

Notice to Members

MAY 2006

SUGGESTED ROUTING

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

KEY TOPICS

Debt Securities
Operations
Rule 6200 Series
TRACE Rules
Transaction Reporting

REQUEST FOR COMMENT

Corporate Debt Securities

NASD Requests Comment on Publicly Disseminating in TRACE Information Whether a Transaction was an Inter-Dealer or a Dealer-Customer Transaction and, in Dealer-Customer Transactions, Whether the Broker-Dealer was a Buyer or Seller; **Comment Period Expires June 15, 2006**

Executive Summary

Currently, NASD members that are parties to a transaction in a TRACE-eligible security report several types of information to the Trade Reporting and Compliance Engine (TRACE) system. Among other things, for each transaction, the member reports that it is a buyer (Buyer) or a seller (Seller) (Buy/Sell information) and the member's counterparty is another broker-dealer (Dealer) or a customer (Customer) (Customer/Dealer information). The Buy/Sell and Customer/Dealer information is not currently disseminated. NASD requests comment on publicly disseminating the Buy/Sell information and the Customer/Dealer information.

Action Requested

NASD encourages all interested parties to comment on this proposal. Comments must be received by June 15, 2006. Members and interested persons can submit their comments using the following methods:

- ◆ Mail comments in hard copy to the address on the address below; or
- ◆ Email written comments to pubcom@nasd.com.

06-22

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, D.C. 20006-1506

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 (or certain policies) must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.²

Questions/Further Information

As noted above, hard-copy comment should be mailed to Barbara Z. Sweeney. Questions regarding this *Notice* may be directed to Elliot Levine, Chief Counsel, Transparency Services, Markets, Services and Information (MSI), at (202) 728-8405; David H. Lefferts, Vice President, Transparency Services, MSI, at (212) 858-4389; or Sharon K. Zackula, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8985.

Background and Discussion

Currently, NASD publicly disseminates the following information for each transaction in a TRACE-eligible security that is required to be disseminated under TRACE Rule 6250: the bond identifier (e.g., the TRACE symbol), the price inclusive of any mark-up, mark-down or commission, the quantity (expressed as the total par value),³ the yield, the time of execution and, if the transaction was executed on a day other than when the information is being disseminated, the actual day of execution of the transaction. For inter-dealer (Dealer) trades, NASD receives a TRACE report from each member, but disseminates the sell side only; for dealer-customer (Customer) trades, NASD receives only one TRACE report (from the member) and disseminates information from that TRACE report, which may be either of a dealer's buy from a customer (Buy) or a dealer's sale to a customer (Sell).

NASD is proposing that the Buy/Sell information and Customer/Dealer information (but not the MPID or identity of the dealer) be disseminated publicly for each transaction because dealers and investors need it to compare prices. Investors also need it to request better, lower prices (*i.e.*, prices including mark-ups (or mark-downs) and commissions). In addition, dealers require it to aid them in complying with a dealer's best execution obligations under Rule 2320 and the fair and reasonable mark-up/mark-down requirements under Rule 2440 and other provisions of the federal securities laws.⁴

Under current law and NASD's proposed debt mark-up interpretation (Proposed Debt Mark-Up Interpretation or Proposal),⁵ when a dealer is pricing, or determining mark-ups (or mark-downs) by referring to last-sale transaction prices other than the dealer's own price, a dealer must be able to determine if the trade was an inter-dealer trade representing an arms-length negotiation between two market professionals, or a trade between a dealer and a customer, and to identify which side the dealer price reflected when engaging in a Customer or a Dealer transaction.⁶ Disseminating the Buy/Sell and Customer/Dealer information would allow dealers to more accurately identify the type of pricing information disseminated by TRACE, and would permit them to use the information for mark-up (or mark-down) and best execution determinations.

Currently, the TRACE price disseminated is an "all-in" price that includes, if it is a principal trade with a customer, a mark-up (or a mark-down) and, if it is an agency trade with a customer, a commission. As noted above, a TRACE data user cannot readily identify those transactions reflecting *inter-dealer prices* (generally considered the most reliable measure of the prevailing market price of a security after dealer's contemporaneous cost) for mark-up (or mark-down) purposes, because inter-dealer prices are intermingled with dealer-customer prices. Adding the Customer/Dealer information would solve this problem and make inter-dealer pricing clearly identifiable for mark-up (or mark-down) and best execution purposes.

In addition, given the limited frequency of transactions in certain sectors of the debt markets, including the corporate debt sector, the need to understand whether each of the prices that is available reflects Dealer or Customer prices and which side of the market the dealer stood on the trade is even more crucial. The Buy/Sell information, combined with the Customer information, makes clear that the disseminated price includes a mark-down or a commission (*i.e.*, the dealer was a buyer or facilitating finding a buyer) or the disseminated price includes a mark-up or a commission (*i.e.*, the dealer was a seller or facilitating finding a seller). Given both Customer/Dealer and Buy/Sell information, TRACE data users, whether dealers or customers, will be able to knowledgeably assess and compare the disseminated "all-in price" of their purchases and sales with other customer transactions. In addition, dealers will be able to determine approximate levels of inter-dealer pricing by "backing out" of a disseminated all-in price clearly labeled as a Customer transaction, a mark-up (or mark-down) or commission amount if inter-dealer pricing is not available in TRACE for both mark-up and best execution purposes.

The MSRB determined that disseminating the Buy/Sell and Customer/Dealer information was an important part of providing transparency in the municipal securities market. The MSRB currently disseminates both Buy/Sell and Customer/Dealer information real-time together with other price, quantity and yield information per transaction.⁷

In April 2005, a commenter on the Proposed Debt Mark-Up Interpretation highlighted the deficiencies in TRACE, noting that TRACE data does not differentiate between Customer and Dealer transactions, thus making the identification of inter-dealer pricing difficult.⁸ (In the absence of applicable contemporaneous transactions, inter-dealer pricing is a highly reliable indicator of the prevailing market price of a security.) In October 2005, in NASD's response to the comments on the Proposal, NASD indicated that NASD was "evaluating enhancing the quality of disseminated TRACE information to show, for each trade, whether the trade is inter-dealer or customer, as is now indicated in real-time disseminated municipal securities transaction data."⁹

Over a two-and-one-half-year period, NASD staff has received many comments from dealers requesting that indicators distinguishing Customer and Dealer and Buy and Sell transactions be added to the publicly disseminated TRACE data to assist firms in their pricing and their mark-up analyses. In many instances, these comments arose in the context of NASD seminars for members on debt mark-ups. In addition, at public events and industry conferences, both NASD staff and SEC staff have indicated that debt mark-ups are an area of regulatory concern and focus. In this regard, in 2005, member firm personnel attending NASD debt mark-up seminars expressed concern that NASD was *delaying* the implementation of the dissemination of Customer/Dealer and Buy/Sell information beyond 2005, given NASD's and SEC's regulatory focus on debt securities pricing and debt mark-ups.

In contrast, NASD recently received comments from The Bond Market Association on behalf of various dealers and members of its Asset Managers' Forum stating that the dissemination of the Buy/Sell and Customer/Dealer information raises concerns among large dealers and some large institutional customers. They believe that such dissemination may permit market participants to identify and reverse-engineer their trading strategies, especially in illiquid TRACE-eligible securities.

NASD seeks input from members, other market participants and the public regarding the efficiencies, benefits and costs to the market, market participants and all TRACE data users of adding the Customer/Dealer and Buy/Sell information; the regulatory costs and benefits of adding such information for all members subject to regulatory review for fair debt mark-ups and best execution; and all other benefits and costs to members, non-members and the public.

Endnotes

- 1 See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or email addresses, will not be edited from submissions. Submit only information that you wish to make publicly available.
- 2 Section 19 of the Securities Exchange Act of 1934 (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 the rules thereunder.
- 3 If a transaction in a TRACE-eligible security is Investment Grade and exceeds \$5 million, or is Non-Investment Grade and exceeds \$1 million, the quantities disseminated are, respectively, \$5 million and \$1 million, followed by an "E," indicating that the volume figure is estimated.
- 4 An excessive or unreasonable mark-up/mark-down is a violation of Rule 2110, Rule 2440, IM-2440 (except in connection with municipal securities) and, in some cases, Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder. For transactions in municipal securities, mark-ups (or mark-downs) and other fair pricing issues are analyzed under Municipal Securities Rulemaking Board (MSRB) Rule G-30, Rule G-18 and Rule G-17, and, in some cases, Section 10(b) of the Exchange Act and Rule 10b-5.
- 5 See File No. SR-NASD-2003-141, filed September 17, 2003, and amendments thereto.
- 6 Under current law and the pending Proposal, a dealer must mark-up a transaction from the prevailing market price. The dealer's contemporaneous cost is presumed to be the most reliable indicator of the prevailing market price unless the dealer has no contemporaneous transaction(s) or can show that the dealer's contemporaneous cost is not indicative of the prevailing market price.

When the dealer has no such costs or certain events have occurred, the Proposal lists several categories of information containing pricing information (factors) that the dealer must consider to identify prevailing market price and to calculate the dealer's mark-up (or mark-down). TRACE is the source of most or all of the last-sale pricing information available for corporate bonds, and when a dealer looks to pricing information other than the dealer's own, TRACE should be the richest source of reliable data. When reviewing the TRACE data, it is important for the dealer to be able to identify Buy/Sell and Customer/Dealer information as part of the analytical process of determining if the dealer's cost remains contemporaneous or is stale, and to judge the applicability of the following factors containing reference prices or yields:

- (1) Inter-dealer prices – Customer/Dealer information is needed to identify Dealer transactions in TRACE (under current law, dealers are required to analyze this type of pricing information when the dealer's contemporaneous cost is not considered to be indicative of prevailing market price);
- (2) Prices of contemporaneous dealer purchases (sales) in the security in question from (to) certain institutional accounts as defined in the Proposal – Customer/Dealer and Buy/Sell information would assist significantly in identifying these trades and side of market;
- (3) Prices of contemporaneous inter-dealer transactions in similar securities as described in the Proposal – Customer/ Dealer information is required (under current law, it may be necessary for dealers to analyze this type of pricing information in certain instances);
- (4) Prices of contemporaneous dealer purchase (sale) transactions in similar securities with certain institutional accounts – Customer/ Dealer and Buy/Sell information is required;

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- (5) Yield calculated from prices of contemporaneous inter-dealer transactions in similar securities – Customer/Dealer information is required; and
 - (6) Yield calculated from prices of contemporaneous dealer purchase (sale) transactions in similar securities with certain institutional accounts – Customer/Dealer and Buy/Sell information is required.

In addition, in many cases under the Proposal and in current practice, a dealer refers to transactions in similar securities, and, under the Proposal, a dealer must know side of market (Buy/Sell information) to determine the relative comparability of a transaction in a similar security to the transaction that is being marked.

- 7 Disseminated municipal securities transaction prices, like TRACE-disseminated prices, are “all-in prices.”
- 8 Letter from The Bond Market Association (regarding File No. SR-NASD-2003-141), to Jonathon G. Katz, Secretary, SEC, dated April 5, 2005, p. 13 (“[T]he NASD’s TRACE system does not differentiate between inter-dealer trades and customer trades in its disseminated reports, making the identification of an inter-dealer trade difficult.”).
- 9 Response to Comments on Additional Mark-Up Policy for Transactions in Debt Securities (regarding File No. SR-NASD-2003-141), to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated October 4, 2005, p. 13.