



March 28, 2011

BY ELECTRONIC MAIL

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, N.W.
Washington, D.C. 20006-1506

Re: FINRA Regulatory Notice 11-08,
Markups, Commissions and Fees

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association¹ (“SIFMA”) appreciates the opportunity to comment on the Financial Industry Regulatory Authority’s (“FINRA’s”) Regulatory Notice 11-08 (the “Markup Proposal”).

INTRODUCTION AND SUMMARY

The Markup Proposal represents a laudable effort to modernize aspects of NASD Rule 2440 and IM-2440-1 by withdrawing both the antiquated “Five Percent Policy” and the proceeds provision. These and other changes – such as the transfer of existing NYSE Rule Interpretation 375/01 and NASD Rule 2430 – are sensible and appropriate in the context of FINRA’s rulebook consolidation efforts. Broadly speaking, and subject to certain recommendations set forth below, SIFMA supports these steps.

SIFMA is concerned, however, with the reduction in certainty that would follow the withdrawal of the Five Percent Policy unless accompanied by the simultaneous adoption of a modern alternative. In footnote 14 of the Regulatory Notice, FINRA stated that it expects to provide future guidance on what percentage markups, markdowns and commissions would warrant additional regulatory scrutiny. While SIFMA agrees with FINRA that the Five Percent Policy should be withdrawn, we believe that FINRA should withdraw the Five Percent Policy only in conjunction with issuing the new guidance, so that member firms may fully evaluate the potential consequences of the proposal. It is difficult for SIFMA to fully embrace giving up the Five Percent Policy without knowing what may replace it. Moreover, given the breadth and

¹ SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.



complexity of today's debt and equity markets, FINRA should consider working with the bond dealers to make data available across a variety of metrics that would enable informed comparisons, not endeavor to update benchmarks, however well intentioned or supported by periodic studies. A recommendation is set forth below, but SIFMA would welcome the opportunity to work with FINRA to consider other alternative approaches that focus on the provision of data instead of rigid benchmarks or thresholds that do not take into account volatility or the differences across product classes, markets, and business models.

SIFMA also is disappointed that the Markup Proposal misses an opportunity to revisit unsettled issues that arose in connection with the Debt Markup Interpretation (current IM-2440-2), consideration of which was explicitly postponed in 2007 pending greater regulatory experience with its administration. In that respect, SIFMA recommends the expansion of the so-called "QIB Exemption" to apply generally to all transactions in debt securities with "qualified institutional buyers" ("QIBs") that meet the relevant standard, whether or not the debt security carries a non-investment-grade rating. In light of continued uncertainty and implementation difficulties under current IM-2440-2, some of which were further highlighted by the recent financial crisis, FINRA also should provide greater clarity on the operation of that interpretation (Proposed FINRA Rule 2122) and the meaning of certain of its key terms.

Finally, although generally supportive of transparency and disclosure initiatives, SIFMA is surprised by the Markup Proposal's mandate to create and publish retail equity schedules of commissions. In this respect the Markup Proposal would address a need that is simply not present: equity commissions are already disclosed on a trade-by-trade basis to customers pursuant to Rule 10b-10. As currently proposed, SIFMA strongly objects both to the proposed requirement and to its consideration outside of a framework that allows for a comprehensive assessment of retail disclosures more generally, such as the ongoing efforts described in Regulatory Notice 10-54 and the U.S. Securities and Exchange Commission's (the "SEC's") work and study related to Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.²

SIFMA's views on the Markup Proposal are summarized as follows:

- **SIFMA Generally Supports the Withdrawal of the Five Percent Policy But Requests Certain Modifications.** SIFMA supports the retirement of the Five Percent Policy, but believes that this step must be accompanied by the simultaneous provision to member firms of the guidance identified in footnote 14 of the Regulatory Notice and data relevant to evaluation of markups and commissions by product and by business model, in order to avoid unnecessary and prolonged uncertainty. This data need not – and SIFMA believes should not – be expressed as a threshold or benchmark, but rather made available in the same fashion as other forms of execution or order data in other contexts. Data may help members and their

² Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203 (111th Cong. 2d sess. 2010) ("Dodd-Frank").

trading and compliance staff assess markup practices as well as the adequacy of their policies and ongoing monitoring efforts. At the same time, SIFMA objects to the use of nonpublic studies undertaken in the absence of any notice and comment opportunity as bases for standard setting or regulatory guidance that will influence FINRA's assessments of the fairness of markups. SIFMA is already concerned that these non-transparent studies and the citation to them in the Regulatory Notice will be misused in connection with ongoing investigations and contemplated disciplinary proceedings. SIFMA also objects to the retention of the outdated generalization in the Markup Proposal that markups on common stock transactions are customarily higher than those on similarly sized bond transactions in light of developments in the bond markets over the years and the diversity of fixed income products. Accordingly, SIFMA requests that FINRA expressly state that the studies cited in the Regulatory Notice are not to serve as guidance in the context of investigations or otherwise, and that FINRA withdraw the general statement about bond markups as no longer instructive.

- **SIFMA Recommends the Removal of the Rating Agency-Based Limitation on the QIB Exemption.** SIFMA recommends the expansion of the QIB Exemption to apply to all transactions by QIBs meeting the relevant standard in debt securities regardless of rating. There is no fundamental basis for bifurcating the markup standard applicable to non-investment grade securities and investment grade securities. If a QIB is capable of evaluating the quality of execution on a transaction in a non-investment grade security, it should certainly be capable of doing the same with an investment grade security. Experience in the several years since the adoption of the QIB Exemption has demonstrated that that exemption is a workable, effective standard. There is also a complete absence of any evidence that the exemption has led to any increase in customer abuse or unfair pricing. Particularly in light of a broad based movement away from Nationally Recognized Statistical Rating Organization ("NRSRO") ratings-based regulation and the fact that at times a fair assessment of the credit may be at odds with the ratings, FINRA should recognize the success of this exemption and remove the artificial limitation upon it.
- **SIFMA Seeks Guidance Addressing Interpretive Difficulties under Current IM-2440-2.** SIFMA seeks guidance concerning Proposed Rule 2122 (current IM-2440-2) in light of the challenges faced by trading desks and compliance personnel applying certain of its provisions, particularly in illiquid and/or volatile markets. Of particular concern is the inability of trading desks to transact in these markets without fear that trades executed a day or more apart will later be considered "contemporaneous," resulting in asymmetrical risk whereby desks providing liquidity undertake unlimited downside exposure and limited upside potential. Interpretive guidance should make clear that market volatility and liquidity are appropriate considerations in an assessment of which trades are "contemporaneous" under Proposed Rule 2122. Related concerns exist in connection with trading in odd or small lots and certain illiquid debt securities, when frequently even close-in-time trades in that security may not (because of size or other attribute of the contemplated transaction) reflect the prevailing market price for that security. SIFMA also requests that FINRA acknowledge

that minor differences in assumptions about collateral can lead to major differences in pricing views for structured debt, and allow members to have greater flexibility when transacting with institutional customers in debt securities. Further, SIFMA requests that FINRA change current Transaction Reporting and Compliance Engine (“TRACE”) dissemination practices to reflect whether reported net prices are *inclusive* or *exclusive* of broker compensation.

- **SIFMA Seeks Guidance on the Records Required to Justify Markups.** SIFMA seeks guidance concerning the types of records or information that would be necessary for member firms to justify markups in excess of a given threshold or more generally, in order to address the “additional regulatory scrutiny” referred to in footnote 14. With a clear understanding of the types of records or information that would be required, supervisory and compliance staff could better evaluate not only the fairness of any given transaction but also compile in advance an appropriate record should they, in consultation with the executing trader, conclude that a markup in excess of a particular threshold is appropriate. Moreover, SIFMA recommends the adoption of a presumption by which evidence of certain types of appropriately informed and documented trade approvals would constitute prima facie evidence of compliance with Proposed Rule 2121.
- **SIFMA Objects to the Proposed Mandate To Adopt and Publish Retail Equity Commission and Services Schedules and Recommends That These Mandates be Considered in an Appropriate Rulemaking.** SIFMA objects to the proposed requirement that would mandate the adoption and publication of retail equity commission schedules and related disclosures (Proposed Rule 2121(e)) and the similar requirement for services (Proposed Rule 2123(b)). SIFMA believes that such a proposal should be considered only in connection with FINRA’s broader effort to fashion a retail “written statement” as described in Regulatory Notice 10-54 and the SEC’s related efforts under Section 913 of Dodd Frank. Moreover, SIFMA has significant doubts about the need for such a requirement in light of current requirements under Securities Exchange Act of 1934 (the “Exchange Act”) Rule 10b-10³ and questions the complete absence of any assessment of the burdens or the potential for confusion in circumstances in which commission rates are customarily subject to negotiation by customer or trade. The proposed requirement does not sufficiently take into account that commissions vary widely by account type and customer segment, making even a schedule (or series of schedules) of *indicative* commissions of limited value to retail customers.

In the event FINRA goes forward with Proposed Rule 2121(e), SIFMA requests that relief from the retail commission schedule mandate extend beyond institutional accounts defined under NASD Rule 3110(c)(4). In particular, SIFMA believes that the mandate should not apply to any institutional customers without respect to asset size or to accounts that are discretionarily managed by investment advisers (whether registered or unregistered). There are many sophisticated institutions that do not satisfy the requirements of Rule 3110(c)(4) but nevertheless would neither desire nor benefit from the proposed disclosure. Similarly, the

³ 17 C.F.R. §240.10b-10.

requirements should not apply to owners of accounts that are discretionarily managed because it is the investment adviser's responsibility to select the broker-dealer and negotiate the commission arrangements, thus minimizing any potential benefit to the underlying customer from the proposed disclosure. Also, the mandate should not apply to clearing brokers, because the introducing broker is the party responsible for negotiating (or disclosing) any fees or commissions it charges to the end-client for services. In addition, the obligation to provide in writing any amendments to schedules of commission 30 days in advance of the changes should only apply when a change would negatively impact a retail customer. Further, the annual delivery requirement should be eliminated entirely given that customers will receive initial delivery and notice of subsequent changes as set forth above.

- **SIFMA Seeks Clarification On or Removal of Certain Statements in the Regulatory Notice.** SIFMA seeks confirmation that certain statements in the proposing notice did not intend to change the current rule or existing practices. SIFMA is particularly concerned with passages in the proposed rule and Regulatory Notice that may be read to suggest that dealers performing market making functions are not entitled to compensation for that function (Proposed Rule 2121(a)) or that market appreciation may in certain situations bear on the fairness of a markup (Proposed Rule 2121(b)(3)). In particular, SIFMA is concerned that the replacement of the term "profit" with the term "remuneration" in the Markup Proposal goes further than necessary to dispel any notions that dealers may ignore later provisions of the rule regarding the fairness of a markup, and could be construed to suggest that a member firm may not be compensated for providing liquidity through market making activity. SIFMA also requests that FINRA provide an explanation about the language in Proposed Rule 2121(b)(3) which injects uncertainty about whether the fairness of any particular markup should be weighed against the gain or loss on market movements.

DISCUSSION

I. THE RETIREMENT OF THE FIVE PERCENT POLICY SHOULD BE COUPLED WITH THE PROVISION OF NEW GUIDANCE.

A. The Need To Replace the Five Percent Policy with Objective Data.

SIFMA generally embraces the withdrawal of the Five Percent Policy as an antiquated rule of thumb given the evolution of the equity and debt markets since the 1940s. For decades, however, the Five Percent Policy has been an important guideline for member firms, their trading personnel, regulators, and courts. It provided an instructive telltale and helped inform trader decisionmaking and compliance surveillance.⁴ Although the NASD, SEC, and courts have long

⁴ Although the Five Percent Policy, serves as a "benchmark of reasonableness to be considered with other relevant factors" and not a rule, the numerical reference is helpful because it provides members with an objective benchmark from which to assess fairness. *See e.g., Lehl v. SEC*, 90 F.3d 1483 (Jul. 19, 1996) (affirming a disciplinary action brought against a registered representative by the NASD that found that the registered representative had reason to know that the markups he charged were excessive because



acknowledged that the Five Percent Policy set forth only a guideline for consideration and not a safe harbor or cap – and that particular markups or commissions above or below five percent could be fair or unfair under the circumstances – it has helped provide a warning track of sorts to compliance professionals, traders, and regulatory staff alike. SIFMA understands the need for the type of flexibility that allows FINRA to police the fairness of markups in any given situation and under changing conditions, but some alternative to the Five Percent Policy is needed.

Recognizing the need both to modernize the Five Percent Policy and to provide some measure of objectivity in this area, FINRA stated that it “expects to provide guidance . . . that markups, markdowns and commissions above certain specified percentages will be subject to additional regulatory scrutiny, requiring members to provide additional justification” of the markups.⁵ SIFMA finds it difficult to embrace the withdrawal of the old guidance, without knowing what new guidance FINRA may propose. FINRA also has not explained its rationale for withdrawing the Five Percent Policy without the simultaneous provision of new guidance. Trading without any replacement guidance would subject FINRA members to the risk of transgressing an unknown boundary that would subject the firm to increased regulatory scrutiny. Even if the member is ultimately successful in defending its markups, it is often put to much expense in doing so. In order to permit members to effectively comment on the total effect of FINRA’s withdrawal of the Five Percent Policy FINRA should publish all relevant and related guidance at the same time.

Further, SIFMA encourages FINRA to provide regular data to member firms about commissions and markups on trades relevant to their business. SIFMA has a specific proposal described below. The provision of data to member firms on an ongoing basis about markups and commissions across a variety of product classes and types of firms – provided there is no suggestion that these be treated as floors or caps for the purposes of Proposed Rule 2121 – would unquestionably inure to the benefit of customers and dealers alike. As witnessed throughout the credit crisis, trailing or historical data can be instructive, but market conditions can change and dramatically alter the assumptions upon which market professionals trade, price, and quote securities. Nevertheless, technological advances over the years have increased transparency and the availability (to FINRA) of substantially more order and execution data across a number of product classes. That data is already used by FINRA and informs its surveillance activity. Sharing aspects of this data on an ongoing and trailing basis would help fill the role previously played by the Five Percent Policy. SIFMA would appreciate the opportunity to work with FINRA to develop appropriate metrics and reports.

he knew the execution prices of certain transactions, the Five Percent Policy and that the firm grossed commission on each transaction equal to 23% of each customer’s investment).

⁵ Regulatory Notice 11-08, at n.14.

B. Standards Should Not Be Premised Upon Nonpublic Studies.

In the Regulatory Notice describing Proposed Rule 2121, FINRA cited a nonpublic study finding that the mean and average equity markups were, respectively, 2.2 and 2.0 percent.⁶ FINRA also cited an ongoing (and similarly nonpublic) study of debt markups suggesting mean and average figures generally lower than 5 percent.⁷ SIFMA recognizes that there are a number of alternatives that may exist that would provide member firms timely data about commissions and markups that may inform whether a particular markup is “fair and reasonable” under the circumstances of any given trade. SIFMA strongly objects, however, to the adoption of the Markup Proposal in its current form with only the promise of future guidance to be issued in forthcoming regulatory notices coupled with references to a nonpublic study.

First, picking an accurate single benchmark percentage for all types of transactions (equity or debt) is impossible. Indeed, the inability to formulate a meaningful, single-figure guideline is one of the problems of existing markup regulation that FINRA proposes to correct by its withdrawal of the Five Percent Policy. For this reason, SIFMA urges FINRA not to replace an antiquated benchmark with one that is more current but no less flawed.

Second, even if FINRA goes forward with the design and publication of replacement guidelines, the Markup Proposal’s suggestion that this guidance would be set in forthcoming regulatory notices and be based on nonpublic studies is entirely inconsistent with notice-and-comment rulemaking and would raise fairness and due process concerns. Any study conducted for the purpose of standard setting or regulatory guidance must be made public, be subjected to notice and comment by member firms, and be capable of examination and review by the SEC and federal courts of appeal.⁸

Third, the limited descriptions of the nonpublic studies cited by FINRA raise serious questions about their appropriateness as bases for standard setting. It is, of course, very difficult to assess the work of even prominent academics without access to the underlying data upon which it is based. And, in this instance, FINRA has not made public the studies themselves. What little description is provided suggests broadly that the data may not be appropriate for generalization. The equity study was based on “lower-priced, less liquid securities” traded by firms with “certain compliance issues” that were subject to a NASD enforcement sweep in 2004. Although such a category may suggest a propensity for higher markups – and, therefore, greater latitude for dealers should it be used as a benchmark – a flawed generalization based on a limited

⁶ Regulatory Notice 11-08 (Feb. 2011), at 4 & nn. 10-11.

⁷ Regulatory Notice 11-08 (Feb. 2011), at 5 & nn. 12-14.

⁸ See *Metropolitan Hospital, Inc. v. Heckler*, 1984 WL 34768 at *5 (N.D. Ga.) (Jun. 25, 1984) (holding that failure to make a critical study available in the process of rulemaking is a serious procedural error and that it is not consistent with the purpose of a rulemaking proceeding to promulgate rules on the basis of inadequate data, or on data that to a critical degree is only known to the agency).



study should not be embraced. Prior to any use of the equity study by FINRA for standard-setting purposes, the study should be made public and FINRA should explain, at a minimum, (1) whether the study itself in any way limited the applicability or use of its mean and average percentages in light of the limitations on the sample data set; (2) whether the report analyzed correlations between higher (or lower) markups and factors such as stock price, principal risk, volatility, lot size, etc. Similarly, FINRA's study of debt markups also needs to be completed and subjected to notice and comment before any use in a standard-setting capacity.

Fourth, SIFMA believes that the references to the studies in the Markup Proposal should not become a new benchmark and firms should not be required to address the references as such. In particular, FINRA should explicitly state that the references to the studies are not intended to create a new benchmark to replace the Five Percent Policy. Without making this specific pronouncement there is a risk that these references could become the new benchmark for enforcement purposes or bring about confusion as to the existence of such a benchmark.

FINRA's citation to these nonpublic and in-process studies stands in contrast to prior efforts to thoughtfully study and report on equity and debt markup practices of broker-dealers. The Report of the Special Study of Securities Markets⁹ and the Institutional Investor Study Report¹⁰ are but two older examples of prior efforts to comprehensively evaluate markups and commissions in certain contexts. Each report published not only the conclusions drawn by the staff but also underlying data, explanatory notes, and methodologies that would enable market professionals and congressional and regulatory staff alike to evaluate proposals based on an understanding of the empirical data themselves. That is an important objective of informed standard setting and self-regulatory organization ("SRO") rulemaking and we see no reason why customary practices should be abandoned here.

C. Studies and Reports Must Take Into Account Differences Among Product Types, Classes and Varying Business Models.

SIFMA rejects any suggestion in Regulatory Notice 11-08 that the former Five Percent Policy has been implicitly superseded by an informal "Two Percent Policy" by virtue of the equity study or that markups on debt transactions, by virtue of the language in Proposed 2121(c), should be lower than 2 percent.

For the same reason that the retirement of the Five Percent Policy makes sense, FINRA ought to embrace a more modern assessment of markups across product lines and business

⁹ See Report of the Special Study of the Securities Markets of the S.E.C., H.R. Doc. No. 95, Part 2, 88th Cong., 1st Sess. (1963), at 541-678 & Apps 679-796 (examining, in a variety of contexts, execution costs and markup regulation).

¹⁰ See Institutional Investor Study Report of the S.E.C., H.R. Doc. No. 92-64, Part 4, 92d Cong., 1st Sess. (1971), at 2151-2322 (examining, in the context of institutional investors, commissions and OTC net trading practices).



models. Means and averages do not allow commissions or markups at, say, discount brokerages, to be compared against commissions at similarly situated firms; or commissions at full service firms to be compared against commissions at other full service firms; or markups on odd lots to be compared against similarly sized trades, and so forth. The ability to make these types of comparisons would benefit dealers and customers alike by removing distortive data that may exaggerate or minimize representative percentages.

Moreover, lumping all corporate debt markups together into a mean or average ignores differences among markups for investment grade corporate debt, high yield and distressed debt, structured debt (which will soon be TRACE reported), and debt with special features such as bankruptcy priority or control rights, special trading restrictions, or other nonstandard attributes.

D. FINRA Should Specify the Records or Information Necessary To Justify Markups or Commissions In Excess of a Given Threshold.

FINRA should specify with precision the types of records or information that member firms would need to provide to examination and enforcement staff to respond to the “additional regulatory scrutiny” that would be triggered by footnote 14 of the Regulatory Notice.

The explicit promise of “additional regulatory scrutiny” and the implicit threat of disciplinary action in the Markup Proposal’s statement is troubling. Nonpublic studies should not be used as a basis for regulatory standard setting. Member firms are being warned that, upon the withdrawal of the Five Percent Policy, their trades will be subject solely to a “fair and reasonable” assessment using thresholds set by unpublished studies. Such a framework presents considerable regulatory uncertainty and would unfairly expose firms, trading personnel, compliance professionals and supervisors to personal liability based on uncertain criteria.

For this reason, FINRA should communicate its expectation of the type of evidence or documentation that would be requested to justify a markup in excess of the yet-to-be-adopted benchmarks. As member firms have experienced over the past several years, responding to trade-specific markup inquiries often imposes costs far in excess of the total profit on any given trade, even when no action is ultimately taken. With a clear understanding of the types of records or information that member firms and trading personnel would need to provide to justify the fairness of markups, supervisory and compliance staff could better evaluate not only the fairness of any given transaction but also compile in advance an appropriate record should they, in consultation with the executing trader, conclude that a markup in excess of a (yet-to-be-adopted) benchmark is appropriate. Similarly, member firms could consider modifications as necessary to trading systems to capture and retain data relevant for this purpose.

In the event FINRA’s benchmark approach goes forward, SIFMA recommends the consideration of a presumption that, for markups exceeding particular benchmarks, member firms could produce evidence created within their normal surveillance period showing that (a) a concise explanation was obtained from a trader, supervisor, or compliance professional



knowledgeable about the circumstances justifying the markup and (b) an evaluation of the trade occurred taking into account relevant circumstances set forth in Proposed Rule 2121. Assuming evidence of this nature is maintained, and in the absence of any special circumstances suggesting concealment or fraud or the receipt of an actual customer complaint, this evidence would constitute prima facie evidence of compliance.

E. The Outdated Maxim About Debt Markups Also Should Be Retired Along with the Five Percent Policy.

SIFMA urges FINRA to remove the observation in Proposed 2121(b)(1) (current IM-2440-1(b)(1)) that markups on common stock transactions as a percentage of notional value are customarily higher than those on similarly sized bond transactions. This observation is as antiquated as the Five Percent Policy itself. This observation was undoubtedly accurate at the time of its adoption in the 1940s – and continues to be accurate as to Treasury debt and certain types of investment grade debt securities. But the observation dates back to a time when the corporate debt market did not include high yield and distressed debt, the modern securitization market had yet to materialize and the equities markets were not automated. The maxim fails to recognize that certain types of debt securities trade with higher spreads for reasons having to do with greater risk in more illiquid markets, the absence of transparency and the need for a “finding” function, the need to develop specialized knowledge, the need to educate potential sellers and buyers about the particular credit instrument, and other features special to the today’s debt markets.

The observation should be eliminated and it is surely incorrect as a general notion. For example, FINRA cannot reasonably suggest that, even as a general matter, all corporate debt markups should generally be lower than the 2 percent figure cited in the equity study. To our knowledge, even disciplinary proceedings enforcing current NASD Rule 2440 in the high yield and distressed debt context have not coalesced around disgorgement of any remuneration exceeding 2 percent.

II. FINRA SHOULD EXPAND THE QIB EXEMPTION.

SIFMA recommends that FINRA expand the QIB Exemption to apply to all transactions by QIBs meeting the relevant standard in debt securities regardless of rating. The NASD declined to adopt SIFMA’s previous request to expand the scope of the exemption in January 2007, stating that it:

believes it is important to see how the market adjusts with respect to this significant change in employing differentiated regulation in the case of markup rules with respect to QIBs in respect of the transactions enumerated in the proposal, and thereby gain regulatory experience in this approach, before considering any



reduction in the protection afforded to customers by NASD Rule 2440 and the interpretation thereunder.¹¹

The reasons for expanding the QIB Exemption are as apt today as they were in 2007 and SIFMA incorporates its relevant comments here.¹² Although all sorts of market developments, special or structured debt characteristics, and corporate events can lead to investment grade-rated debt trading at levels more typically associated with junk ratings,¹³ the touchstone for special treatment is, and ought to remain, an institutional customer's size and sophistication. Congress, the SEC, and FINRA have each endorsed the need for regulation tailored to meet the different needs of retail consumers and sophisticated institutions in the financial services context¹⁴ and that distinction makes good sense here. Moreover, in light of the fact that under Dodd-Frank federal agencies are required to remove references to ratings from their rules, it no longer makes sense for FINRA to maintain the exemption based on the distinctions in credit ratings.¹⁵ Further, leading up to and throughout the credit crisis with the lack of timeliness of rating agency

¹¹ See Letter from Sharon K. Zackula, Associate General Counsel, NASD, to Katherine England, Assistant Director, Division of Market Regulation, SEC (Jan. 12, 2007) at 5 (Second Response to Comments on Additional Mark-Up Policy for Transactions in Debt Securities) (the "Jan. 12, 2007 Letter").

¹² See Letter from Mary Kuan, SIFMA, to Nancy M. Morris, SEC (Jan. 3, 2007) (the "Jan. 3, 2007 Letter"); Letter from Robbin Conner, SIFMA, to Nancy M. Morris, SEC (Jan. 4, 2007) (the "Jan. 4, 2007 Letter"). Copies of the Jan. 3, 2007 Letter and Jan. 4, 2007 Letter are included as Exhibits A and B, respectively.

¹³ Fallen angels are bonds that are issued at investment grade status but later descend into below investment grade status. Their pricing and trading behavior often exhibit distressed characteristics before downgrades occur. Floyd Norris, *Junk Bonds May Yet Earn Their Title*, N.Y. Times, Nov. 16, 2006, at C1. Bundled securities, including MBS, are especially sensitive to changes in ratings because of their concentrated risk. Even a slight change in the market's perception of the risk of a product can have a disproportionate effect on the product's market price, such that a triple-A security that is reduced to a double-A or single-A can collapse in price even without there being any default. See Blair A. Nicholas and Ian D. Berg, *Credit Rating Agencies: Out of Control and In Need of Reform*, Andrews Delaware Corporate Litigation Reporter, 23 No. 26 Andrews Del. Corp. Litig. Rep. 3 (Jul. 13, 2009).

¹⁴ Under Dodd-Frank, the Bureau of Consumer Financial Protection ("CFPB") was created to protect consumers from abusive financial products. See Title 10 of Dodd-Frank. Under the federal securities laws accredited investors, qualified institutional buyers, and qualified investors are able to engage in certain types of transactions in which retail customers are not permitted to engage. See Section 2(a)(15) under the Securities Act of 1933 (defining "accredited investor"); Section 3(a)(54) under the Exchange Act (defining "qualified investor"); Section 3(a)(64) of the Exchange Act (defining "qualified institutional buyer"). FINRA rules similarly distinguish between retail and institutional customers when determining a member's suitability obligation. See IM-2130-3 (Suitability Obligations to Institutional Customers). See also Regulatory Notice 11-02 (Jan. 2011) (proposal to adopt FINRA's obligations for the consolidated rulebook).

¹⁵ See Section 939 of Dodd-Frank.



downgrades,¹⁶ ongoing debate over the reliability of ratings more generally,¹⁷ and perceived over-reliance upon NRSRO ratings in statutes and regulations,¹⁸ the time has come to remove the NRSRO rating limitation.

FINRA has now had several years of experience with the QIB Exemption and has undertaken numerous transaction-specific inquiries implicating its provisions. SIFMA members with institutional bond trading desks believe that the FINRA Market Regulation staff surveillance and investigation activities have appropriately administered this exemption by conducting appropriately tailored reviews of these trades. There has been a complete absence of any enforcement activity that would suggest that abuses have occurred under the QIB Exemption. FINRA should recognize the success of this exemption and remove the artificial limitation placed upon it.

III. ADDITIONAL GUIDANCE IS NEEDED FOR APPLYING IM-2440-2 IN ILLIQUID AND VOLATILE MARKETS.

A. FINRA Should Clarify the Definition of “Contemporaneous Cost” To Address Volatility and Other Market Developments Affecting the Value of Debt Securities.

A fundamental presumption of IM-2440-2 is that contemporaneous cost is the best evidence of prevailing market price. For many years now, SIFMA and other commenters have requested clarity from FINRA on the meaning of “contemporaneous” in this context.¹⁹ However, the issue has not been visited since before 2007 and since then the debt markets have gone through a period of enormous stress that has demonstrated the need for further clarity on the meaning of “contemporaneous.” Furthermore, with the abandonment of the Five Percent Policy, without the simultaneous adoption of alternative guidance, it becomes critically important that the meaning of contemporaneous be updated to address changing market conditions. That guidance would avoid unnecessary examination and justification of markups that are proper under market conditions existing at the time of the transactions.

¹⁶ See H.R. Rep. No. 111-685, 2010 WL 5137044, at *20 (2010).

¹⁷ See Credit Ratings Disclosure, Exchange Act Rel. No. 60797 (Oct. 7, 2009), 74 Fed. Reg. 53086 (Oct. 15, 2009).

¹⁸ See Section 939A of Dodd-Frank. See also Security Ratings, Exchange Act Rel. No. 9186 (Feb. 9, 2011), 76 Fed. Reg. 8946 (Feb. 16, 2011).

¹⁹ See, e.g., Jan. 12, 2007 Letter at 4 (“Over the course of a decade, these issues [including guidance on the term contemporaneous cost] have been discussed repeatedly by publications for comment in an NASD Notice to Members and the Federal Register and NASD’s response, and have been otherwise thoroughly vetted.” (footnotes deleted)).



During the financial crisis, liquidity dried up. At times, price discovery became quite difficult. Customers often wanted to sell paper and were looking for bids. Bidding in a market with limited liquidity and limited price discovery was very risky. The “contemporaneous cost” presumption materially increased the dealer’s risk of bidding, because if the dealer bought the bonds at risk, its ability to realize any upside potential was highly circumscribed. Thus, dealers viewed themselves as having virtually unlimited downside risk and highly limited upside potential. Further, the amorphous definition of “contemporaneous” left market participants scratching their heads about how much time they needed to hold any debt securities that they purchased before they could realize any such upside potential: several hours, days, weeks or months. All of this uncertainty had the effect of limiting the amount of capital dealers were willing to deploy in making markets during a time when a dealer’s ability to use its capital to provide liquidity was most critical.

Given the liquidity constricting effect the “contemporaneous cost” standard had during the financial crisis, SIFMA believes that FINRA should provide guidance as to the meaning of the term “contemporaneous” in various contexts and emphasize, at least with respect to debt trading, a presumption that trades occurring more than one day apart are not “contemporaneous.”

B. FINRA Should Expressly Acknowledge that Retail Trades, Odd Lot Trades, and Trades in Low Dollar Priced Securities Reasonably Carry Comparatively Higher Markups.

FINRA should acknowledge that markups in certain types of transactions can be justified because of attributes of the trades or the market at issue. Minimum commission or transaction charges as applied to low dollar priced securities or small lot sizes are one example of transaction-based compensation resulting in incrementally higher percentages but permissible under current Rule 2440.

Odd lot transactions present special challenges under current IM-2440-2. In a very real sense, the “prevailing market” for an odd lot of a given debt security, say, 130 bonds, is quite different than the “prevailing market” of a round lot of, say, \$2 million par amount. Yet the reported price for a round lot trade may be used to measure the markup on an odd lot transaction and vice versa, often leading to apparently higher (or lower) markups. To its credit, FINRA in practice recognizes the differences in trading characteristics and has accepted explanations based on these distinctions informally in trade reviews and examinations, but formal guidance and recognition is needed. In this respect the rule would be conformed to reiterate existing precedent under current IM-2440-2.²⁰

²⁰ See, e.g., District Bus. Comm. for District No. 5 v. MMAR Group, Inc., Complaint No. C05940001, 1996 NASD Discip. LEXIS 66, at *39 (Oct. 22, 1996) (“[T]he size of a transaction is an important factor to consider in determining the mark-up or the mark-down and . . . the percentage mark-up or mark-down should decline as the size of the transaction increases.”); In re Century Capital Corp., Exchange Act Rel. No. 31203, 1992 SEC LEXIS 2335, at *8 n.10 (Sept. 21, 1992) (noting that a mark-up above 5% may be reasonable if size of total transaction is small and total compensation is reasonable),



Previously, SIFMA members have urged FINRA to restore its proposal that allows dealers to show that contemporaneous cost is not indicative of prevailing market price, if among other things, the size of the transaction caused the transaction to be executed at a price away from the prevailing market price for the same security (the “Size Proposal”).²¹ FINRA withdrew the Size Proposal when it proposed the QIB Exemption on the basis that it was no longer necessary in light of the proposed carve-out for QIBs. The reasons for readopting the Size Proposal are as apt today as they were in 2008 and SIFMA incorporates its relevant comments here.²² If FINRA is unwilling to reconsider the Size Proposal, SIFMA urges that FINRA at least acknowledge that markups in certain transactions, such as odd lots and low dollar priced securities, are generally higher.

C. FINRA Should Expressly Acknowledge that Certain Illiquid Debt Securities Trade By Reference to a Benchmark Interest Rate or Security and May Be Priced Accordingly.

Current IM-2440-2 requires members to follow a strict hierarchy to determine the prevailing market for a debt security. Specifically, in instances where a firm’s contemporaneous cost is not indicative of the prevailing market, the firm is required to follow a strict, defined process to determine the prevailing market price (the “Hierarchy”).²³ For certain transactions, such as trades in securities that are priced by reference to a benchmark security or interest rate, contemporaneous cost is not the best measure of the prevailing market price. Instead, the best measure of the prevailing price in these transactions is the referenced interest rate or security. SIFMA requests that FINRA expressly acknowledge this pricing relationship.

D. FINRA Should Expressly Acknowledge that Minor Differences in Assumptions About Underlying Assets Can Lead to Major Differences in Pricing Views for Structured Debt.

FINRA should expressly acknowledge that minor differences in assumptions can lead to major differences in valuation views and pricing of structured debt securities. SIFMA previously asked the NASD to allow dealers to immediately move from contemporaneous cost to the consideration of economic models for securitized products.²⁴ In support of this request, SIFMA noted the structured nature of securitized products and their general illiquidity often necessitates

aff’d 22 F. 3d 1184 (D.C. Cir. 1994); *In re Gateway Stock & Bond, Inc.*, Exchange Act Rel. No. 8003, 1966 SEC LEXIS 194, at *8 (Dec. 8, 1966) (setting aside an NASD finding of unfair pricing in which a mark-up of 7.3% was charged “where only 10 shares” were sold to the customer).

²¹ Jan. 3, 2007 Letter at 8.

²² *Id.*

²³ *See e.g.*, NASD NTM 07-28.

²⁴ Jan. 4, 2007 Letter at 6.



the use of models to value such products. These economic models require dealers and customers alike to make a number of assumptions in order to price these securitized products. The differences in assumptions used in the models for securitized products can lead to major differences in the resulting price. Even in the absence of news and other developments, dealers should remain free to price structured debt products based on their assessment of value (derived from such things as the performance of underlying assets, the likelihood of future impairment or recovery, and related cash flow projections) and not be tied solely to levels associated with the most recently reported trade.

E. FINRA Should Allow Members to Have More Pricing Flexibility With Institutional Customers for Debt Transactions.

Even trades with sophisticated institutional customers can be artificially constrained by concerns about current IM-2440-2's Hierarchy. When NASD first proposed the QIB Exemption it noted that large institutional customers trading securities in the institutional debt markets tend to have considerable knowledge of those markets and securities²⁵ as well as access to sources of information about pricing and valuation, including models and multiple dealer relationships. Yet differences in valuation views may chill liquidity if a dealer believes it must risk its capital (if at all) at levels tied tightly to the most recent transaction.

For example, if a dealer values a security at 40 (by a model or less formal analysis) and the last TRACE trade in that security was at 52, the dealer may feel bound to transact (if at all) near 52 unless it is transacting risklessly. In other words, a dealer would be safe to buy at 40 and to sell at 40.5 in a riskless principal transaction (thereby charging a ½ point mark-up based on contemporaneous cost), or even to sell at 40.5 from existing inventory, but perhaps might not feel safe to buy at 40 without an off-setting transaction because such a purchase could suggest a potentially inappropriate markdown (either viewed as a 12 point markdown from the 52 TRACE print or from some subsequent close-in-time transaction at an incrementally higher price) in the absence of intervening developments affecting the bond's price. This problem will be amplified in May 2011 when asset backed securities become TRACE reportable.

Similarly, when a dealer commits capital to a principal transaction with an institutional customer during a period of turbulent market conditions such as those witnessed during the financial crisis, it should be able to transact at a price that incorporates its assessment of further price volatility without being constrained by the Hierarchy. Currently, the Hierarchy, like the uncertainty about the meaning of "contemporaneous" discussed above, inhibits the dealer's ability to price volatility into its quotes, which impedes price discovery and liquidity in volatile markets. This paradigm is also true with respect to trades executed outside of normal market hours, during which the dealer's exposure to market moving geo-political events is further heightened. In short, the Hierarchy does not permit dealers to manage risk effectively in volatile markets. In the past, SIFMA has urged that the Hierarchy of current IM-2440-2 be modified to

²⁵ See e.g., Exchange Act Rel. No. 55638 (Apr. 16, 2007) at 11.



allow dealers to exercise more discretion in determining whether there are other factors relevant to pricing decisions, and we renew this request at this time to avoid unnecessary restraints on the provision of liquidity.²⁶ Moreover, the inability for a customer and dealer to transact simply due to constraints on pricing further demonstrates why the QIB Exemption should be expanded.

F. TRACE Reports Do Not Currently Distinguish Among Trades Executed on Behalf of Fee-Based Accounts or By Other Features that May Impact the Net Price, Frustrating Efforts To Design and Implement Supervisory and Surveillance Systems.

SIFMA urges FINRA to address shortcomings in current TRACE dissemination practices that obscure whether reported net prices include a markup. TRACE reports show net transaction prices of principal trades, including any markup. However, not all trades reported to TRACE contain markups. For example, trades executed for investment advisory accounts that pay an asset-based fee would not include any commission. Thus, for certain types of trades the price reported to TRACE includes the compensation paid by the customer, while for other types of trades reported to TRACE, the price reported does not include the compensation paid by the customer. Accordingly, this leaves a misimpression in a type of audit trail that certain reported trades reflect broker compensation when, in fact, they do not. This misimpression understandably becomes a source of confusion in FINRA and SEC examinations.

This problem is substantial and growing. In the experience of SIFMA's member firms, fee-based accounts are quite active in the fixed income markets and fixed income trading flow from these accounts has become a significant portion of TRACE-reported transactions. Differences in prices that flow from differences in broker compensation models frustrate the ability to make apples-to-apples comparisons.

Given the way different compensation models create distortion in the reported TRACE prices, SIFMA recommends that FINRA propose and adopt a change to its current TRACE reporting and dissemination rules to include a field reflecting whether a reported price occurred in a fee-based account. Until such a change can occur, SIFMA would welcome an acknowledgment from FINRA that the TRACE data may not in these instances provide an appropriate benchmark for measuring prevailing market price.

IV. THE EQUITY "COMMISSION SCHEDULE" PROPOSAL SHOULD BE RECONSIDERED AS PART OF FINRA'S BROADER EFFORT TO FASHION A RETAIL "WRITTEN STATEMENT" DOCUMENT.

A. Mandatory Disclosures to Retail Customers Should Not Be Considered In a Piecemeal Manner or Appended to a Rule Addressing Fair Pricing.

²⁶ Jan. 3, 2007 Letter at 10.



SIFMA supports transparency and disclosure initiatives generally, and acknowledges the historical relationship that these factors have had on the regulation of markups. The Markup Proposal, however, addresses a need that is simply not present: equity commissions are already disclosed on a trade-by-trade basis to customers pursuant to Rule 10b-10. Accordingly, the mandate for members to create and publish retail equity schedules of commissions in the hope that this disclosure *may* result in lower commissions is ill-advised. Charging a customer an undisclosed excessive markup has long been held to violate Section 10(b)(5) under the Exchange Act and Rule 10b-5 and existing disclosure requirements already permit customers to evaluate equity commissions.²⁷ The adequacy of retail disclosure is an issue that warrants consideration in a broader context, separate from consideration of markups. The statement in the Regulatory Notice that publishing a schedule of equity commissions would provide a retail investor information to compare commissions among members oversimplifies the process by which member firms set commissions. Most members do not have a single commission schedule, even for retail customers. Rate determinations involve consideration of the entire relationship between the customer and the member, including the various products and services that a customer receives from the member.

While FINRA does recognize that there may be differences in the commissions that firms may charge customers by proposing to allow members to publish more than one schedule of standard commissions and negotiate lower commission rates with retail customers, provided disclosure is made, this approach is confusing and potentially misleading for customers. In determining commissions, members consider all the facts and circumstances of a particular transaction, as required by current NASD Rule 2440.²⁸

Instead, SIFMA recommends that FINRA consider the mandate to create and publish retail equity schedules of commissions in the context of its more comprehensive retail disclosure efforts, as described in Regulatory Notice 10-54. Considering this requirement in the broader context of retail disclosure more appropriately takes into consideration the factors that determine the commissions that a member charges a customer. Regulatory Notice 10-54 proposes that firms create a “written statement” which would disclose fees associated with the customer’s

²⁷ See *Press v. Chem. Inv. Serv. Corp.*, 166 F.3d 529, 534 (2d Cir. 1999); See e.g., *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 193 (2d Cir. 1998); *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 835 F.2d 1031 (3d Cir. 1987); *Barnett v. United States*, 319 F.2d 340, 344 (8th Cir. 1963); *In re Trost & Co.*, 12 S.E.C. 531, 535 (1942).

²⁸ Indeed, to the extent that the Markup Proposal’s citation to the equity study signals a FINRA mandate that (a) standard commission schedules be adopted that (b) contain rates no higher than 2 percent, such a mandate would tread exceedingly close to the Exchange Act’s prohibition on SROs imposing any schedule of commissions on member firms. Exchange Act § 6(e)(1) (providing that “no national securities exchange may impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members”); Exchange Act § 15A(b)(6) (providing that a registered securities association’s rules may not be designed “to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members”).



brokerage account. However, the written statement also would disclose the services offered to retail customers, a specific description of the service provided for each fee and whether fees are negotiable, presented in a manner that allows customers to make comparisons between broker-dealers.²⁹ Further, considering this requirement in the broader retail disclosure context would allow members to work with FINRA to create a single consistent disclosure document for customers thereby alleviating the risk that disclosure will be ineffective because customers receive too many, or inconsistent disclosure documents. For these reasons, SIMFA urges FINRA to reconsider the proposal of mandating a retail equity schedule of commissions in the context of Regulatory Notice 10-54.

B. The Commission Schedule Mandate Would Duplicate Existing Disclosure Requirements, Risk Customer Confusion, and Impose Excessive Burdens.

The requirement to create and publish retail equity schedules of commissions is duplicative of existing regulatory requirements. SEC Rule 10b-10 requires firms to provide a written disclosure of the commission charged to a customer in an equity transaction.³⁰ FINRA's proposed requirement implicitly finds that this disclosure is insufficient, without any explanation or rationale. Given the acknowledged decline in commission rates over the years, the perceived need to revisit settled commission disclosure practices in this context is curious.³¹

Second, the proposed mandate does not take into account the differences between discount and full service brokerage firms. While a firm would be required to publish a retail equity schedule of commissions, the proposal does not recognize the fact that commission charges are directly related to the services that a customer receives from the firm. If a customer is using the commissions schedule to compare a discount and full service firm, the customer is not provided with a means in which to properly compare the two firms which makes the proposed mandate futile.

Third, the proposed mandate would lead to investor confusion because most firms do not have a single "standard" schedule of commissions, but instead use a number of factors to determine commissions. The proposed mandate fails to take these factors into consideration, or even address that in certain circumstances commission rates are customarily subject to negotiation by customer or trade. Because Proposed Rule 2121(e) would permit discounting with disclosure, members would have an incentive to create and publish a schedule setting forth the highest tier of commissions customarily charged, preserving maximum flexibility for negotiation. But rate cards and schedules containing rates rarely used are unhelpful and very doubtfully serve the purpose intended by FINRA. The industry norm is not to price solely based

²⁹ Regulatory Notice 10-54 (Oct. 2010) at 3.

³⁰ 17 C.F.R. § 240.10b-10.

³¹ Regulatory Notice 11-08 (Feb. 2011) at 4.



off a standard schedule, and requiring firms to create and publish in that manner risks misleading or confusing customers.

Fourth, the potential burden of requiring firms to create and publish retail equity commission schedules far outweighs any potential benefit to customers. For the reasons articulated above, SIFMA disagrees that Proposed Rule 2121(e) would result in customers being provided with the information to compare equity commissions across firms. In addition to the “cost” of potential investor confusion, this proposed mandate also would require brokers to expend significant energy to design, adopt, and publish standard retail equity commission schedules to the extent they do not currently exist in the form specified.³²

Fifth, in the event the proposed requirements of Rule 2121(e) were to be adopted, SIFMA recommends that FINRA expand the types of accounts not subject to these disclosure obligations beyond the standards of NASD Rule 3110(c)(4) to other institutional accounts and any discretionarily managed accounts. Many institutions that do not satisfy the standards of NASD Rule 3110(c)(4) are nonetheless highly sophisticated and would not benefit from the proposed disclosure. In addition, customers whose accounts are managed on a discretionary basis by investment advisers (whether registered or unregistered) are not involved in negotiating commissions, and moreover, firms which offer soft dollar arrangements may charge customers a higher rate of commission based on the investment adviser’s use of soft dollar credits to pay for research or brokerage services that benefit those customers. Providing these customers with a standard commission schedule would not be useful to them and would be unduly burdensome to members.

Sixth, the proposed mandate does not differentiate between the obligations of clearing brokers and introducing brokers. The direct client of the clearing broker is the introducing broker, who deals directly with the end-client in servicing his or her account. The introducing broker is the party responsible for negotiating (and disclosing) any fees or commissions it charges to the end-client for its services. Similarly, member firms may have direct clients that are registered investment advisers (“RIAs”), who in turn, service end-client accounts. Similar to the distinction between clearing brokers and introducing brokers described above, it is the RIA, as the fiduciary, that negotiates and discloses any fees or other charges it imposes to the end-client for its services. Therefore clearing brokers (and member firms servicing RIAs as their direct clients), should be exempt from the disclosure requirement to the end-client (inclusive of any “stratification” requirement). Nor should clearing brokers (or member firms servicing RIAs as their direct clients) incur any obligation to monitor the commissions or fees charged to end-client by a third-party for “fairness and reasonableness” under the proposed rules. We recognize, however, that fees or commissions posted by the introducing brokers (or RIAs) on the clearing brokers (or member firms) system would continue to be disclosed on the confirmation or statements provided by the clearing brokers (or member firm) to the end-client.

³² Many firms provide written disclosure information to retail customers at account opening that provides information on duties, conflicts of interest and fees.



Seventh, the obligation to provide in writing any amendments to schedules of commissions to retail customers should only apply when a change would negatively impact a customer. A requirement to deliver notice of any change 30 days in advance of implementation would impede efforts to compete based on retail commissions where firms chose to do so. In addition, the annual delivery requirement should be eliminated altogether given that customers will receive initial delivery and notice of subsequent changes. But, again, in light of existing trade-by-trade disclosure of equity commissions to customers pursuant to Rule 10b-10, the proposed requirement is unnecessary and potentially confusing.

V. OTHER ISSUES.

A. Markups May Take Into Account Services Provided By the Member Firm, Including Market Making Activities and the Provision of Liquidity.

Current NASD Rule 2440 states that when a member is engaged in a principal transaction, “he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including . . . the fact that he is entitled to a profit.” The Markup Proposal would amend this provision to replace “profit” with “remuneration,” apparently to dispel any notion that dealers may ignore later provisions of the rule:

[A] member’s right to set profitable transaction charges does not obviate the requirement to comply with the standards of the rule; is not a license to set high minimum markup, markdown or commission charges; and does not allow a member to factor into such charges realized and unrealized market losses on securities that a member holds or has held in inventory.³³

SIFMA has no objection to the replacement of the term “profit” with “remuneration,” but is concerned that the language in the Regulatory Notice goes much further than necessary to address this concern. Specifically, to the extent that this language suggests that FINRA does not believe that dealers performing market making functions are generally entitled to be compensated by the difference between the price at which they are willing to buy or to sell a security, such a position would be inconsistent with longstanding regulatory guidance acknowledged by FINRA in connection with rulemaking under this very provision.

The reason for permitting dealers performing market making functions to calculate their “markups” from something other than their contemporaneous cost stems from concerns that to do otherwise “would deter market makers from taking the risk of maintaining a market or a position in a security and, consequently, would impair market liquidity.”³⁴ The SEC has

³³ Regulatory Notice 11-08 (Feb. 2011), at 3-4.

³⁴ *In re* Peter J. Kisch, Exchange Act Rel. No. 19005, 1982 WL 529109, at *5 (Aug. 24, 1982).



recognized that a dealer performing market making functions is generally entitled to a “dealer’s turn” and that a regulatory scheme that did not permit compensation for this service would threaten market liquidity.³⁵

More recently, the Financial Stability Oversight Council (“FSOC”) published a report pursuant to Section 619 of Dodd Frank addressing market making activities by investment banks. Market making activity is explicitly excluded from the Volcker Rule’s prohibition on proprietary trading because of its importance to liquidity in the secondary markets. Specifically addressing illiquid debt markets, the FSOC observed that market making activity included the following indicia:

- Purchasing or selling the financial instrument from or to investors in the secondary market;
- Holding oneself out as willing and available to provide liquidity on both sides of the market (i.e., regardless of the direction of the transaction);
- Transaction volumes and risk proportionate to historical customer liquidity and investment needs; and
- Generally does not include accumulating positions that remain open and exposed to gains or losses for a period of time instead of being promptly closed out or hedged out to the extent possible. For example, an aged open position taken to facilitate customer trading interest would be hedged rather than exposed to gains and losses for a period of time.³⁶

Of particular concern to SIFMA’s members with debt trading operations is FINRA’s prior refusal to recognize the liquidity-providing functions performed by trading desks engaged in market making activities in debt securities. After much correspondence, the NASD abandoned its position previously announced in a series of 2004 settlements denying the existence of debt market makers³⁷ and acknowledged that, under both the plain language of the

³⁵ *In re Adams Securities, Inc.*, Exchange Act Rel. No. 31971 (Mar. 9, 1993) (“The difference between the market maker’s bid and offer, or the ‘dealer’s turn,’ is appropriate compensation for market makers because, by acting as market makers, they provide a liquidity service to the marketplace.”).

³⁶ FSOC, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds 29 (Jan. 2011).

³⁷ See, e.g., *In re Deutsche Bank Securities Inc.*, NASD AWC No. CMS040105, at 5 n.6 (July 28, 2004) (“Legal authority, however, provides that, to be considered a market maker, a dealer ‘must be willing to buy and sell the security at issue *in the inter-dealer* market on a regular or continuous basis.’”)



Exchange Act and SEC precedent, debt dealers can and do perform market making functions and, when they do, are entitled to price accordingly:

NASD continues to embrace the concept of market makers in the debt markets. NASD agrees with the commenters' assertions that "whether a dealer is acting as a market maker depends on the particular facts and circumstances" and recognizes legal precedent that has application in the current, decentralized, over-the-counter ("OTC") bond markets that may lack centralized markets and facilities.³⁸

The relevant statutory provision, Section 3(a)(38) of the Exchange Act, states that a market maker is [1] "any dealer acting in the capacity of a block positioner" or [2] "any dealer who with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system *or otherwise*) as being willing to buy and sell such security for his own account on a regular or continuous basis."³⁹ Although definitions vary, a block positioner generally acts as a market maker "by committing its own capital to fill part of a customer's block sale order or effecting a short sale (or sale from inventory) to fill part of a customer's block purchase order."⁴⁰ The second prong of the statutory provision is phrased disjunctively, permitting a dealer to hold itself out by using an inter-dealer quotation system "or otherwise." For this reason, among others, the SEC has cautioned against applying the Exchange Act's "market maker" definition woodenly.⁴¹

(emphasis in original); *see also id.* ("Buying from one customer for resale to another customer does not constitute market making.").

³⁸ Letter from Sharon K. Zackula, Associate General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC (Oct. 4, 2005) (responding to comments received in response to SR-NASD-2003-141) at n. 5 & n. 17.

³⁹ Exchange Act § 3(a)(38), 15 U.S.C. § 78c(a)(38) (emphasis added).

⁴⁰ Securities Confirmations, Exchange Act Rel. No. 15219, 43 Fed. Reg. 47,495 (Oct. 6, 1978) (noting that "[a] determination as to whether a quantity of a security is a block necessarily rests to some degree on the purpose for which the determination is being made"); *see also* Securities Transactions by Members of National Securities Exchanges, Exchange Act Rel. No. 15533 (Jan. 29, 1979) (stating that block positioners "position[] at least some part of the block — that is, by purchasing securities for its own account to fill all or part of a customer's block sale order, or by selling securities for its own account, as either a short sale or a sale from its inventory, to fill all or part of a customer's block purchase order"); Exchange Act Rule 3b-8(c) (defining "qualified block positioner").

⁴¹ *See, e.g., In re Adams Securities, Inc.*, Exchange Act Rel. No. 31971 (Mar. 9, 1993) ("The application of this [Exchange Act] definition [of 'market maker'] is affected by the specific context in which the issue arises.").



SIFMA is not recommending any revisitation of prior debates over how best to define market making in the context of the decentralized debt markets. Current NASD Rule 2440 and IM-2440-1 explicitly permit markups that are fair under the circumstances (NASD Rule 2440) and that reflect the nature of a member's business and the services provided (IM-2440-1). Nothing in the Markup Proposal or in current law should be construed to suggest that a member firm may not be compensated for providing liquidity through market making activity.

B. Proposed Rule 2123(b) Should Be Deferred and Reconsidered as Part of FINRA's Effort To Fashion a Retail "Written Statement" Document.

For the reasons set forth in Section IV, above, FINRA should defer consideration of any requirement that member firms adopt and publish schedules of retail fees until it can be addressed as part of FINRA's broader effort to fashion a retail "written statement" as described in Regulatory Notice 10-54 and the SEC's related efforts under Section 913 of Dodd Frank.

C. Proposed Rule 2121(b)(3)'s Statement About Market Appreciation Requires Explanation.

Markups and markdowns should be measured from a security's prevailing market price and the fairness of any particular markup should not be weighed against the gain or loss on market developments. SIFMA is not aware of any precedent for treating market appreciation or depreciation as part of a fair pricing analysis and, under existing guidance for determining a security's prevailing market price, market appreciation is expressly excluded. SIFMA is concerned that language used in Proposed Rule 2121(b)(3) injects uncertainty into this long established point. Proposed Rule 2121(b)(3) provides, in pertinent part:

If a member sells a security to a customer from inventory or buys a security from a customer for inventory, the amount of profit or loss to the member from market appreciation or depreciation before, or after, the date of the transaction with the customer would not ordinarily enter into the determination of the amount or fairness of the markup or markdown.⁴²

The underlined qualification is unexplained in the Regulatory Notice. Assuming the term "ordinarily" was used to hedge against unforeseen circumstances, it should be deleted as unnecessary.

⁴² Proposed FINRA Rule 2121(b)(3) (emphasis added).



CONCLUSION

SIFMA thanks FINRA for the opportunity to comment on the Markup Proposal. If you have any questions, please do not hesitate to call me at 212-313-1118 or Paul Eckert, SIFMA's outside counsel at Wilmer Cutler Pickering Hale and Dorr LLP, at 202-663-6537.

Respectfully submitted,

A handwritten signature in black ink, which appears to read "Sean Davy". The signature is fluid and cursive, with a long, sweeping tail that extends to the right.

Sean Davy
Managing Director
Corporate Credit Markets Division
SIFMA

Exhibit A

January 3, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-NASD-2003-141, Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities

Dear Ms. Morris:

The Securities Industry and Financial Markets Association ("SIFMA")¹ is pleased to submit this comment letter to the Securities and Exchange Commission ("SEC" or "Commission") in connection with the National Association of Securities Dealers, Inc.'s ("NASD") proposed interpretation concerning the application of its mark-up policy to transactions in debt securities (the "Proposed Interpretation" or "Proposal"). The Proposal recently was amended and published for comment by the SEC.²

SIFMA appreciates the NASD's response to industry concerns relating to earlier iterations of the Proposal. SIFMA also commends the NASD's recognition that a

¹ SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

² Notice of Filing Amendments Nos. 3, 4, and 5 to a Proposed Rule Change Relating to Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities, Exchange Act Rel. No. 54799 (Nov. 21, 2006), 71 Fed. Reg. 68856 (Nov. 28, 2006) (the "Proposing Release"). The NASD originally filed the Proposal with the SEC on September 17, 2003. The NASD filed two amendments to the Proposal in 2004, which the SEC published for comment in 2005. See 70 Fed. Reg. 12764 (Mar. 15, 2005). The Bond Market Association ("BMA"), a predecessor association to SIFMA, commented on the Proposal, as amended, by letter from Mr. Micah S. Green, President, BMA and Ms. Michele C. David, Vice President, and Assistant General Counsel, BMA to Mr. Jonathan G. Katz, Secretary, SEC (Apr. 5, 2005) ("BMA 2005 Letter"). The NASD responded to the BMA 2005 Letter and other comment letters by letter from Ms. Sharon Zackula, Associate General Counsel, NASD, to Ms. Katherine A. England, Assistant Director, Division of Market Regulation, SEC (Oct. 4, 2005) ("Zackula Letter"). The NASD filed Amendment Nos. 3, 4, and 5 to the Proposal in October 2005, November 2005, and October 2006, respectively. The SEC published these amendments on November 21, 2006.

dealer's relationships with institutional customers are qualitatively different from its relationships with retail customers, and supports the NASD's proposal to exempt from NASD Rule 2440 and IM-2440 ("Mark-Up Policy") certain trades between dealers and qualified institutional buyers ("QIBs"). This aspect of the Proposal represents a tremendous step forward that substantially addresses dealers' concerns with earlier iterations of the Proposal.

SIFMA applauds the NASD's positive efforts in these respects. SIFMA also requests that a number of areas be clarified or expanded. SIFMA respectfully requests that the NASD: (1) expand the exemption from the Mark-Up Policy to include transactions by dealers with QIBs in certain additional securities; (2) provide dealers with more guidance regarding the definition of "contemporaneous cost", including restoring the "size" proposal; (3) allow for a more flexible and nuanced approach in determining prevailing market price where the dealer establishes that contemporaneous cost is not the best evidence of the prevailing market price; and (4) expand the discussion of the situations in which a bond dealer may consider itself a market maker.³ As described more fully below, we believe these changes would significantly enhance the efficient pricing of debt instruments, promote liquidity in the bond markets, and provide meaningful, practical guidance that is consistent with the manner in which dealers and institutional investors make pricing determinations. Further, given the significance of the Proposal, we respectfully request that the SEC expedite its review and consideration of these comments.

SUMMARY OF THE PROPOSAL

Under NASD rules, dealers are required to transact with customers at prices reasonably related to the prevailing market price of the security.⁴ Under the Proposal, "[a] key step in determining whether a mark-up (mark-down) is fair and reasonable is correctly identifying the *prevailing market price* of the security. . . ."⁵ The Proposal contains a presumption that contemporaneous cost is the best evidence of prevailing market prices for non-market makers. The Proposal then specifies three exclusive factors that a dealer may use to overcome the presumption that its contemporaneous cost is not indicative of the prevailing market price: (1) interest rate changes after the dealer's contemporaneous transaction that would reasonably cause a change in pricing; (2) significant credit quality changes after the trade; or (3) news issued or distributed and known to the marketplace that had an effect on the perceived value of the security after the dealer's contemporaneous transaction.

The Proposal next specifies a hierarchy (the "Hierarchy") that dealers must use to determine the prevailing market price if the dealer has presented evidence sufficient

³ SIFMA notes the Zackula Letter has discussed the status of bond dealers as market makers. *See, infra*, n. 29.

⁴ NASD Rule 2440 and IM-2440.

⁵ Proposing Release, at 68858 (emphasis in original).

to overcome the presumption that contemporaneous cost or proceeds is the best evidence of prevailing market price, or if the dealer establishes that its costs are not contemporaneous.⁶ The Hierarchy requires dealers to look at three factors in a particular order and prohibits reference to a subsequent factor if an earlier factor is present. First, dealers must look at the pricing of contemporaneous interdealer transactions in the same security. Second, in the absence of interdealer transactions, dealers must look to the prices of contemporaneous dealer purchases from institutional accounts with which any dealer regularly effects transactions in the same security. Third, if neither of the prior two factors is available, dealers must look to contemporaneous bid (offer) quotations for the security in question for proof of the prevailing market price if the securities are "actively traded" and such quotations are made through an interdealer mechanism through which transactions generally occur at the displayed quotations.

If none of the above three factors in the Hierarchy is available, the dealer then may take into consideration a non-exclusive list of four factors to establish prevailing market price, focusing on contemporaneous transactions in similar securities.⁷ If none of these four factors is available, then a dealer may consider prices or yields derived from economic models that take into account various specified measures, including credit quality, interest rates, time to maturity, and optionality. Further, in any instance where the dealer is using something other than contemporaneous cost to establish the prevailing market price, the dealer must be prepared to provide evidence to establish the basis for the dealer's pricing determination.

Importantly, the Proposal exempts from the definition of "customer" QIBs meeting certain suitability requirements that are purchasing securities that are or would be rated below investment grade or unrated privately placed securities, regardless of credit quality.⁸

DISCUSSION

I. SIFMA Commends the NASD for Providing a Limited Carve Out for Certain Transactions By QIBs, But Urges the NASD to Extend this Exclusion to All Private Transactions Between Dealers and QIBs Pursuant to SEC Rule 144A or the So-Called Section 4(1^{1/2}) Exemption.

As discussed above, SIFMA strongly supports the NASD's proposed "carve

⁶ Unless otherwise noted, the discussion of mark-ups and contemporaneous cost in this letter also applies to mark-downs and contemporaneous proceeds.

⁷ These four factors relate to yields and prices on certain trades in similar securities.

⁸ QIB is defined in Rule 144A under the Securities Act of 1933, as amended ("Securities Act"). Rule 144A, adopted in 1990, exempts from the registration requirements of Section 5 of the Securities Act resales to QIBs under certain circumstances, based on the idea that the QIBs are sufficiently sophisticated and have sufficient ability to analyze information that they do not need the protections afforded by the Securities Act. *See, infra*, n. 14.

out” of suitable QIBs from the definition of “customer” for purposes of its Mark-Up Policy. This carve out is consistent with the well-recognized principle that a dealer’s relationships with institutional customers are qualitatively different from its relationships with retail customers.⁹

Currently, the proposed carve out only applies to trades by QIBs in “non-investment grade debt securities.” The Proposal defines “non-investment grade securities” as securities that: (1) a nationally recognized statistical rating organization (“NRSRO”) has assigned a rating lower than one of the four highest generic rating categories (e.g., below BBB or Baa); (2) if the security is unrated, either the dealer has analyzed the security as non-investment grade, retains credit evaluation documentation and demonstrates to NASD (using credit evaluation or other demonstrable criteria) that the security’s credit quality in fact is equivalent to a non-investment grade debt security; or (3) if the security is unrated, the security was initially offered and sold and continues to be offered and sold pursuant to an exemption from registration under the Securities Act of 1933 (“Securities Act”).

SIFMA requests that the NASD revise the Proposal to expand the exclusion from the definition of customer to apply to all bond trades originally issued pursuant to the exemption from registration provided by Section 4(2) of the Securities Act and transacted between a dealer and a QIB pursuant to Rule 144A under the Securities Act or the so-called Section 4(1^{1/2}) exemption, regardless of the debt securities’ rating.¹⁰ The NASD’s rationale for excluding trades by QIBs in non-investment grade debt securities would appear to apply equally to these transactions. Specifically, as set forth in the Proposing Release, the basis for the carve out for non-investment grade securities is two-fold. First, securities “that are sold pursuant to an exemption from registration under the Securities Act, and thereafter continue to be resold in private transactions rather than in the public markets, often may yield little or no pricing information that a

⁹ See Exchange Act Rel. No. 37588, 61 Fed. Reg. 44,100, 44,111-12 (Aug. 27, 1996) (“The NASD acknowledges, as does the Commission, that the relationship between a broker-dealer and an institutional customer generally may be different in important respects from the relationship a broker-dealer has with a non-institutional investor. In the latter circumstance, a broker-dealer frequently has knowledge about the investment and its risks and costs that are not possessed by or easily available to the investor. Some sophisticated institutional customers, however, may in fact possess both the capability to understand how a particular securities investment could perform, as well as the desire to make their own investment decisions, without reliance on the knowledge or resources of the broker-dealer.”). More recently, the MSRB adopted the term “sophisticated municipal market professionals” for use in connection with its fair practice standards for particular transactions that acknowledges the relevance of the nature of the customer to a dealer’s obligation. See Exchange Act Rel. No. 45849, 67 Fed. Reg. 30,743 (May 7, 2002).

¹⁰ The so-called “4(1^{1/2}) exemption” essentially permits dealers to engage in private transactions on the same basis that an issuer would be permitted to engage in such a transaction. W. Hicks, Exempted Transactions Under the Securities Act of 1933, §9:109 (2005). SIFMA’s ABS/MBS Division has submitted a separate comment letter to the Proposal. See Letter from Robbin Conner, Vice President and Assistant General Counsel, SIFMA, to Nancy M. Morris, Secretary, SEC, dated January [X], 2006. (the “SIFMA ABS/MBS Letter”). As explained in that letter, SIFMA believes there are unique issues for structured products that merit a broader exemption from the definition of customer for trades in any structured product by a QIB, regardless of registration status and regardless of credit rating.

dealer may use with confidence to determine the prevailing market price and a fair mark-up or mark-down for such debt securities transactions.”¹¹ Second, “[m]any large institutional investors have sufficient knowledge of the market or certain sectors of the market to trade debt securities with broker-dealers at prices negotiated at arms length, reducing the need for such customers to be protected with respect to every transaction under Rule 2440, IM-2440-1 and the Proposed Interpretation.”¹²

We believe these principals apply equally to situations where a QIB engages in bond transactions pursuant to Rule 144A or Section 4(1^{1/2}), regardless of the rating of the debt security. With regard to the first point articulated by the NASD, even if securities sold pursuant to 144A or Section 4(1^{1/2}) are investment grade rated, there may be little or no pricing information regarding them and tend to be less liquid than registered bonds.¹³ This is particularly the case with bonds transacted pursuant to the 4(1^{1/2}) exemption. Also, the rationale for excluding QIBs because of their level of sophistication should apply equally to trades in investment grade rated private bond securities that are executed pursuant to Rule 144A or the Section 4(1^{1/2}) exemption. Indeed, in proposing and adopting Rule 144A, the SEC recognized that — as a general matter — different standards should apply to private trades by QIBs. In doing so, the SEC did not distinguish between different types of private bond transactions, but rather noted that, as a general matter, certain sophisticated investors do not need the same protections afforded to retail investors.¹⁴

Similarly, in the context of suitability interpretations, the NASD has recognized that institutional and retail investors are qualitatively different. In providing special guidance for assessing the suitability of recommendations to institutional customers, the NASD did not differentiate between institutional investors, based on the type of security traded.¹⁵ In that regard, the regulatory history of the NASD’s institutional suitability interpretation makes clear that many institutional accounts do, in fact, have the ability not only to assess the intrinsic value of particular debt securities, but also to evaluate independently the market for them. Certain institutional accounts that are active in the debt securities markets employ considerable in-house expertise evaluating potential investments — expertise that at times may be superior to those of bond

¹¹ Proposing Release, at 68861-2.

¹² Proposing Release, at 68861-2.

¹³ Among other things, the NASD has proposed to exclude QIBs from the definition of “customer” if they trade unrated securities that initially were sold and continue to be sold pursuant to an exemption from registration under the Securities Act.

¹⁴ Securities Act Rel. No. 6806 (Oct. 25, 1988), 53 Fed. Reg. 44016, 44022 (Nov. 1, 1988). “Congress and the Commission historically have recognized the ability of professional institutional investors to make investment decisions without the protections mandated by the registration requirement of the Securities Act. The Commission has not until now, however, formally addressed the difference between the institutional and public resale markets. The institutional resale market for restricted securities has evolved to a point where its existence should be acknowledged.” *Id.*

¹⁵ See Suitability Obligations to Institutional Customers, NASD IM-2310-3, Preliminary Statement as to Members’ Obligations.

dealers. These institutional customers include the asset management arms of virtually every multi-service financial services firm, large insurance companies, and hedge funds specializing in a wide range of liquid and illiquid debt instruments. These institutional customers also typically have sales and trading relationships across several investment banks, regularly possess internal research departments with specialized knowledge of the industry sectors in which they invest, contact issuing companies directly, and have access to their own capital in addition to the capital in the dealer market. They also have access to information from multiple dealers as well as trading screens on which they may do comparative requests for quotations among their dealers. As such, SIFMA does not see the basis for distinguishing between investment grade and non-investment grade private bond transactions in determining whether a QIB should be considered a customer for purposes of the NASD Rule 2440.

Finally, it is important to emphasize that an extension of the carve out, as we have proposed, would not result in a negative effect for unsophisticated, retail customers because, by definition, these persons would not qualify as QIBs. Also, TRACE transaction reports are not publicly disseminated for private bond transactions and, as such, prices established pursuant to such transactions should not impact publicly available data regarding securities prices. For these reasons too, SIFMA believes that bond transactions with suitable QIBs pursuant to Rule 144A or Section 4(1^{1/2}) should be outside the scope of the Proposal, regardless of rating. To be sure, with an expanded carve out, the institutional investors would be protected because in order for the carve out to apply, dealers would need to establish a reasonable basis for concluding that the QIB is making independent investment decisions and is capable of independently evaluating investment risk.¹⁶

II. The NASD Should Provide More Guidance to Dealers About Which Trades May or May Not Be Considered Contemporaneous and, In Doing So, Should Reinstate the Size Proposal and Clarify the Scope of the News Exception.

The prevailing market price provides the baseline from which the dealer must calculate any mark-up. The method for determining prevailing market price, therefore, is critical to any mark-ups analysis. The Proposal presumes that contemporaneous cost is the best evidence of prevailing market price. The meaning of contemporaneous cost, then, is equally critical. In response to earlier comments, the NASD provided a definition of "contemporaneous cost." While SIFMA appreciates the NASD's efforts to provide guidance on this difficult concept, we are concerned that the proposed definition lacks objective standards and will be difficult to apply. As such, SIFMA requests that the NASD (1) clarify the meaning of contemporaneous cost as set forth below, (2) reinstate the size proposal, and (3) clarify the scope of the "news" exception

¹⁶ In this regard, it is worth noting that SIFMA's Asset Management Group ("AMG") supports concepts in this letter, and additionally supports an exemption from the NASD's Mark-Up Policy for professional customers. The AMG has stated that such an exemption also should include all registered investment advisers, regardless of whether the adviser meets the QIB definition.

as discussed below.

A. The Definition of “Contemporaneous Cost” is Difficult to Apply.

SIFMA appreciates the NASD’s provision of a definition of “contemporaneous cost” in the Proposal, but urges the NASD to provide additional clarification because this definition will be difficult for dealers to apply. In particular, SIFMA requests that the NASD provide additional guidance on the meaning of “contemporaneous,” including (1) clarifying that time is not the only factor that may cause trades to not be contemporaneous, (2) clarifying that a dealer’s good faith determination that trades are not “contemporaneous” will be presumptively respected, and (3) establishing that trades that are separated from each other by a certain amount of time are presumptively not contemporaneous.

SIFMA believes these clarifications are critical because the proposed definition of contemporaneous is circular and subjective. The word contemporaneous means “originating, existing, or happening during the same period of time.”¹⁷ Under the Proposal, a dealer’s cost is “considered contemporaneous if the transaction occurs *close enough in time* to the subject transaction that it would reasonably be expected to reflect the current market price for the security”¹⁸ As such, contemporaneous transactions are close enough in time if they happen during the same time period, a circular definition that is difficult for dealers to apply. Further, the passage of time appears to be the only factor in determining whether or not a prior trade is considered contemporaneous with a subsequent trade.

As a matter of logic, it must be the case that as more time passes between transactions, the less likely the transactions would be deemed to be contemporaneous. The amount of time that must elapse, however, appears to be an elastic concept, based on “reasonable expectations.” In this regard, the NASD has stated that:

Whether a cost (or price) is contemporaneous to the transaction for which the mark-up (mark-down) is being calculated is a facts-and-circumstances test determined by the trading patterns of, and liquidity in, the subject security over time and during the period in question, and other factors. There are no absolute temporal standards used to determine if a transaction and the dealer’s cost (proceeds) are “contemporaneous” to the subject transaction. . . .¹⁹

It must be understood that this circular definition combined with the lack of objective standards for determining whether transactions are contemporaneous makes the

¹⁷ THE AMERICAN HERITAGE COLLEGE DICTIONARY (4th ed. 2002).

¹⁸ Proposing Release, at 68857 (emphasis added).

¹⁹ Zackula Letter, at 7.

definition quite difficult to apply in practice. Accordingly, a dealer's good faith determination that a prior trade is not contemporaneous should presumptively be respected.²⁰

B. The Size Proposal Should Be Restored.

In Amendment Nos. 3 and 4 to the Proposal, the NASD proposed that dealers may be able to show that contemporaneous cost (or proceeds) are not indicative of prevailing market price if, among other things, the size of the transaction (either large or small) caused the transaction to be executed at a price away from the prevailing market price of the same security, as evidenced by contemporaneous transactions in the same securities or similar securities (the "Size Proposal").²¹ The Size Proposal, thus, recognized the economic reality that for small sell transactions, counterparties will typically pay a premium, whereas for large sell transactions, counterparties will typically pay a discounted price (the vice versa being true for purchases). In Amendment No. 5, however, the NASD withdrew the Size Proposal, on the basis that it no longer would be necessary in light of the proposed carve out for certain trades by QIBs.

As described above, the carve out for certain trades by QIBs is a welcome proposal. However, because this carve out covers a limited universe of transactions, the Size Proposal is still necessary for those trades that do not involve QIBs, or do not involve non-investment grade securities. For this reason, SIFMA urges the NASD to reinstate the Size Proposal, and allow dealers to disregard, for purposes of determining prevailing market price, the discount or premium inherent in pricing small or large bond transactions.

The size proposal is significant for both small trades and large trades. In the corporate markets, trades of relatively small size may trade at a discount (for customer sells) or premium (for customer purchases), given the paucity of demand for small lots relative to larger, round lots. Since these small transactions generally are not with QIBs and do not involve bonds rated below investment grade, the exception for qualifying QIBs will not resolve these issues. SIFMA is concerned that dealers will be required to use the discounted or premium prices resulting from small bond trades as the prevailing market price from which they would be required to compute markups on subsequent, round lot trades. This could put dealers in a difficult position, requiring them to sell bonds at a price that is lower than the prevailing market price, or buy bonds at a price that is higher than the prevailing market price. Therefore, we request that the NASD recognize the differences in pricing between round lots and odd lots.

Similarly, with large blocks dealers may negotiate discounts or premiums, and this may occur for both investment grade and non-investment grade bonds. Requiring

²⁰ See BMA 2005 Letter, at n.57 (noting a settlement finding that trades 38 days apart were contemporaneous, in *In re Howe, Solomon & Hall*, Exchange Act Rel. No. 40038 (May 28, 1998)).

²¹ See Proposing Release, at 68862.

the dealer to use the discounted or premium price as the prevailing market price for the next trade could put the dealer in a difficult position for the reasons discussed above. The QIB exception is helpful with respect to QIBs trading non-investment grade debt, but not with respect to investment grade debt.

C. The NASD Should Clarify that “News” that May Affect Prevailing Market Price May Be Distributed Through a Variety of Channels and May Encompass Different Types of Information, and Clarify Documentation Issues.

SIFMA welcomes the NASD’s inclusion of language recognizing that a dealer’s (near) contemporaneous cost may not be indicative of the prevailing market price of a security when news that has an effect on the perceived value of the security has subsequently been disseminated to the market. As the NASD states, such a provision is necessary, since certain significant news would not be captured by previously proposed language which was limited to a recognition that interest rate changes and credit quality changes may affect the price of a debt security.

SIFMA asks the NASD, however, to clarify that such news may be distributed through a variety of channels, and is not limited to information that has been broadly disseminated or made widely available to the marketplace, such as by means of a press release carried over a major news service, a major news publication, or a public filing made with a regulatory agency.²² In that regard, the distribution of information through narrower channels may affect the price of a debt security, even if such information has not been broadly disseminated to the marketplace. For this reason, the NASD should clarify that dealers may be able to rely on information distributed through a variety of channels in proving and documenting that contemporaneous cost may not be reflective of prevailing market price

In addition, SIFMA requests clarification that “news” includes information that may not directly impact the issuer but may still impact the price of the issuer’s debt securities. For example, news may come out that a security with similar characteristics is being issued by a different issuer. This may reduce the demand for the first issuer’s bonds, although the news about the new issue would not affect the issuer of the first bond per se. We believe that the rule as written is broad enough to encompass this scenario, as the news of the new issue could have an effect on the perceived demand for

²² For instance, dealers may also receive news from subscription-based services such as Debtwire or from paid consultants who analyze and report on the content of public filings. SIFMA requests that the NASD clarify that information from such sources may qualify as “news” for purposes of the Proposal. The SIFMA ABS/MBS Letter additionally requests that the NASD clarify that “news” includes (1) news relating to other factors that may affect a security (e.g., news that may affect the collateral underlying a structured product), and (2) any information or events that may affect expectations about the value of a structured product or collateral pool.

the issuer's debt securities, and hence the perceived value of the existing debt security. However, we would appreciate it if the NASD would confirm this understanding.²³

Finally, the NASD should clarify how a dealer may consider news to rebut the contemporaneous cost presumption in the context of illiquid securities. Since transaction data and contemporaneous quotes may not be available in the post news period for such securities, a change in market perception about value of the relevant securities may be difficult to document. In effect, the dealer's transaction could be the first transaction to "price in" such news. While dealers may be able to demonstrate the news, it may be more difficult for dealers to demonstrate how the news affected the "perceived value" of the debt security. As such, the NASD should clarify that dealers are permitted to use alternatives to contemporaneous cost whenever intervening news would reasonably be expected to have a material effect on the value of a security without being required to separately demonstrate that effect.

III. The Hierarchy for Determining Prevailing Market Price Is Overly Rigid and Does Not Reflect the Way the Institutional Debt Trading Markets Operate.

As described above, the Proposal allows dealers to: (1) establish evidence to overcome the presumption that contemporaneous cost is the best evidence of prevailing market price in three limited instances; and (2) establish that the passage of time has rendered a prior trade not contemporaneous. The Proposal requires dealers to follow a strict, defined process to determine prevailing market price in these instances (*i.e.*, the Hierarchy). SIFMA is concerned that a strict application of the Hierarchy may lead to inaccurate determinations of prevailing market price because it requires dealers to ignore important pricing information. A strict application of the Hierarchy also will be difficult for dealers to apply in practice because it does not fully reflect the way that dealers and institutional investors make pricing determinations. For these reasons, SIFMA believes the Hierarchy should be modified to allow dealers to exercise more discretion in determining whether there are other factors that are relevant to pricing decisions.

A. The Hierarchy Should Be More Flexible, and Allow Dealers to Consider Other Information Relevant to Pricing Determinations.

The rigidity of the Hierarchy will require dealers consciously to ignore information that is relevant to their pricing decisions in determining prevailing market

²³ As discussed below, dealers also receive a great deal of bid and offer information throughout the trading day, including information from interdealer brokers and customers for securities that the dealers own and for similar securities. This information also may affect the perceived value of the security and, thus, its price. In a sense, this information too could be viewed as news affecting the perceived value of an issuer's securities. In addition, certain news, such as news of tax law changes or accounting changes, may impact the perceived value of certain types of debt securities, without regard to any particular issuer or industry group. While it would appear that news of such changes would be included in the Proposal as drafted, SIFMA requests clarification that this is the case.

price where dealers establish that contemporaneous cost is not the best evidence of prevailing market price or that prior trades are not contemporaneous. SIFMA fears that expecting dealers to ignore information that they believe in good faith to be relevant is not realistic and would expose them to risk, leading to increased bid-offer spreads and worse prices for customers. In determining fair levels at which to trade bonds, dealers are focused on the market risk involved in establishing or terminating positions. While the factors specified contain important information for dealers in managing their risk, other information may be equally or more important to dealers, such as quotation information or indications of interest in the same or similar securities. The Hierarchy, however, permits traders to use this information *only* in very specific circumstances. As such, dealers in possession of such information are required to ignore it if the information does not fit into the Hierarchy, or if it fits in a different order in the Hierarchy – even if they, in good faith, consider it important in determining the prevailing market price.

In particular, dealers should have greater flexibility to consider quotation information when determining prevailing market price. In that regard, dealers receive a plethora of bid and offer information throughout the trading day, including information from interdealer brokers and customers for securities that the dealers own and for similar securities. Dealers may receive this information orally or electronically (*e.g.*, via facsimile, Bloomberg or other electronic messaging systems, or website access). Dealers view this quotation information as critical in assessing the current market price for a bond because it reveals the demand and supply for a particular security or type of security, which – according to basic economic principles – determines price. In some instances, this information may be more important than prior trades, especially given the open-ended nature of the definition of “contemporaneous cost.” Under the Proposal, however, dealers may use quotation information only if the first three factors in the Hierarchy are not present, and then only if the securities are considered “actively traded.”

While SIFMA appreciates that quotations are not always reliable indications of the current market, we believe it is not appropriate to require dealers to disregard relevant quotation information in all instances that do not comport with the Hierarchy. The legal basis underlying the Hierarchy was developed in connection with the equity markets, and largely in the context of “pump and dump” schemes perpetrated by penny stock boiler rooms on retail customers.²⁴ In contrast to the debt markets, in the equity markets there are registered market makers, consolidated quotation information, and fewer securities. Market makers in equity securities determine prevailing market prices based on current, consolidated quotes, which generally reflect very recent trades. In the debt markets, however, quotations are not published in a consolidated manner (if at all), there are many more securities (most of which trade infrequently), and the market maker concept is more constrained. It is inappropriate, therefore, to import the legal structure developed in the equity context into the very different debt markets. By

²⁴ See, *e.g.*, *First Independence Group Inc. v. SEC*, 37 F.3d 30, 32 (2d Cir. 1994); *Barnett v. U.S.* 319 F.2d 340, 344 (8th Cir. 1963); *In the matter of Alstead, Dempsey & Co.*, Exchange Act Release No. 20825 (Apr. 5, 1984).

requiring dealers to look to quotation information *only* if other factors are not present and *only* if the securities are “actively traded,” the Proposal would require dealers to ignore information that they consider to be critical in pricing securities.

SIFMA therefore requests that the NASD permit dealers to utilize quotation information in situations where (1) the dealer regularly trades in the particular security or class of securities as principal and provider of liquidity, and (2) the dealer has a good faith belief in the independence and validity of the quotes. Given the differences between the manner of disseminating quotation information in the equity and debt markets, dealers’ use of quotation information should not be limited to information for actively traded securities provided through quotation mediums or inter-dealer quotation systems.

B. As a Separate Matter, the Hierarchy Also Is Not Practical, Given the Realities of the Way the Debt Markets Operate.

Given the fast pace and high-pressure nature of most bond trading desks, it is difficult (if not impossible) to imagine a dealer actually going through the steps outlined in the Proposal. Specifically, each time a trader buys or sells a bond from a customer, the trader would need to undergo a formalistic process *before* engaging in the trade. To a trader, this process is a rigid construct that does not reflect the way the debt markets operate or the manner in which dealers and institutional investors determine pricing:

- First, the trader must determine if there are any “contemporaneous” trades in the security.
- Next, the trader must determine whether there are any credit events, news events, or interest rate changes that might negate the presumption that contemporaneous cost is the best evidence of prevailing market price.
- Third, the trader must: (1) identify interdealer trades (if any); (2) if there are none, identify institutional trades (including determining that the customer’s trade qualifies under the rule); (3) if there are none, determine whether the market is “active” and if so, whether there are any “qualifying” quotes.
- If none of these factors is available, the trader must look at: (1) prices of interdealer trades in similar securities; (2) prices of institutional customer trades in “similar securities” (as that term is defined under the Proposal); (3) yields from interdealer trades; (4) yields from institutional customer trades (including determining that the customer’s trade qualifies under the Proposal); and (5) yields computed from validated quotes.
- Finally, if (and only if) none of these factors is available, the dealer may

look to economic models.

Also, in applying the Hierarchy, the trader would be required to consciously disregard other available information – even if the trader has a good faith belief that such information is relevant to a pricing determination.

SIFMA believes that it is unrealistic to expect that dealers will go through the detailed process described above, while at the same time ignoring information that they may believe is important to pricing. As such, the Proposal would place supervisors and compliance officers in a very difficult position because it would result in their conducting after-the-fact reviews of trades, working to fit particular trades into the Hierarchy on a post hoc basis. Supervisors and compliance officers conducting after-the-fact reviews of trades may face situations where, based on all relevant pricing factors, the firm's pricing seems appropriate, although a strict application of the Hierarchy may suggest a different result. For these reasons, too, SIFMA requests that the NASD provide additional flexibility to permit dealers to take into account size, quotes, and other appropriate criteria in determining prevailing market price in situations where the dealer has established that contemporaneous cost is not the best evidence of prevailing market price.

IV. The Proposed Interpretation Should Acknowledge the Critical “Market-Making” Role Played by Dealers in the Bond Markets and Expressly Recognize Precedent Related to that Definition.

SIFMA requests that the NASD further clarify that debt dealers may be market makers, as the market maker concept is important in determining prevailing market price other than based on contemporaneous cost.

A “mark-up equals the price charged to the customer minus the . . . [bond's] . . . prevailing market price”²⁵ and, pursuant to the NASD's Mark-Up Policy, dealers must transact with customers at prices reasonably related to this “prevailing market price.” Dealers risking capital in connection with market making activities may, subject to certain conditions, treat the prices at which they are willing to buy (in the case of a customer sale) or to sell (in the case of a customer purchase) as a security's “prevailing market price.”²⁶ Dealers that are not engaged in this type of market making activity generally must instead, under the Proposed Interpretation, use a bond's “contemporaneous cost” as the presumptive measure of its prevailing market price. In its simplest terms, the NASD's Mark-Up Policy permits dealers engaged in market making activities to “mark-up” from the prices at which they stand willing to transact (as a block positioner or otherwise) rather than from their contemporaneous cost. Accordingly, when a dealer is engaged in market making activities, the NASD's so-called five percent “guideline” applies to the mark-up (if any) from a dealer's bid or

²⁵ *Banca Cremi, SA v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1033 (4th Cir. 1997).

²⁶ In a proposed disclosure statement for retail investors, the NASD equated this term with “a fair price reasonably related to then current market prices.” NASD NTM 05-21, at 15 (2005).

offer price and not from the acquisition price of the bond. The SEC has stated that, without this special accommodation to dealers that risk capital, dealers would be deterred "from taking the risk of maintaining a market or a position in a security and, consequently, would impair market liquidity."²⁷

As described in the BMA April 2005 Letter, bond dealers regularly risk their capital to facilitate customer transactions, and regularly provide quotes to customers and in the interdealer market. SIFMA continues to believe that dealers in debt securities may, under certain circumstances, be market makers. Further, SIFMA continues to believe that the NASD should take into account structural differences between the equity and bond markets in determining whether a debt dealer may be a market maker. SIFMA has in the past requested that the NASD's mark-up proposal provide specific interpretive guidance on when a dealer in the debt markets may be considered a market maker, continues to believe that such an approach is appropriate and urges the NASD to reconsider its position on this point.²⁸ While the current proposal does not contain any such guidance, SIFMA applauds the NASD for recognizing the market maker concept in the Proposing Release.²⁹

Further, SIFMA applauds the NASD for recognizing, in the Zackula Letter, legal precedent for the definition of market maker that has application in the current, decentralized, over-the-counter bond markets, including *Adams Securities Inc.*,³⁰ *Raymond James & Associates, Inc.*,³¹ and *C.R.A. Realty Corporation v. Tri-South Investments*.³² SIFMA, however, believes that these points are of sufficient significance to its members that the NASD should expressly include its recognition of the relevant precedent in its discussion in its Statement of the Purpose of, and Statutory

²⁷ *In re Peter J. Kisch*, Exchange Act Rel. No. 19005, 1982 WL 529109, at *5 (Aug. 24, 1982).

²⁸ See, e.g., BMA 2005 Letter, at 17 ("The Association believes the NASD should specify that dealers that devote substantial capital to provide liquidity to investors are market makers within the meaning of the Mark-Up Policy. The definition of market maker in the debt markets should not be tied to particular securities, but rather to broad classes of securities in which the dealer holds itself out as ready to act as counterparty. . . .").

²⁹ See Proposing Release, at 68858, n.8. See also, Zackula Letter, at n.17 ("NASD continues to embrace the concept of market makers in the debt markets").

³⁰ *Adams Securities, Inc.*, Admin. Proc. File No. 3-7624, 1993 SEC LEXIS 506, at *6 (March 9, 1993) ("whether a dealer is acting as a market maker depends on the particular facts and circumstances.");

³¹ *Raymond James Assoc., Inc.*, Admin. Proc. File No. 3-8801, 1997 SEC LEXIS 1581, at *9-10. The SEC held that Raymond James acted as a market maker in direct participation programs: (i) where it "did not sell these securities to dealers other than [wholly owned subsidiaries] during the two-monthly period under review"; (ii) where its advertising literature referred to the firm as a market maker; (iii) where it did not furnish quotations in an interdealer quotation system, although no such system existed and the firm made extensive efforts to distribute its quotes widely; and (iv) where it incurred market risk and added liquidity to a largely illiquid market.

³² *C.R.A. Realty Corp. v. Tri-South Investments*, 738 F.2d 73 (2nd Cir. 1984) (for purposes of Section 16 of the Exchange Act, a broker-dealer was a market maker in convertible debentures (and the equity security to which debentures were convertible) in an OTC market in which there was no centralized mechanism for publishing bids and offers).

Basis for, the Proposal. By doing so, the NASD's views would be reflected clearly in a single document that will be part of the SEC's approval process and that market participants will regularly consult for guidance. SIFMA believes that such a statement of the NASD's views is particularly important in light of statements in settled NASD enforcement actions that appear to take a narrower view of the availability of the market maker definition in the debt markets.³³

CONCLUSION

For the reasons discussed above, SIFMA believes that the NASD should expand the exemption for QIBs to cover all transactions pursuant to Section 4(1^{1/2}), regardless of rating; provide dealers with more guidance about the meaning of contemporaneous cost; restore the size proposal; permit a more flexible application of the hierarchy; and clarify the concept of market making. Further, given the significance of the Proposal, we respectfully request that the SEC expedite its review and consideration of these comments.

We appreciate this opportunity to comment on the Proposal. If you have any questions concerning these comments, or would like to discuss these comments further, please feel free to contact me at 646.637.9220 or via email at mkuan@sifma.org.

Sincerely,



Mary Kuan
Vice President and
Assistant General Counsel

cc: Mary L. Schapiro, Chairman and CEO, NASD
Marc Menchel, General Counsel, NASD
Stephen Luparello, Senior Executive Vice President, Regulatory Operations, NASD
Sharon Zackula, Assistant General Counsel, NASD
Erik R. Sirri, Director, Division of Market Regulation, SEC
Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC
Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, SEC
Katherine A. England Assistant Director Division of Market Regulation, SEC

³³ See BMA 2005 Letter, at 15-16.

Exhibit B

January 4, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-NASD-2003-141, Mark-Up Policy for Transactions in
Debt Securities, Except Municipal Securities

Dear Ms. Morris:

On behalf of the MBS and Securitized Products Division of the Securities Industry and Financial Markets Association ("SIFMA"),¹ SIFMA is pleased to submit this additional comment letter to the Securities and Exchange Commission ("SEC" or "Commission") in connection with the National Association of Securities Dealers, Inc.'s ("NASD") proposed interpretation concerning the application of its mark-up policy to transactions in debt securities (the "Proposed Interpretation" or "Proposal"). The Proposal recently was amended and published for comment by the SEC.²

In a companion letter submitted in response to the Proposal, SIFMA provided comments on the Proposed Interpretation as it applies to the debt markets generally, with particular application to the market for corporate debt.³ The ABS/MBS Division fully supports the

¹ SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

² Notice of Filing Amendments Nos. 3, 4, and 5 to a Proposed Rule Change Relating to Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities, Exchange Act Rel. No. 54799 (Nov. 21, 2006), 71 Fed. Reg. 68856 (Nov. 28, 2006) (the "Proposing Release").

³ In that letter SIFMA requested that the NASD expand the exemption from NASD Rule 2440 and IM-2440 (the "Mark-Up Policy") to (1) include private bond transactions by dealers with QIBs in all debt securities; (2) provide dealers with more guidance regarding the definition of "contemporaneous cost", including restoring the "size" proposal; (3) allow for a more flexible and nuanced approach in determining prevailing market price where the dealer establishes that contemporaneous cost is not the best evidence of the prevailing market price; and (4) expand the discussion of the situations in which a bond dealer may consider itself a market maker.

positions described in that letter. SIFMA submits this additional letter to comment on provisions of the Proposed Interpretation as they apply to securitized products.⁴

As the SEC has historically recognized in no-action letters, in Regulation AB and in other contexts, securitized products have characteristics that make them fundamentally different from corporate debt and Treasuries.⁵ These differences in the products have necessitated differences in regulatory treatment. It is equally the case that securitized products are different for purposes of the Proposed Interpretation, as the way securitized products are valued and traded differs materially from the valuation and trading of other debt securities. We therefore summarize some of the most relevant differences in order to establish the foundation for the discussion that follows:

- Rather than providing a determinate payment schedule and fixed maturity, securitized products pay principal and interest at a rate that is linked to the performance of an underlying asset pool and depends on one or more of (i) pre-payment rates, (ii) default rates, (iii) recovery rates on defaults, (iv) default correlations and (v) structural characteristics of the relevant tranche. Thus, the use of mathematical analysis to model these variables is almost always necessary to price securitized products. Differences in modeling techniques among firms can result in very different price estimates for all but the most commoditized products (certain plain-vanilla liquid AAA tranches of MBS and ABS).
- Structuring technologies provide originators of securitized products with tremendous flexibility to customize capital structures to satisfy the particular risk/return demands of investors. Such technologies permit originators to create “single tranche” securitized products which reflect only a portion of the risk and return associated with a pool of reference assets. Due to the ability to customize securitized products, they are highly varied, and any individual securitized product will most commonly be sold to a limited number of sophisticated institutional investors.
- In securitized products, the credit rating assigned to an issuer or its assets is only one indicator of a security’s level of risk, price volatility or liquidity. The way a

⁴ For purposes of this letter, the term “securitized products” includes asset-backed securities (ABS), residential mortgage-backed securities (MBS), commercial mortgage-backed securities (CMBS), collateralized debt obligations (CDOs), synthetic CDOs and risk-linked bonds such as catastrophe bonds. We emphasize that the securitized products market is characterized by rapid innovation and development in the application of securitization techniques to new assets classes and that the list of products noted above is not intended to be exhaustive.

⁵ See, e.g., *Greenwood Trust Co., Discover Master Card Trust I*, SEC No-Act. (Apr. 5, 1996) (use of written materials outside a statutory prospectus); *Public Securities Association*, SEC No-Act. (Feb. 7, 1997) (publication of research reports by broker-dealers proximate to an offering registered on Form S-3); Exchange Act Rules 13a-15 and 15d-15 (special form of certification under Section 302 of the Sarbanes-Oxley Act); SEC Rel. IC-19105 (Nov. 19, 1992) and Investment Company Act Rule 3a-7 (exclusion from the definition of “investment company”); SEC Rel. 33-8238 (Jun 5, 2003) (exemption from reporting and attestation requirements relating to internal controls under Section 404 of the Sarbanes-Oxley Act); SEC Rel. 34-50905, (Jan 7, 2005) (adopting Regulation AB); SEC Rel. 33-8591 (Jul 19, 2005) (adopting securities offering reform).

security has been structured and offered will often have a greater impact on characteristics such as liquidity and price behavior. For example, securities can be structured so that what benefits one class will operate to the detriment of another class. Consequently, as interest rates change, underlying assets default, reserve accounts are funded or depleted, or other events affecting a pool or structural protections occur, the values of securities that are backed by the same class of assets and that bear the same credit rating may be affected in different ways and may in fact move in opposite directions. Highly rated but complex or exotic securities are generally sold to one or a small number of sophisticated institutional investors and tend to be illiquid.

- In trading equity securities, it is possible to trade successfully without knowledge of the underlying security or issuer, because the “market” sets the price for such securities based on supply and demand. Further, investors may trade based on the “momentum,” upward or downward, of a stock or other “technical” trading characteristics. In fact, SEC Rule 15c2-11 recognizes that, even as to relatively illiquid securities, dealers may have little fundamental knowledge of the security, but may trade based only on the state of the market. Trading in this manner is not possible as to most securitized products. As the individual securities tend to be unique and to trade infrequently, momentum and other technical factors are of little relevance. In the market for illiquid securitized products, most trades are based to a significant extent on results from models.

I. The NASD should Expand the Proposed Carve Out for QIBs to Include Additional Transactions in Securitized Products Where Restrictive Price Regulation is Unnecessary.

In the Proposing Release, the NASD recognizes that large institutional investors frequently have sufficient knowledge of the market to negotiate at arms-length, and proposes to exempt QIBs who meet certain additional tests from the definition of “customer” for purposes of the Proposed Interpretation. However, the NASD proposes to limit the exemption to transactions in non-investment grade securities. The NASD does not directly explain the rationale for limiting the QIB exception, but suggests that the absence of an investment grade rating is a proxy for illiquidity and notes that in the case of generally illiquid market sectors (including securitized products sold pursuant to an exemption from registration under the Securities Act), the application of the so-called “Hierarchy” and attempts to compare “similar” securities would not yield useful pricing information.

SIFMA appreciates the NASD’s responsiveness to prior industry comments on the application of the Proposed Interpretation to transactions with sophisticated investors and its addition of an exemption for certain transactions with QIBs. The proposed exemption would provide regulatory relief with respect to a substantial number of transactions in debt securities for which the significant costs of price regulation are not justified. However, SIFMA submits that the scope of the proposed QIB exemption is better tailored for the market for corporate debt securities than for securitized products. For securitized products, credit rating is a poor indicator of liquidity or the likelihood that the Proposed Interpretation will provide useful pricing information. Moreover, due to the particular characteristics of securitized products, expansive

application of the Proposed Interpretation to those products that are investment grade will have significant adverse effects on the market for such products that are not present to the same degree for corporate debt.

For these reasons, SIFMA urges the NASD to expand the QIB exemption to include all transactions in securitized products (including investment grade securitized products). Alternatively, the NASD should at least exempt all QIB transactions in debt securities that are initially offered and sold pursuant to the exemption provided by Section 4(2) of the Securities Act and continue to be offered and sold pursuant to Rule 144A or the so-called Section "4(1)1/2" exemption from registration under the Securities Act (collectively, "private bond transactions") as the NASD's own rationale for the exception applies to these securities.

A. The QIB Exception Should Cover Securitized Products Regardless of Rating.

SIFMA believes that the exception should be available for all transactions in securitized products with QIBs. As a starting matter, sophisticated institutional investors are certainly as capable of negotiating fair prices with respect to investment grade and/or liquid securitized products as they are with respect to such products that are illiquid. Indeed, where there is a liquid market and robust market information is available to institutional investors, the policy rationale for restrictive price regulation disappears and therefore we do not believe that its cost can be justified.⁶

More significantly, in the case of securitized products particularly, SIFMA believes that application of the Proposed Interpretation to investment grade transactions with QIBs will have a material adverse effect on liquidity and market efficiency in situations where dealer willingness to risk capital is most critical. For example, news of deteriorating payment rates in asset pools, such as a particular vintage of sub-prime mortgage pools, can cause rapid price movements and disorderly markets in MBS, CMBS and ABS.⁷ In such cases, the provision of buy-side liquidity in the face of strong selling depends on dealers willing to commit capital in the midst of high volatility. If dealers are required to apply "contemporaneous" cost and the "Hierarchy" to large transactions with QIBs in such a volatile marketplace, they are likely to be deterred from providing the liquidity necessary for the marketplace to function most efficiently.

In addition, there will almost certainly be numerous other circumstances in which the rigid set of proxies for market price required by the Proposed Interpretation will create unanticipated market inefficiencies for securitized products. Thus, SIFMA believes that application of the Proposed Interpretation to QIBs who do not need such protection is likely to result in unjustified costs.

⁶ Consistent with the requirements for the QIB exemption generally, members would still be required to establish that a QIB has the capacity to evaluate investment risk independently and is in fact using independent judgment in deciding to enter into the relevant trade.

⁷ It is not atypical in today's market for spreads to widen by 30 basis points or more over a series of a few trades and for the prices for such securities to be highly discontinuous.

B. If the NASD Does not Include all Securitized Products Transactions with QIBs, the QIB Exception Should at Least Include all Private Bond Transactions.

If the NASD nevertheless decides not to generalize the QIB exemption, it should at least exempt any private bond transaction in a securitized product, whether the security is investment grade, non-investment grade or unrated. As described in the introduction to this letter, an investment grade credit rating is not a good indicator of liquidity for securitized products nor is it an indicator of retail participation. Structured bonds that carry investment grade ratings can be highly illiquid because of the manner in which the transaction is structured or the complexity of underlying assets. For example, it is typical for securitized products such as cash CDOs to include one or more investment grade tranches that are sold to no more than a handful of institutional investors. Such sales are conducted without registration under the Securities Act, and the private nature of the transaction combined with the limited initial placement and the complexity of the instrument make such bonds quite illiquid.

In fact, most highly customized securitized products, most subordinate but investment grade tranches of CDOs, and securitized products based on "exotic" assets such as litigation settlement securitizations in private transactions, are sold only to a small number of highly sophisticated institutional investors, including in investment grade tranches. Due to the highly innovative and dynamic nature of the securitized products markets, there are in fact a wide variety of products sold exclusively to sophisticated institutional investors that are generally illiquid even though they have an investment grade rating.

SIFMA suggests that the manner of offering provides a better guide in many cases than credit rating to situations in which securitized products should be exempted from the Proposed Interpretation. Securitized products sold to QIBs in private placements or through 144A transactions are often comparatively illiquid whether or not they are given an investment grade rating, and in all cases the institutional parties to the transaction are well informed and able to understand the risks. Thus, the NASD's rationale for excluding trades by QIBs in non-investment grade debt securities applies equally to private bond transactions by QIBs involving securitized products, regardless of rating.

C. In the Event that the QIB Exception Continues to be Tied to Credit Rating, the NASD Should Clarify That a Separate Credit Evaluation is Not Required for Unrated Debt in Appropriate Circumstances.

Finally, to the extent that the NASD does limit the QIB exemption to non-investment grade debt, it should clarify the requirements of the exemption with respect to unrated debt. Specifically, the NASD should provide guidance clarifying that it is not necessary to document a separate credit evaluation of such debt in order to demonstrate that the credit quality is equivalent to non-investment grade when the appropriateness of treating unrated debt as non-investment grade can be demonstrated. Such circumstances would include where a dealer can demonstrate that it treats the relevant security as non-investment grade debt for other business purposes, or can establish that the security in question is affirmatively determined to be equivalent to non-investment grade.

II. When Securitized Products are Not Otherwise Exempt From the Application of the Mark-up Rule, the NASD Should Permit Dealers to Immediately Move From Contemporaneous Cost to Consideration of Economic Models.

As described in SIFMA's other comment letter to the Proposed Interpretation, SIFMA believes that the rigidity of the Hierarchy would unrealistically require dealers to ignore relevant price information and consequently increase risk. This is particularly true for securitized products, because both the structured nature of such securities and their general illiquidity necessitate the use of models. Given the need to model securitized products in order to value them, SIFMA believes that dealers should be permitted to move more directly from contemporaneous cost to a models-based assessment of prevailing market price. The superiority of this approach to forcing dealers to prioritize other information at the expense of their own model-based view of proper pricing can be seen in several ways:

- Because all dealers necessarily model securitized products, the "prevailing market prices" for such securities, is, as a practical matter, the calculated result of such models. A dealer's own models-based view of the proper price of a debt security is a critical input into the price formation process and is probative of market price regardless of whether the so-called "Hierarchy" information is available.
- At least for the bulk of securitized products that are inactively traded, pricing information obtained from economic models is superior to prices derived by applying the so-called "Hierarchy." As currently drafted, the Proposed Interpretation would appear to preclude a dealer from considering other factors once any relevant pricing information (i.e., a single transaction by another dealer) within the "Hierarchy" is available.⁸ Yet, for many securitized products, such pricing information, when available at all, would be nothing more than the application of the other dealer's model. Requiring one dealer to price based on another's model rather than its own can hardly be justified by a requirement for fair pricing, would reduce the efficiency of price formation and indeed would frequently result in worse prices for customers.
- For most securitized products, there are no "similar" securities. Moreover, comparisons to the prices of "similar" securities would generally be nothing more than comparisons of model results, as a prior transaction in a similar security was

⁸ While the Proposed Interpretation provides that "[i]n reviewing the pricing information available within each category, the relative weight, for purposes of identifying prevailing market price, of such information....depends on the facts and circumstances of the comparison transaction or quotation," it only permits a dealer to move from one category to the next "in the absence of transactions" described in the preceding category. We note that, the direction that "a member may consider a succeeding category of pricing information only when the prior category does not generate relevant pricing information", appears to conflict with the subsequent statement in the Proposed Interpretation that "isolated transactions or isolated quotations generally will have little or no weight or relevance in establishing prevailing market price." Given this conflict, the Proposed Interpretation creates some uncertainty as to when members must adhere to pricing information obtained through the application of the Hierarchy and when, as a result of the isolated nature of the transactions that gave rise to that information, such information should be disregarded.

almost certainly the result of pricing based on another dealer's models. In other words, for securitized products, a dealer's determination of "similarity" itself would be the product of the use of models.⁹

- It is inevitable that application of the NASD's approach to mark-ups would prevent dealers from entering into transactions. That is, if one dealer's model shows a value that is materially at variance with a trade for the same or a similar security affected by another dealer, the second dealer will be effectively precluded from trading unless it is willing to conform its prices to those produced by the models of the other dealer.

In addition, rigid gating through the series of comparisons required by the Proposed Interpretation would be unduly burdensome for dealers of securitized products. Each of the steps in the progression that would be required under the Proposed Interpretation poses significant difficulties. While "similar" securities will not be available for securitized products other than very high-grade MBS and certain ABS, the Proposed Interpretation would place the burden on dealers to show the absence of such similar securities before going to models. Even where "similar" securities did exist, a dealer would be faced with a potential conflict of models, and would have to determine whether transactions in such (likely illiquid) securities were sufficiently timely and similar in terms of size, side of market, and spread to serve as a proper benchmark. Similarly, in applying the "Hierarchy," a dealer would be required at each step to determine whether any transactions were "contemporaneous," notwithstanding that the prices of such transactions could differ significantly from what the dealer's own models tell it is the proper price. For these reasons SIFMA believes that requiring dealers to treat models as price indicators of last resort would result in decreased liquidity, wider spreads and worse prices for customers.

III. In The Event that the Use of Models Remains a Last Resort, the NASD should Clarify the Burden of Proof for Determining that Use of Models is Acceptable.

In the event that the NASD nevertheless requires dealers in securitized products to apply the full process required by the Proposed Interpretation before using models, it should at a minimum provide guidance specifying that they would not be required to have burdensome documentation procedures to demonstrate that they have done so. While the NASD has provided general and informal assurances in this regard, the Proposed Interpretation is silent on what a dealer would be required to do in any particular case to demonstrate to the satisfaction of the NASD's examiners that the NASD's preferred sources of prevailing market price were either not available, not "contemporaneous" or (in the case of "similar" securities) insufficient as a guide to price.

⁹ For example, a dealer's models could tell it that a security could serve as a reasonable benchmark for a securitized product for small changes in expected interest rates, but a poor benchmark for larger changes.

IV. The NASD Should Clarify that "News" Deemed to Affect the Prevailing Market Price Includes any Publicly Available Information Reasonably Expected to Have a Material Effect on the Value of Securitized Product.

SIFMA welcomes the NASD's inclusion of language recognizing that a dealer's (near) contemporaneous cost may not be indicative of the prevailing market price of a security when news that has an effect on the perceived value of the security has subsequently been disseminated to the market. As the NASD states, such a provision is necessary, since certain significant news would not be captured by previously proposed language which was limited to a recognition that interest rate changes and credit quality changes may affect the price of a debt security.

However, SIFMA is concerned that the accompanying explanatory language in the Proposing Release could be read to limit the Proposed Interpretation to news affecting issuers specifically, rather than applying to any news that affects the price of a security.¹⁰ In the context of securitized products, price changes generally reflect news relating to the value of the pool of assets underlying the relevant security rather than the issuer as such. For example, hurricanes, floods or other natural disasters in a particular region will obviously affect the price of MBS based on assets originating in that region. Since such price-relevant information is also not captured by the concepts of interest rate changes or credit-quality changes, the NASD should clarify that "news" includes news relating to the collateral underlying, or other factors affecting, a securitized product.

In addition, given the models-based approach to valuing securitized products, the NASD should also clarify that news affecting expectations about the value of a collateral pool are included. Such "news" could include, for example, publicly available information concerning observed payment rates, delinquencies, losses and recoveries on assets in the trustee reports for a securitization, views on the relationship between interest rates or other variables and mortgage prepayments, new evidence on correlations of underlying assets in a CDO, or advances in modeling techniques. While the NASD has previously rejected "changes in valuation assumptions" used by a dealer as a basis for considering factors other than contemporaneous cost,¹¹ changes in the state of knowledge about the expected behavior of a collateral pool is a fundamental form of market information that can not be appropriately ignored, and all investors are benefited when such information can be priced into the marketplace as quickly and efficiently as possible.

Finally, as discussed more generally above, the NASD should clarify how a dealer may consider news to rebut the contemporaneous cost presumption in the context of illiquid

¹⁰ In the Amended Proposing Release, NASD states that "'News' referred to in paragraph b(4)(ii) of the Proposed Interpretation . . . may affect specific issuers, a group of issuers or an industry sector and includes news such as pending or contemplated legislative developments (e.g., relating to asbestos claims); the announcement of a judicial decision; the announcement of new pension regulation or a new interpretation; and the announcement of a natural disaster, an attack or a war."

¹¹ Sharon K. Zackula, NASD Response to Comments on Additional MarkUp Policy for Transactions in Debt Securities, (Oct. 4, 2005)

securities. Since transaction data and contemporaneous quotes will frequently not be available in the post-news period for such securities, a change in market perception about value of the relevant securities would frequently be difficult to document. In effect, the relevant dealer's transaction could be the first transaction to "price-in" such news. Rather than requiring dealers to demonstrate that the "perceived value" of a security has changed, the NASD should make clear that dealers are permitted to use alternatives to contemporaneous cost whenever intervening news would reasonably be expected to have a material effect on the value of a security or the perceived value has otherwise been affected.

CONCLUSION

SIFMA appreciates this opportunity to comment on the Proposal and the markets for securitized products. We would welcome the opportunity to provide any additional information that could be of assistance in considering the issues discussed in this letter. If you have any questions concerning these comments, or would like to discuss the issues raised herein, please feel free to contact me at (646) 637-9228 or via email at rconner@sifma.org.

Sincerely,

Handwritten signature of Robbin Conner, followed by the initials "/ck".

Robbin Conner
Vice President and Assistant General Counsel

cc: Marc Menchel, General Counsel, NASD
Sharon Zackula, Assistant General Counsel, NASD