Notice to Members

MARCH 2005

SUGGESTED ROUTING

Legal and Compliance
Operations
Registered Representatives
Senior Management
Technology
Training

KEY TOPICS

Confirmations
Debt Securities
Operations
Transaction Reporting

REQUEST FOR COMMENT

Proposed Rule to Enhance Confirmation Disclosure in Corporate Debt Securities Transactions

NASD Requests Comment on Proposed Rule Requiring Members to Provide Additional Disclosures for Transactions in Debt Securities; **Comment Period Expires April 19**

Executive Summary

NASD is requesting comment on whether it should propose a new rule, Rule 2231, that would require members to provide additional disclosures to customers when effecting a transaction in a debt security for or with the account of a customer. Currently, members effecting such transactions are required to provide certain disclosures to their customers pursuant to Rule 10b-10 under the Securities Exchange Act of 1934 (Exchange Act). Under the proposed rule, members would provide additional transaction-specific disclosures to supplement the disclosures made under Rule 10b-10 and, with the transaction-specific disclosures, include a statement referring customers to NASD educational materials about bonds that would be located on NASD's Web site. (*See* Attachment A, Proposed Rule 2231, and Attachment B, draft educational materials.)

The proposed rule is based upon NASD standing committee input on a broad framework laid out by the Corporate Debt Market Panel (Panel), a group of 12 industry experts convened by NASD to make recommendations to NASD's Board of Governors regarding how to best ensure market integrity and investor protection in the corporate bond market.

Questions/Further Information

Questions concerning this *Notice* should be directed to James L. Eastman, Assistant General Counsel, Office of General Counsel (OGC), Regulatory Policy and Oversight (RPO), at (202) 728-6961; Sharon K. Zackula, Associate General Counsel, OGC, RPO, at (202) 728-8985; or Elliot Levine, Chief Counsel, Transparency Services, Markets, Services and Information, at (202) 728-8405.

Action Requested

NASD encourages all interested parties to comment on the proposal. Comments must be received by April 19. Members and other interested persons can submit their comments using the following methods:

- **Mail** comments in hard copy to the address below; or
- **E-mail** comments to *pubcom@nasd.com*.

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method. Comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1500

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.[1]

Before becoming effective, a proposed rule change regarding additional debt disclosures must be filed with the Securities and Exchange Commission (SEC), and then approved by the SEC, following publication for public comment in the *Federal Register*.[2]

Background and Discussion

With the implementation of NASD's Trade Reporting and Compliance Engine (TRACE) on July 1, 2002, and the subsequent availability of a consolidated view of pricing in the U.S. corporate bond market, a number of trends have emerged that have implications for the regulatory framework of the corporate debt market. In particular, there appears to be greater investor awareness of the role that corporate bonds can play in a diversified investment portfolio. NASD believes that ensuring that investors understand some of the key risks associated with bond investing is an important element of its efforts to enhance transparency in the corporate debt market. The rulemaking presented in this *Notice to Members* is a result of NASD's increased focus on the corporate debt market. The recommendations result from staff and NASD standing committee interpretations and modifications to a broad-based framework laid out by the Panel.

The objective of the Panel was to review and make recommendations to the NASD's Board of Governors regarding how to best ensure market integrity and investor protection in the corporate bond market.[3]

The Panel reviewed information showing significant levels of participation by individual investors in the corporate bond market,[4] as well as NASD surveys showing that individual investors often do not understand certain key structural aspects of specific bonds or the market in which bonds are traded. For example, 34 percent of individuals surveyed did not believe that they were paying a fee for buying or selling a bond, and approximately 60 percent of investors surveyed did not understand that bond prices generally fall as interest rates rise.[5] The Panel concluded that individual investors would benefit from additional guidance and information disclosure, and recommended, among other things, that investors obtain improved access to information on bonds and receive increased disclosures regarding their bond transactions.

Proposed Rule 2231

Under proposed Rule 2231, members would provide additional, transaction-specific disclosures in debt securities transactions.[6] The proposals that follow, including the transaction-specific disclosures and the educational materials, are rooted in the Panel's recommendations and NASD surveys of bond customers' understanding of bond pricing, mechanics, and transaction remuneration. NASD staff finalized these proposals after a further series of consultations with its advisory committees.

The additional transaction-specific disclosures include a brief statement about applicable brokerage charges, the credit rating of the security, and whether transaction price information is publicly available for the security. For purchases only, members would disclose information regarding interest, yield, and, if applicable, call provisions. In addition, members would be required to include a statement referring their customers to NASD's Web site for important general information about investing in bonds. The disclosures would be provided in the same manner that a member confirms the terms of a transaction in a debt security under Rule 10b-10.[7] Importantly, members would not be required to make any disclosure that would be duplicative of a disclosure already required under Rule 10b-10 for a particular type of debt transaction.

In proposed Rule 2231, there are three significant exceptions to the general requirement that members provide supplemental disclosures to customers in connection with every debt securities transaction. First, none of the requirements would apply to transactions with "institutional customers," which is defined to include all "qualified purchasers" (as defined under the Investment Company Act of 1940).[8] The second and third exceptions exclude transactions in "exempted securities" as defined in Section 3(a)(12) of the Exchange Act[9] and "asset-backed securities" as defined in Rule 10b-10.[10]

The transaction-specific disclosures in proposed Rule 2231 are as follows:

- The debt security's CUSIP and the TRACE symbol of the debt security, if NASD has assigned one. NASD is requiring that the CUSIP be included for proper identification of the security. NASD is also requiring disclosure of the TRACE symbol, if any, because a non-institutional investor may identify a debt security more readily by its TRACE symbol than by its CUSIP.
- One of three specified statements in a "brokerage charges" field that informs the customer that he or she paid a commission, mark-up, or mark-down, if applicable:
    - If the member acted as agent for the customer and received or will receive remuneration from the customer in connection with the transaction that would be required to be disclosed to the customer under Rule 10b-10 under the Act, "you paid a commission to our firm for its services";
    - If the member acted as principal, purchased a debt security from the customer, and reduced the proceeds paid to the customer by a payment for its services, "the proceeds you received from the debt security you sold were reduced by a payment to our firm for its services"; or
    - If the member acted as principal, sold a debt security to the customer, and incorporated a payment to the member in the price paid by the customer, "a payment to our firm for its services was incorporated in the price you paid for the debt security you purchased."

  As discussed more fully below, in some cases investors are unclear that there is any remuneration paid in connection with debt securities transactions. NASD is not requiring that the amount of the member's mark-up or mark-down be disclosed. This disclosure requirement is consistent with NASD guidance provided in *Notice to Members 04-30*.[11]
- If the debt security is rated by a Nationally Recognized Statistical Rating Organization (NRSRO) to which the member subscribes, the member must disclose the NRSRO and the credit rating issued by the NRSRO. Both members and investors view credit ratings issued by NRSROs as providing essential information about a corporate debt security. NASD is proposing that such information be provided to the customer, but only if the member is already

a subscriber to one or more NRSROs. If a member subscribes to more than one NRSRO, the member would be required to identify each NRSRO and the related rating in the proposed disclosures. If the provision is adopted as proposed herein, NASD will monitor the percentage of firms that subscribe to and disclose NRSRO ratings. In the event that a uniform practice of disclosure of NRSRO ratings does not arise should the rule be adopted, NASD will consider the advisability of mandating at least one subscription to an NRSRO.

- The member must disclose whether transaction price information for the bond is available and, if it is, where it is available for no charge (*e.g.*, TRACE information), if that is the case. NASD believes that investors should know *if* transaction price information is available regarding a security, and if it is available, where an investor can access such information at no charge. For example, for TRACE-eligible securities, a member would indicate that such information is available and refer the customer to a source of free bond price information, such as NASD's Web site, or another Web site, if such information is or becomes available at an industry- or association-sponsored Web site.[12]
- The frequency of principal and interest payments must be disclosed. NASD believes that investors should be aware of and receive written disclosure of the frequency of interest payments, and, if applicable, any payment of principal that may occur before a bond matures.
- The yield to maturity, and certain call information must be disclosed (whether a bond is callable and, if so, whether it is continuously callable or otherwise callable, the next occurring call date, and the related call price). NASD is aware that yield to maturity and certain call information must be disclosed for certain (but not all) transactions under Rule 10b-10. (As noted above, proposed Rule 2231 does not require the disclosure of information that a member is already required to disclose under Rule 10b-10.)
- A member must disclose whether a coupon rate is variable. Additionally, under the proposal, members will be required to provide, upon a customer's written request, certain information relating to debt securities carrying a variable coupon rate. NASD believes that investors who purchase debt securities subject to a variable interest rate should be aware of the formula for the recalculation of the interest and other basic information. At this time, NASD is proposing only that the member indicate that the coupon rate may vary and that the member will provide in writing additional information relating to the calculation of the debt security's interest and principal payments upon a written request from the customer. The written request must be sent not later than six months from the date of settlement.
- For a zero coupon bond (or one similarly structured) with a call feature, the investor must receive disclosure regarding the bond's compound accreted value and the call price as of the next occurring call date.

NASD Educational Materials about Bonds

NASD believes individual investors need more information and guidance regarding the purchase and sale of bonds. This information should allow investors to determine if bonds are appropriate for their investment objectives, what execution quality they receive, and the bond's overall risk/return. To enhance investor understanding in these areas, NASD would make available an educational brochure about investing in corporate bonds. In this brochure, the staff intends to provide basic descriptive information about various types of corporate bonds and their features, such as coupon rate, face value, and maturity. Other topics covered would be bond pricing, the relationship between the price of a debt security and its yield, and the differences between a bond's yield to maturity and its yield to call.

The educational brochure also would cover some of the key risks related to investing in debt securities, such as interest rate risk, call and reinvestment risk, refunding risk (along with sinking fund provisions), and default and credit risk, as well as the differences between subordinated and non-subordinated debt. Certain debt securities with special features, such as floating rate bonds, zero coupon bonds, convertible bonds, and guaranteed and insured bonds also would be discussed, as they carry somewhat unique risks for the bond investor. The importance of credit ratings and the differences between investment grade and non-investment grade debt also would be discussed to enhance investors' ability to understand the impact credit risk may have on the value of their bonds.

NASD is particularly concerned about NASD survey data showing that more than a third of those surveyed didn't understand they were being charged a fee when buying or selling debt securities. In this regard, the educational materials would cover the different types of broker compensation (*e.g.*, commissions and mark-ups/mark-downs), how it can affect a bond's yield, and the potential for broker compensation to influence whether a particular bond is recommended for purchase.

Generally, NASD is very concerned that investors do not understand the differences in the way the debt and equity markets operate, particularly when attempting to assess execution quality of a bond transaction. For example, NASD believes that bond investors may not understand that some debt securities are difficult to sell because of a lack of liquidity, and, as a result, a member may charge a premium in such transactions. The educational materials would highlight this liquidity risk and investors would be advised to consider the possibility that they might not be able to sell easily or without a discount a bond that has not traded in many months as compared to a bond that trades frequently. The impact that illiquidity may have on a debt security's bid/ask spread also would be addressed. Relatedly, investors would be urged to explore with the member that sells them a particular bond the member's ability and willingness to purchase that bond if the investor desires to sell the bond prior to maturity, particularly if the market for that bond is illiquid.

A member that makes the transaction-specific disclosures discussed above also would be required to disclose that the educational materials are available on NASD's Web site. In addition, and subject to the stated exceptions, a member would be required to provide the customer the educational materials in hard copy upon a customer's written request.

Request for Comment

NASD is soliciting comment on proposed Rule 2231 requiring members to provide additional disclosures for transactions in debt securities. NASD seeks comments on NASD's general approach, the specific disclosure provisions, the educational materials that NASD would make available on its Web site, costs, and issues relating to implementation. In commenting on NASD's general approach, NASD urges members also to review and consider the recommendations of the Panel. Members are asked to consider if the exception for "institutional customers" and the two exceptions for transactions in "exempted securities" and "asset-backed securities" are appropriate in scope, and if other types of transactions should be excepted.

NASD seeks comments on all the specific disclosure provisions, and in particular the disclosures regarding NRSRO information and the yield and call provisions. NASD specifically seeks comment on NASD's approach to information provided by NRSROs, and issues related to costs. NASD also seeks comment as to whether any of the other items of disclosure are misleading, are likely to lead to customer confusion, require additional exceptions or would be difficult for firms to implement.

Finally, NASD seeks comment on costs and implementation. The proposal provides members flexibility in determining the means for delivering the disclosures. For example, the proposal contemplates that members may provide the disclosures on the same document on which Rule 10b-10 disclosures are printed, or may use supplemental documentation, provided that the information is transmitted in the same manner that the Rule 10b-10 disclosures are made. NASD seeks member input on the appropriate period needed for members to address systems and operational issues to prepare for additional disclosures.

Endnotes

1 *See NTM 03-73* (Nov. 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or e-mail addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.

2 Section 19 of the Exchange Act permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. *See* Exchange Act Section 19 and rules thereunder.

3 The Panel's findings and recommendations were released publicly in September 2004 in the *Report of the Corporate Debt Market Panel (Panel Report)*. The complete text of the *Panel Report* is available at *www.nasd.com/pdf_text/corp_debt_panel_report.pdf*.

4 The *Panel Report* notes that information obtained from TRACE shows that approximately "two thirds of corporate bond transactions reported to TRACE are in quantities of $100,000 or less in value, a size widely viewed as representative of individual investor activity." *Panel Report* at 4.

5 *Panel Report* at 4.

6 For purposes of proposed Rule 2231, "debt security" is defined to have the same meaning it has under Rule 10b-10.

7 A member would not be required to provide the supplemental disclosures required under proposed Rule 2231 on the same piece of paper or electronic document (if the confirmation is provided electronically) as that containing the Rule 10b-10 confirmation.

8 The term "qualified purchaser" is defined in Section 2(a)(51) of the Investment Company Act of 1940, which provides, in pertinent part:

> any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) [15 USCS § 80a-3(c)(7)] with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission…or any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments….

9 Exchange Act Section 3(a)(12)'s definition of "exempted security" covers a variety of securities, including government securities, municipal securities, an interest or participation in certain trust funds, pooled income funds and collective investment funds, and securities issued in connection with certain qualified plans and church plans. This definition is complex and, in determining the scope of this term, members may wish to consult with the staff of the Securities and Exchange Commission regarding any interpretive questions that may arise.

10 "Asset-backed security" is defined in Rule 10b-10(d)(10) to mean:

> a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders.

11 *See generally NTM 04-30* (NASD Reminds Firms of Sales Practice Obligations in the Sale of Bonds and Bond Funds) (April 2004).

12 NASD provides investors access to bond price information free of charge at *www.nasdbond info.com*. Information obtained from NASD's Web site may not be used for commercial purposes.

©2005. NASD. All rights reserved. *Notices to Members* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

ATTACHMENT A

Text of proposed Rule 2231.

Rule 2231. Confirmation of Transactions in Debt Securities

(a) Confirmation of Transactions in Debt Securities

(1) Any member that is required to disclose to a customer information pursuant to Rule 10b-10 under the Act in connection with any transaction in a debt security also shall disclose to the customer the information set forth in paragraph (b). Except as otherwise provided herein, this information shall be disclosed in the same manner in which the member discloses to the customer information in connection with the transaction pursuant to Rule 10b-10 under the Act. Transactions by a member's institutional customers are not subject to this Rule. A member need not disclose to customers information required to be disclosed under this Rule if the member will disclose such information pursuant to Rule 10b-10 under the Act.

(2) For purposes of this Rule:

(A) "institutional customer" means a customer that is a "qualified purchaser" as defined in Section 2(a)(51) of the Investment Company Act of 1940;

(B) "debt security" shall have the same meaning it has in Rule 10b-10 under the Act, except that any exempted security or asset-backed security is excluded from this definition;

(C) "exempted security" shall have the same meaning it has in Section 3(a)(12) of the Act;

(D) "asset-backed security" shall have the same meaning it has in Rule 10b-10 under the Act; and

(E) "nationally recognized statistical rating organization" ("NRSRO") shall have the same meaning it does when used in Rule 15(c)(3)-1 under the Act.

(b) Information Required to be Disclosed

(1) *Debt security information*. Disclose the debt security's CUSIP,[1] and, if it is a TRACE-eligible security, the TRACE symbol of the debt security if one has been designated by NASD.

(2) *Brokerage charges*. Disclose in a text field labeled "brokerage charges" one of the following three statements if applicable:

(A) If the member acted as agent for the customer and received or will receive remuneration from the customer in connection with the transaction that would be required to be disclosed to the customer under Rule 10b-10 under the Act, "you paid a commission to our firm for its services";

(B) If the member acted as principal, purchased a debt security from the customer, and reduced the proceeds paid to the customer by a payment for its services, "the proceeds you received from the debt security you sold were reduced by a payment to our firm for its services"; or

(C) If the member acted as principal, sold a debt security to the customer, and incorporated a payment to the member in the price paid by the customer, "a payment to our firm for its services was incorporated in the price you paid for the debt security you purchased."

(3) *Credit rating.* If the debt security is rated by any NRSRO to which the member subscribes, disclose:

(A) the NRSRO; and

(B) the credit rating.

(4) *Indicators of marketability and liquidity*. Disclose whether transaction price information on the debt security is publicly available and if it is, that a customer may, if the debt security is a TRACE-eligible security, obtain such information at the Internet Web site *www.nasdbondinfo.com* for the customer's non-commercial use at no charge, or at other sources that provide such information.

1 The acronym, CUSIP, stands for Committee on Uniform Securities Identification Procedures. CUSIP numbers belong to Standard and Poor's, a division of the McGraw-Hill Companies, Inc. (S&P). S&P's CUSIP numbers are proprietary to S&P and are protected by copyright and other intellectual property laws. S&P licenses to NASD the use of the terms Committee on Uniform Securities Identification Procedures and CUSIP, which may not be copied or otherwise reproduced, repackaged, further transmitted, transferred, disseminated, redistributed or resold, or stored for subsequent use for any such purposes, in whole or in part, in any form or manner or by any means whatsoever, by any person without S&P's prior written consent.

(5) *Cash flow information*. For purchases only, disclose on a per debt security basis:

(A) The frequency of interest and principal payments;

(B) Yield to maturity, and, if the debt security is callable, whether the debt security is continuously callable or otherwise callable, and the next occurring call date and associated call price;

(C) For debt securities carrying a variable coupon rate, disclosure indicating that the coupon rate may vary and that the member will provide in writing additional information relating to the calculation of the debt security's interest and principal payments upon a written request from the customer that is sent not later than six months from the date of settlement. Members shall provide such additional information to any customer, except an institutional customer, within three business days of receiving the customer's request. Any such additional information shall contain:

(i) the amount of the next interest payment based on the current coupon rate,

(ii) a statement that this amount will change if the coupon rate changes,

(iii) how often the coupon rate may be recalculated,

(iv) an explanation of the event(s) that may trigger the recalculation, and

(v) the formula for recalculating such coupon rate;

and

(D) For purchases of debt securities that are callable and, at issue, are not structured to include scheduled interest payments (*e.g.*, "zero coupon bonds"), the compound accreted value as of the next occurring call date and whether the call price equals, exceeds, or is less than the compound accreted value as of the call date.

(6) *Notice of availability of NASD disclosure*. The following statement must appear in a clear and conspicuous manner in any disclosure provided pursuant to this paragraph (b), "A disclosure document discussing your rights as a bondholder and some of the risks related to buying and holding bonds, titled 'Important Information You Need to Know About Investing in Corporate Bonds,' has been prepared by NASD and is available online at *www.NASD.com*. A paper version of this document is available from your broker upon your written request made not later than six months from the date of settlement of your transaction." Members must provide the document, "Important Information You Need to Know About Investing in Corporate Bonds," to any customer, except an institutional customer, within three business days of receiving the customer's request. Members may access the current version of this document at NASD's Web site at *www.NASD.com* or obtain it from NASD.

ATTACHMENT B

Important Information You Need to Know about Investing in Corporate Bonds

This document is intended to provide you with some basic facts about the most common features of corporate bonds, and to alert you to some of the risks associated with buying, selling, and holding corporate bonds.

As with any investment, before buying a corporate bond, you should analyze the bond on its own merits, weighing its risks, costs, and rewards. Consult with your firm about any questions you may have about investing in a particular bond.

Corporate Bond Basics

What is a corporate bond?

Corporate bonds are, at their simplest, loans that investors make to public and private corporations. Consequently, bonds are referred to as **debt securities**. Corporations generally issue corporate bonds to raise money for capital expenditures, operations, and acquisitions.

Typically, bondholders receive interest payments during the term of a bond (or, for as long as a bondholder owns a bond), at the stated interest rate—also called the **coupon rate**. In addition, if bondholders hold bonds until **maturity**, they also are repaid the principal amount, called **par value** or **face amount**.

Bond Price and Yield

Price

If you sell a bond before it matures, you may not receive the full principal amount of the bond. This is because a bond's **price** is not based on the par value of the bond. Rather, it is set in the secondary market and is established by the current market values of such bonds, which may be more or less than the amount of principal the issuer would be required to pay the bondholder at maturity. Therefore, it is impossible to predict in advance the price that a bondholder will receive if the bondholder purchases a bond and later sells the bond before maturity.

The price of a bond is often above or below its par value because the price is adjusted according to current interest rates in the whole market for the same debt security and comparable debt securities. For example, if the bond you desire to purchase has a fixed interest rate of 8 percent, and similar quality new bonds available for sale have a fixed interest rate of 5 percent, you will have to pay more than the par amount of the bond that you intend to purchase, because you will receive more interest income than the current interest rate (5 percent) being attached to similar bonds.

Yield

Yield is the overall return on the capital you invest in the bond. Yield is similar to, but different from, a bond's interest rate. This distinction is important, because as is explained above, while a bond's face amount or par value is fixed, its market value almost always changes over time. Because bond prices fluctuate continually in the market, the yield your bond investment will provide if it is sold prior to maturity also changes constantly. *A bond's price is inversely related to its yield. As a bond's price increases, its associated yield decreases; as the price of a bond decreases, the associated yield increases.*

For example, a bond that sells today for $1,000 and has a coupon rate of 8 percent has a current yield of 8 percent. Because the "price" equals the face amount of the bond, the current yield of 8 percent equals the 8 percent fixed interest rate. However, usually after the first sale of a bond, the price of a bond differs from the face amount. For example, if the same bond sells tomorrow for $990, the current yield would be slightly higher than 8 percent.

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

Yield to maturity is calculated by taking into account the total amount of interest you will receive over time, your purchase price (the amount of capital you invested), the face amount (or other amount you will be paid when the issuer "redeems" the bond), the time between interest payments, and the time remaining until the bond matures.

If you hold a callable bond, another type of yield calculation, **yield to call**, also is important for you to understand. This calculation takes into account the impact on a bond's yield if it is called prior to maturity and is often done using the first date on which the issuer could call the bond. (Other call dates may be used in specified circumstances.) A bond's yield to call may be lower than its yield to maturity.

To get a more accurate picture of what a bond will cost you or what you received for it, you should also ask your broker to calculate the yield adjusting the purchase price up (when you purchase) or down (when you sell) by the amount of the mark-up or commission (when you purchase) or mark-down or commission (when you sell) and other fees or charges that you are charged by your broker for its services. This is called **yield reflecting broker compensation.**

Corporate Bond Risks

Like virtually all investments, corporate bonds carry risk. It is important that you fully understand the risks of investing in corporate bonds. These risks include:

Interest Rate Risk

When interest rates rise, bond prices fall, and when interest rates fall, bonds prices rise. Interest rate risk is the risk that changes in interest rates generally in the U.S. or the world economy may reduce (or increase) the market value of a bond you hold. Interest rate risk increases the longer that you hold a bond. For example, if interest rates rise throughout the economy, bond issuers, along with other borrowers, will need to offer potential bondholders higher rates to compete with the higher interest rates available elsewhere.

Any bonds issued in a period of rising interest rates generally will carry higher coupon rates, which will be more attractive to potential bondholders than the coupon rate paid by bonds issued before the rise in interest rates. This decreased appetite for older bonds that pay lower interest depresses their price in the secondary market, which would translate into your receiving a lower price for your bonds if you chose to resell them in a period of rising interest rates. The opposite holds true as well, and the market value of older bonds that pay higher than current interest rates tends to rise in periods where interest rates are generally declining.

Call and Reinvestment Risk

Bonds with a call provision can be redeemed or "called" by the bond issuers, requiring bondholders to redeem their bonds at the call price well before their maturity dates. Bonds often are called when market interest rates are falling, because bond issuers want to refinance their debt at lower interest rates (similar to when a home owner seeks to refinance a mortgage at a lower rate when mortgage interest rates decrease). This is known as **call risk**.

With a callable bond, a bondholder might not receive the bond's coupon rate for the entire term of the bond, and it might be difficult or impossible to find an equivalent investment paying rates as high as the called bond. This is known as **reinvestment risk**. Additionally, at any given point in time, the stream of a callable bond's cash flow is uncertain and any appreciation in the market value of the bond may not rise above the call price.

Refunding Risk and Sinking Funds Provisions

A **sinking fund provision**, which often is a term included in bonds issued by industrial and utility companies, requires a bond's issuer to retire a certain number of bonds periodically. This can be accomplished in a variety of ways, including through purchases in the secondary market or forced purchases directly from bondholders at a pre-determined price.

Holders of bonds subject to sinking fund redemptions should understand that they risk having their bonds called (or redeemed) prior to maturity. Unlike other bonds subject to call, depending on the sinking fund provision, there may be a relatively high likelihood that the the issuer will be able to redeem some or many of the bonds prior to maturity, even if market-wide interest rates do not change.

It is important to understand that there is no guarantee that an issuer of these bonds will be able to comply strictly with any redemption requirements. In certain cases, an issuer may need to borrow funds or issue additional debt to refinance an outstanding bond issue subject to a sinking fund provision when it matures. If the issuer is unable to raise adequate funds to refinance the outstanding issue, the bondholder may be faced with an issuer default and potential loss of principal.

Default and Credit Risk

If you ever loaned money to someone, chances are you gave some thought to the likelihood of being repaid. Some loans are riskier than others. The same is true when you invest in bonds. You are taking a risk that the issuer's promise to repay both principal and interest will be upheld. In the case of Treasuries and other government-issued bonds backed by the "full faith and credit of the U.S. government," that risk is almost zero. However, with most corporate bonds there is some risk of default. This means the corporations issuing them may either be late paying bondholders or—in worst-case scenarios—be unable to pay at all.

Bond ratings are a way of measuring default and credit risk. Five ratings agencies have been designated by the staff of the Securities and Exchange Commission to be a Nationally Recognized Statistical Rating Organization. They are A. M. Best, Dominion, Fitch, Moody's, and Standard & Poor's. These organizations review all information known about the issuer, especially all financial information, such as the issuer's financial statements and assign a rating—AAA (or Aaa) to D.

Generally, bonds are categorized in two broad categories—**investment grade** and **non-investment grade**. Bonds that are rated BBB (or Baa) or higher are considered investment grade. Bonds that are rated BB (or Ba) or lower are non-investment grade. Non-investment grade bonds are also referred to as **high-yield** or **junk bonds**, and in some cases, **distressed bonds**. These bonds are considered riskier investments because the issuer's general financial condition is less sound, and the issuer may default—(may not be able to pay the interest and principal to bondholders when they are due).

Many bondholders heavily weigh the rating of a particular corporate bond in determining if the corporate bond is an appropriate and suitable investment for them. Although credit ratings are an important indicator of creditworthiness, you should also consider that the value of the bond might change depending on changes in the company's business and profitability. The credit rating could be revised downward. In the worst scenario, corporate bankruptcy, holders of corporate bonds could suffer significant losses, including the loss of their entire investment. Finally, some bonds are not rated. In such cases, an individual bondholder may find it difficult to assess the overall creditworthiness of the issuer of the bond.

Liquidity Risk

You should determine whether the bond in which you are interested has traded frequently, infrequently, or not at all in recent months, and if your broker regularly buys and sells the bond. While certain bonds are very actively traded and are relatively "liquid," other bonds, including many high-yield bonds, are traded much less frequently or not at all and may not be easy to sell. If you think you might need to sell the bonds you are purchasing prior to their maturity, you should carefully consider the likelihood of your being able to do so, and whether your broker will be able and willing to assist you in liquidating your investment at a fair price reasonably related to then current market prices. It is possible that you may be able to re-sell a bond *only* at a heavy discount to the price you paid (loss of some principal) or not at all. Additionally, bonds that are less frequently traded may be subject to wider "spreads" in the secondary market, which means that you would receive less for your bond if selling, or pay more if buying, than otherwise would be the case.

Corporate Bonds with Special Features

It also is important to understand any special features a bond may have before you buy, since these features may affect risk.

Floating Rate Bonds

Floating-rate bonds have a floating or variable interest rate that is adjusted periodically, or **floats**, using an external value or measure (for example, the prime rate or a stock index). Such bonds offer protection against interest rate risk, but their coupon rate is usually lower than those of **fixed-rate bonds**.

Zero-Coupon Bonds

Zero-coupon bonds, unlike other bonds, don't make regular interest payments. Instead, the bondholder buys the bond at a discount from the face value of the bond, and, when the bond matures, the issuer repays the bondholder the face amount. The difference between the discounted amount the bondholder pays upon purchase and the face amount later received is the **imputed interest**. Because zero-coupon bonds don't pay any interest until maturity, their prices may be more volatile than other bonds with similar maturities that pay interest periodically.

Secured Bonds

Secured bonds are backed by collateral that the bond's issuer has agreed to sell if it otherwise is unable to meet its obligation when the bond matures. For example, a bond might be backed by a specific factory or industrial equipment. However, any such backing is only as good as the value of the asset being used as collateral, the value of which can decrease during the term of the bond.

Bonds that are not backed by any collateral are unsecured and are sometimes called **debentures**. Debentures are backed solely by an issuer's promise to repay you. Most corporate bonds are debentures.

Guaranteed and Insured Bonds

Certain bonds may be referred to as **guaranteed** or **insured**. This means that a third party has agreed to make the bond's interest and principal payments if the issuer is unable to make these payments. You should keep in mind that such guarantees only are as valuable as the creditworthiness of the third party making the guarantee or providing the insurance.

Convertible Bonds

Convertible bonds may be converted into the stock of the bond's issuer. A bondholder should be careful to understand the conditions under which the bonds may be converted, as this right often is contingent upon the issuer's stock reaching a certain price level, among other things. Bond investors also should ask their broker or financial adviser whether there is any charge or fee associated with making a conversion.

Junior or Subordinated Bonds

The more junior bonds issued by a company typically are referred to as **subordinated debt**, because a junior bondholder's claim for repayment of the principal of such bonds is subordinated to the claims of bondholders holding the issuer's more senior debt. Additionally, other types of claims also may have priority on the issuer's remaining assets over the claims of *all* bondholders (*e.g.*, certain supplier or customer claims). Therefore, although bondholders generally are paid prior to stockholders in a bankruptcy proceeding, this may offer little comfort if the issuer's assets are reduced to zero by other creditors that have the right to be paid before bondholders of a particular class of bonds.

Broker Compensation for Selling Bonds

No commission does not mean no charge.

You should understand that your broker is being compensated for performing services for you, even if you are not charged a **commission** when you buy or sell a bond. In most bond transactions, brokers are compensated, even though a commission charge is not disclosed, because the transaction is structured as a principal transaction (*i.e.*, your broker sells you a bond it already owns). This is because when a dealer sells you a bond in a principal capacity, the dealer increases or marks up the price you pay over the price the dealer paid to acquire the bond. The **mark-up** is the dealer's compensation and is similar to a commission. Similarly, if you sell a bond, a dealer will offer you a price that includes a **mark-down** from the price that the dealer believes he can sell the bond to another dealer or another buyer. Although the broker is not required under the federal securities laws or NASD rules to disclose the amount of the broker's mark-up or mark-down, you should understand that the firm has charged you a fee for its services.

Would a similar bond cost less?

Finally, it is important to consider the potential conflict of interest presented by the payments made to your broker. Bonds issued by different issuers often have very similar risk profiles and carry similar coupon rates. You should consider whether there are other bonds available with similar risk/return profiles that might be available at lower cost. You also should strive to understand how your broker is being compensated for any bond transaction, particularly those that are recommended to you where similar bonds may be available.