is a necessary statutory requirement, then those materials had better be complete, straightforward, clear, unambiguous, and as incapable of misinterpretation as humanly possible.

II. Specific Disclosures

My comment is that I trust the member firms which have been engaged in corporate bond activity for years will present clear and concise commentary, which will then result in confirmation and other disclosure requirements that are both functionally appropriate and not burdensome in cost and implementation.

Implementation of procedures by Member firms to comply with Rule 2231 cannot be achieved free of costs, costs which would then be passed along to the consumer in higher retail commissions, mark-ups and mark-downs, reducing investor yield by some as-yet undetermined number of basis points.

A firm's 'pattern' of mark-ups is a relevant factor in the NASD 5% policy, which applies to OTC transactions in corporate bonds. Costs, so long as they are not excessive, are another relevant factor. Will the NASD instruct its District examiners to allow a higher pattern of mark-ups to offset the increased costs of 2231 compliance, or will members be expected to absorb the costs of 2231 entirely.

In the pursuit of investor protection and market integrity, care needs to be taken that the dealer community isn't induced to shift its activities to markets not undergoing intense and zealous new scrutiny, markets not subject to declining profit margins. As stated above, let's hope the dealer community provides input that leads to a balanced and functionally appropriate Rule 2231 which, at the end of the day, provides both a tangible and intangible 'net' benefit to the individual investor as well as the bond market as a whole.

One last observation on specific disclosures integrated with 10b-10 existing requirements: NRSRO ratings are one of many tools in the decision-making toolbox of bond investors, and are obviously highly meaningful to member firms and issuers. Due care must be exercised that overemphasis is not placed on NRSRO ratings, in particular when those ratings are top investment grade. Lest we forget that rating organizations have, at times in the past, been slow to downgrade, Orange County, California – 1994, comes to mind. Some may say that's an unfair example. So be it. Due care still needs to be taken when 'educating' the public investor about the significance and reliability of NRSRO ratings.

On the other hand, the 2231 proposal does suggest that alerting bond investors about forward looking credit indicators will possibly be a required disclosure, which may mitigate the concern about purchases (or sales) right before a rating change. However, the potential danger inherent in that part of the proposal is that it is vague, and may encourage one Member firm, which may be in possession of not-yet-widely-known information (positive or negative) due to its investment banking or advisory relationship with an issuer, to question whether to provide this disclosure under the heading of strict compliance with 2231 forward looking disclosure requirements.

Bear in mind that NRSRO rating disclosure will also require the client to be educated about split ratings. This has been addressed previously in the TRACE rules, but those were not designed for public consumption, nor do they respond to the natural curiosity of the individual investor about the 'why' of split ratings.

III. Educational Materials

Proposed Rule 2231, para. (b)(6) *Notice of availability of NASD disclosure.*

"A disclosure document…has been prepared by NASD and is available online at www.NASD.com. A paper version is available from your broker…"

My reaction was probably the same as many of you reading this right now, and many of my colleagues…An NASD-prepared disclosure document sounds like a great idea!…let's see what they've prepared.

I've read *Important Information You Need to Know about Investing in Corporate Bonds* and made some notes.

But before sharing those notes, I have a few questions which haven't been addressed in the 2231 proposal, or the Debt Panel report.

*Is the NASD immune from liability if an investor makes an investment decision based upon a disclosure in the NASD-prepared materials, which disclosure may be misleading, or which disclosure may omit to make statements which would make the disclosures made not misleading?

*Is the member firm which effected the transaction for that client liable if it relied upon NASD-provided and mandated information disclosures which may be misleading as described above?

*Will a member firm be able to present this NASD-provided disclosure document at an arbitration proceeding as evidence of compliance, in a dispute in which the public customer claims, whether rightly or wrongly, that the firm's disclosures regarding bonds were inadequate.

*Are these educational materials going to contain any caveats, in bold print or otherwise.

My comments pertaining to the content of the *Important Information You Need to Know about Investing in Corporate Bonds* are shown below.

Before you read these comments, bear in mind that I attempted to put myself in the mindset of an individual investor who has not invested in corporate bonds before. Perhaps he or she has put money into a bond mutual fund or unit trust, and perhaps that bond fund investment was made in his or her 401(k) or other company-sponsored retirement arrangement where current taxation is not a consideration. The mutual fund investor is aware that liquidity at NAV is well-established, the shares are redeemable.

So now we have John/Jane Q. Public considering putting money into individual corporate debt issues, and they require help in getting to know much more about bonds before they take the plunge, before they reach for their wallets so to speak. And one place they turn for help is to the NASD, in addition to their own broker, who may only be a Series 6 qualified IC/VC limited representative. Their Series 6 financial planner can't sell them individual bond issues. They may have to open an account elsewhere to get those bonds.

That's the mindset with which I approached the educational disclosure document written, endorsed and approved by the NASD.

In the words of the Debt Panel, the information disclosures should be complete, straightforward, with minimal jargon and 'Wall St.' terminology.

(The phrases and sentences in italics are direct from the NASD proposal and are the sections to which I have added my comments directly beneath in regular type.)

Corporate Bond Basics

What is a corporate bond?

bondholders receive interest payments during the term of a bond (or, for as long as a bondholder owns a bond)

John Q. Public could read that statement and say 'hey, that's like my Series E savings bonds. When I held them several years past maturity, I remember the bond kept earning more interest until I cashed them in."

*if bondholders hold bonds until **maturity**, they also are repaid the principal amount*

John Q. looks at that statement and just might think that he has to hold the bond to maturity to get repaid the principal amount. Later paragraphs point out that the market price fluctuates prior to
maturity, however, John Q. might not connect the dots unless he's told point blank;
the only time in the life of the typical corporate bond the issuer is required by contract to pay back the $ 1,000 loan is at maturity.

Therefore, it is impossible to predict in advance the price that a bondholder will receive if the bondholder purchases a bond and later sells the bond before maturity.

John Q. looks at this and says 'wait a minute, if I am a bondholder, haven't I already purchased the bond that I'm now thinking of selling prior to maturity?' John's confused about the use of the word bondholder after reading this.

Yield

Because bond prices fluctuate continually in the market, the yield your bond investment will provide if it is sold prior to maturity also changes constantly.

John Q. is really scratching his head now. He learned that the interest rate on his bond is fixed, and now he's being told that his yield changes every day. And he's thinking 'wait a minute, if I buy a bond and hold it to maturity, every day I owned it, it had a different yield to ME?'
John knows that selling the bond early at a price different than he paid makes a difference in his overall return. He knows that fact from stocks and mutual funds.
This wording might lead John Q. to draw a wrong conclusion about buying individual bonds and calculating their yield to him. Even though the sentence is correct, the message could be misconstrued.

For example, if the same bond sells tomorrow for $990, the current yield would be slightly higher than 8 percent.

John Q. is looking around for the calculation or the formula for this thing called current yield. And he's saying to himself 'wait a minute, if I paid a grand for this 8% bond, and I sell it for $ 990, how on Earth do I end up

with a yield of slightly higher than 8% when I just took a $10 hit. I don't understand this at all.'
The material isn't clear about which 'you' it's talking about…the you who is the original owner, or the you who picked it up at a discount in the secondary market.

Yield to maturity and yield to call: What's the difference?

In my opinion, this set of paragraphs has to be absolutely clear, and I don't believe they are as clear as they could be.
*The term Callable is used but isn't defined until later in the materials.
*First call date versus later call dates isn't described clearly.
*The reader is told that yield to call may be lower than YTM, but not told it could be higher than YTM. Why the omission?
*The whole paragraph devoted to asking your broker to calculate yield both before and after retail charges requires a firm to do a wholesale calculation of yield they generally don't now do, at least
I do not believe bond retail firms do it. Why show wholesale yield at all when the business has always quoted bonds on a yield basis using net (retail) assumptions, when dealing with John Q. Public.

Corporate Bond Risks

Interest Rate Risk

Interest rate risk increases the longer that you hold a bond.

John Q. reads this and incorrectly concludes that buying a bond and holding it for years, or to maturity, might be ill-advised. What John needs to understand is that his bond investment is 'exposed' to the likelihood of interest rate changes every day he holds it, but there are two other important investment considerations:

*don't sell it when & if it declines in value (absent an emergency)
*the closer the bond gets to maturity, the smaller the price swings.
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So phrased from another perspective, the longer you hold the bond, the impact of interest rate risk upon your bondholdings is decreased, not increased. John Q. would have no way of surmising that from this material.

Call and Reinvestment Risk

With a callable bond, a bondholder might not receive the bond's coupon rate for the entire term of the bond.

Just prior to this sentence, John Q. read the definition of callable. But he just read this sentence warning him that he might not receive the coupon interest for the entire time he holds the bond.
This is NOT the intent of the sentence but to John Q., it sure looks that way. And he's asking himself 'what kind of broker is peddling THIS?'

the stream of a callable bond's cash flow is uncertain,
and any appreciation in the market value of the bond may not rise above the call price.

Now you've got John Q. down for the count. He has no clue what this means. And he doesn't know why you're telling him about appreciation in the same breath with uncertain cash flow streams. The uncertainty isn't clearly explained, nor the reason why callability may effectively 'cap' market appreciation in spite of interest rate declines.

Certainly there should be a clearer way of telling John Q. that if he buys callable bonds, he's buying bonds with a feature that allows the company to prepay the loan, without 'consulting' him. But, at least he'll get par or higher, and interest right up to the date they prepay him. And because this callable feature takes some 'portfolio control' away from John Q., his bond may carry a higher coupon rate than a non-callable bond of equal quality and maturity, to compensate John for the prepayment risk.

Refunding Risk and Sinking Funds Provisions

There may be a relatively high likelihood that the the issuer will be able to redeem some or many of the bonds prior to maturity, even if market-wide interest rates do not change.

John Q. is asking himself what's so bad about being given back his principal when interest rates are <u>not lower</u> than the rate on his refunded bonds. And John Q. is thinking 'wait a minute…if I've been getting 8% on a 20 year bond, and they give me back par in,let's say 8 years, then I just made 8% per year on 8-year debt...which is way higher than 8 year maturities were paying when I first bought the 20 year investment.
If John understands the dynamics correctly, he's asking himself what he's missing in this paragraph. Why the warning? Is it a warning at all?

If the issuer is unable to raise adequate funds to refinance the outstanding issue, the bondholder may be faced with an issuer default and potential loss of principal.

John Q. says 'wait a minute…isn't this true of every bond. Isn't it true that corporate bonds, whether they have sinking funds or not, may run into this potential problem at or near maturity?'

Default and Credit Risk

Bonds backed by the full faith and credit of the US government are identified as having *almost* no credit or default risk. Much of the readily accessible literature has, for quite some time, identified Treasuries as having no credit or default risk. Which is it, John wants to know?

Adding to John's confusion is that when he read the investment information available currently at the NASD website, he read that Treasuries are *relatively safe investments.* John is asking himself 'if Treasuries are relatively safe, relative to what?…what debt securities are safer…and which are safest?'

The discussion of non-investment grade bonds properly identifies them as riskier than investment grade, but states that non-investment grade bonds *may default*.

John Q. is wondering if this means investment grade debt won't, even though his common sense is telling him otherwise.

Liquidity Risk

If you think you might need to sell the bonds you are purchasing prior to their maturity, you should carefully consider the likelihood of your being able to do so, and whether your broker will be able and willing to assist you in liquidating your investment at a fair price reasonably related to then current market prices.

John Q. is thinking about this paragraph and he's wondering how on Earth he could know today whether he might need to sell the bonds years into the future, prior to maturity.
But much more worrisome to him is that he just read that he should carefully consider whether his broker might not be willing to liquidate the bonds at a fair price. Isn't that unethical or fraudulent, for a broker to execute transactions at prices unrelated to current market? John wouldn't even know how to ask his broker 'are you willing to be fair to me in the future?'
And because it is the NASD who is telling him he needs to carefully consider this, John is very confused and troubled.

Broker Compensation for Selling Bonds

No commission does not mean no charge.

Similarly, if you sell a bond, a dealer will offer you a price that includes a ***mark-down*** *from the price [* at which *] that the dealer believes he can sell the bond to another dealer or another buyer*.

John is puzzled. He has no problem understanding that when dealers in any business deal with other dealers, they deal at wholesale.

What is puzzling John is who or what is *another buyer* mentioned in the paragraph? Is that someone like John who's getting a better deal than John. And if so, why do they rate wholesale instead of retail?

Closing Comments on 2231

It is an admirable and serious venture undertaken by the self-regulatory organizations, to do things proactively, in anticipation of trends and potential problem areas.

My goal has been to share my thoughts and comments on the proposed new rule in a manner that will be useful to decision-makers in crafting a final version of the rule which achieves the best possible outcome for all participants in the corporate bond market.

I look forward to reading the comments of others and to the final form of Rule 2231.

R. Lowenstein
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