

December 29, 2003

BY ELECTRONIC MAIL AND HAND DELIVERY

Ms. Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: **Amendment No. 2 and Response to Comments to File No. SR-NASD-2003-157** – Permanent Approval of Fees for the Trade Reporting and Compliance Engine (“TRACE”)

Dear Ms. England:

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC”) this Amendment No. 2 and response to comments to SR-NASD-2003-157 (the “Rule Filing”), which seeks permanent approval of the TRACE fee structure prior to the expiration of the pilot program for fees on January 31, 2004.¹ The TRACE facility provides for the reporting of transactions and dissemination of transaction information in certain corporate debt securities designated as “TRACE-eligible securities” as provided in the Rule 6200 Series (or “TRACE rules”).²

¹ Exchange Act Release No 34-48714 (October 29, 2003), 68 FR 62483(November 4, 2003), File No. SR-NASD-2003-157.

² The Commission approved the Rule 6200 Series on January 23, 2001. See SR-NASD-99-65 and Amendments No. 1 through 4 thereto, approved in Securities Exchange Act Release No. 43873 (January 23, 2001), 66 FR 811 (January 29, 2001) (“TRACE Approval Order”).

I. Response to Comments

NASD received two comment letters on SR-NASD-2003-157.³ The comments raised several issues. NASD's response is set forth below.

Costs and Revenues of TRACE

In its comment letter, The Bond Market Association ("TBMA") raised concern with the revenues generated by, and the costs relating to, the operation and development of TRACE. At the outset, it is important to note that NASD is a not-for-profit association, owned by its members and dedicated to focusing on its primary mission of regulating markets and members. NASD's objective in operating TRACE is primarily regulatory in nature - to protect investors and ensure efficient markets. NASD is committed to operating TRACE in a fiscally prudent manner that will ensure a cash flow which enables NASD to continue to invest in the TRACE system and regulation of the fixed income market. NASD has no profit motivation in operating TRACE.

Since 1998 when former SEC Chairman Arthur Levitt requested that NASD develop a system to increase transparency in, and surveillance of, the corporate debt market, NASD has been working to develop and launch the TRACE system. TRACE became effective on July 1, 2002. NASD has worked extensively with the industry, including representatives of TBMA to develop and implement the TRACE system. In addition, NASD established the Bond Transaction Reporting Committee ("BTRC"), one-half of whose members were proposed by TBMA, to provide recommendations to the NASD Board of Governors regarding dissemination of TRACE data.

On June 28, 2002, the SEC approved proposed NASD fees relating to the operation of the TRACE system on a pilot basis.⁴ Through subsequent rule filings with the SEC, the pilot has been extended and is scheduled to expire on January 31, 2004. During this pilot period, in an effort to make the initial fee structure even more fair and

³ Comment letter from Michele C. David, Vice President and Assistant General Counsel, The Bond Market Association, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated November 25, 2003 ("TBMA Comment Letter"); and comment letter from Rene L. Robert, President and CEO, Advantage Data, Inc., to Secretary, Securities and Exchange Commission, dated November 20, 2003 ("Advantage Data Comment Letter" and together with the TBMA Comment Letter, the "Comment Letters").

⁴ The Commission approved Rule 7010(k) relating to TRACE fees on June 28, 2002 on a pilot basis. See Securities and Exchange Act Release No. 45145 (June 28, 2002), 67 FR 44911 (July 5, 2002), File No. SR-NASD-2002-63.

reasonable to members, NASD submitted four rule filings with the SEC to reduce both Transaction Reporting Fees and System Fees to reflect actual usage of the new system.⁵

The development and operation of TRACE has been a tremendous undertaking by NASD and has required significant investment and resource allocation. Levels of trade reporting activity have been 82% higher than anticipated in the pre-launch 2002 forecast prepared by NASD, with TRACE currently processing approximately 28,000 trades per day. In addition, approximately 1,900 NASD member firms have registered for TRACE reporting, over 29,000 corporate debt issues are subject to TRACE reporting requirements, and approximately 4,900 corporate bonds are eligible for dissemination. All of this information must be monitored by NASD for accuracy and regulatory surveillance of the corporate bond market.

The pre-launch 2002 forecast used by NASD in the original May 2002 rule filing⁶, which included investment cost and anticipated operating expenses, was based on estimates of activity levels gathered in late 2001 and NASD's expectation of the level of service required to effectively meet the needs of the marketplace indicated through conversations with members and other market participants and vendors as of early 2002. TRACE reporting activity has been 82% higher than was originally anticipated and the service needs of participants and media have been significantly greater than anticipated.

First, NASD did not anticipate the current level of demand for generating data for analysis by the BTRC, detailed activity reports for participating members, and aggregate statistics for media outlets. As a result, NASD has had to embark on data management initiatives to improve its capabilities in these areas at additional cost to NASD.

Second, as noted in the Rule Filing, member requests for system enhancements have resulted in NASD releasing 2 major and 5 minor technology upgrades over the first twelve months of operation. NASD is committed to making on-going investments in technology to ensure that the TRACE system is current and responsive to investor and member needs and has implemented one major upgrade since the Rule Filing. NASD believes that its continued investment in technology will provide long-term benefits to members, investors and other users of the TRACE system by providing more efficient and reliable reporting and data retrieval systems.

⁵ See Securities Exchange Act Release No. 46893 (November 22, 2002), 67 FR 72008 (December 3, 2002) (File No. SR-NASD-2002-167); Securities Exchange Act Release No. 47056 (December 19, 2002), 67 FR 79205 (December 27, 2002) (File No. SR-NASD-2002-176); Securities Exchange Act Release No. 47444 (March 4, 2003), 68 FR 11602 (March 11, 2003) (File No. SR-NASD-2003-25); and Securities Exchange Act Release No. 48110 (July 7, 2003), 68 FR 40315 (June 30, 2003) (File No. SR-NASD-2003-97).

⁶ Exchange Act Release No. 34-45960 (May 17, 2002), 67 FR 36654 (May 24, 2002), File No. SR-NASD-2002-63.

All totaled, these differences in activity levels and support demands have contributed significantly to the current levels of expenditure. Although NASD experienced an 82% increase in reporting activity over the pre-launch 2002 forecast, operating expenses grew at a slower pace of 60%. For the first twelve months of operation (period ending June 30, 2003), TRACE expenses were approximately \$12.4 million. This was comprised of \$9.8 million in operating expenses plus an accrual for the recovery of original investment of \$2.6 million (based on a four year recovery of the investment and an appropriate cost of capital). There was a modest 11% or \$800 thousand increase in the investment costs over the pre-launch 2002 forecast (from an estimated \$7.2 million to an actual of \$8.0 million) as the result of launch cost and final development cost unavailable at the time the original estimate was compiled.

As noted in the Rule Filing, for the first twelve months of operation (period ending June 30, 2003), TRACE generated revenues of approximately \$12.4 million reflecting approximately \$2.0 million, \$8.9 million, and \$1.5 million for System Fees, Transaction Reporting Fees, and Market Data Fees, respectively. In line with (but with a slower growth rate) the experience in actual trade reporting activity levels, aggregate revenue was 70% higher than included in the pre-launch 2002 forecast.

NASD has reduced System Fees and Transaction Reporting Fees four times over the last 15 months, and is proposing additional reductions as part of this permanent fee rule filing. Members may select several methods to report TRACE transaction data, each with a different fee, based on their needs and usage. Transaction Reporting Fees are also based on a sliding scale to ensure that the fees are fairly allocated among members.

Over the past fifteen months, NASD has demonstrated its strong commitment to seek ways to minimize industry costs for reporting their trades and operating the overall system. NASD will continue to assess the TRACE fee structure to ensure that the fees remain reasonable.⁷

NASD believes the proposed fees for TRACE are reasonable and non-discriminatory. Further, NASD believes the proposed fees have been reasonably allocated, based on total TRACE revenues annually. This allocation is based on NASD's costs to develop and operate the system, maintain the system and database, and engage in oversight of the fixed income market.

⁷ As part of its regular assessment of TRACE fees, NASD anticipates reducing transaction charges for TRACE bonds at least once in 2004. In addition to the factors that it considers as part of its regular assessment, NASD anticipates considering the overall financial effect on TRACE participants of any new NASD fees such as the Trading Activity Fee.

Proposed Charges for BTDS Professional Delayed-Time Data Display Fee

The Advantage Data Comment Letter, questions the appropriateness of NASD fees for delayed-time TRACE transaction data.⁸ In this Rule Filing, NASD proposes to charge a fee of \$15 per month, per user ID, for subscribers to Delayed-Time TRACE transaction data (as such term is defined in the Rule Filing). Advantage Data asserts that a charge for delayed data is unreasonable as a matter of principle. Based on its experience with TRACE, as well as its extensive experience overseeing and monitoring the principle market for virtually all corporate bonds, the OTC market, NASD believes that the proposed fee for Delayed-Time TRACE transaction data for professionals is appropriate. In addition, professional participants in the TRACE system have stated to NASD staff that Delayed-Time data is valuable to the bond market for pricing thinly traded bonds, spotting trends, and creating derivative products. Professional subscribers to Real-Time TRACE transaction data (as such term is defined in the Rule Filing) will not also be charged for Delayed-Time data. In addition, NASD continues to provide Real-Time TRACE transaction data to non-professionals for \$1.00 per month, per user ID. Delayed-Time TRACE transaction data will continue to be provided at no charge to non-professionals and professionals will continue not be charged for delayed data that is received after 11:59:59 p.m. Eastern Time of the same calendar day in which the transactions are reported and disseminated.

NASD believes that the proposed BTDS Professional Delayed-Time Data Display Fee leads to a more equitable allocation of market data fees among TRACE participants. Due to the nature of the corporate bond market, such Delayed-Time TRACE transaction data continues to be valuable to members. Members who use Delayed-Time TRACE transaction data should bear some costs for the TRACE system.

Implementing Pilot Program for BTDS Professional Delayed-Time Data Display Fee

In recognition of the fact that the BTDS Professional Delayed-Time Data Display Fee is new, NASD hereby amends the proposed rule change to provide that the proposed BTDS Professional Delayed-Time Data Display Fee will operate as a nine-month pilot program, to end October 31, 2004 if the Rule Filing is approved by the SEC on or before January 31, 2004, or if the Rule Filing is approved after January 31, 2004, such date that is the last calendar day of the month that is nine months thereafter. At the end of the nine-month period, the pilot program relating to the BTDS Professional Delayed-Time Data

⁸ The Advantage Data Comment Letter raised several other concerns relating to the TRACE system, including specifically the use of CUSIP numbers in TRACE, Nasdaq's management of TRACE, and ownership of derived data. NASD has addressed these concerns in prior rule filings and, therefore, is not addressing them herein. See Securities and Exchange Act Release No. 43873 (January 23, 2001), 66 FR 8131 (January 29, 2001), File No. SR-NASD-99-65; and Securities and Exchange Act Release No. 47302 (January 31, 2003), 68 FR 6233 (February 6, 2003), File No. SR-NASD-2002-174.

Display Fee will terminate unless NASD seeks and obtains SEC approval to extend or permanently adopt the proposal, or proposes a revised fee for approval. In evaluating whether to seek amendment, extension, or approval of the proposed BTDS Professional Delayed-Time Data Display Fee, NASD will review its experiences with the proposed rule change during the nine-month period of the pilot program.

Accordingly, NASD amends the language of the proposed Rule 7010(k) to add the following text. New text is underlined.

7010(k)(3) Market Data Fees

(A)(ii). For a pilot period commencing [insert the date of the SEC's approval order] and lasting until October 31, 2004 [or if the SEC's approval order is after January 31, 2004, insert date that is the last calendar day of the month that is nine months after the date of such approval order].

BTDS Professional Delayed-Time Data Display Fee of \$15 per month, per terminal charge for each interrogation or display device receiving Delayed-Time TRACE transaction data; provided, that subscribers to the BTDS Professional Real-Time Data Display Fee described above shall not be charged this additional fee. Subject to the execution of appropriate agreements with NASD, certain summary market information of Delayed-Time TRACE transaction data may be published or distributed by newspapers, press associations, newsletters, or similar media sources without charge.

II. Accelerated Approval of Amendment No. 2

NASD requests that the Commission find good cause pursuant to Section 19(b)(2) of the Securities Exchange Act of 1934 to approve proposed Amendment No. 2 prior to the 30th day after publication in the Federal Register. Although not previously published, the proposed rule change responds to comments and proposes to adopt a pilot status for the TRACE BTDS Professional Delayed-Time Data Display Fee.

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If you have any questions, please call Kosha K. Dalal, NASD, Regulatory Policy and Oversight, Office of the General Counsel, at (202) 728-6903; e-mail kosha.dalal@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

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