

BY HAND

January 5, 2001

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: File No. SR-NASD-99-65
Proposal to Require Reporting and Dissemination
of Fixed Income Transactions (TRACE)
Response to Comments

Dear Ms. England:

Pursuant to Rule 19b-4, the National Association of Securities Dealers, Inc. ("NASD" or "Association") is filing this letter to respond to comments after the publication of Amendment Nos. 2 and 3 of SR-NASD-99-65.

Comments Regarding Competitive Issues.

Several commenters suggested in a variety of ways that the proposal imposes a burden on competition not justified in furtherance of the purposes of the Securities Exchange Act of 1934 ("Exchange Act"). Among other things, commenters suggested that: (1) the proposal gives the NASD a "monopoly" on the collection and dissemination of bond data; (2) as a result, the fees the NASD will charge, while subject to SEC oversight, will inevitably involve inflated cost estimates and cross-subsidization of the stock market business of The Nasdaq Stock Market, Inc. ("Nasdaq") and NASD's regulatory program; (3) at a minimum, the NASD should commit to data sale revenue sharing with the dealers, and allow The Bond Market Association ("TBMA") to have rights in historical data; and (4) the Commission should wait until the SEC Advisory Committee on Market Information ("Market Information Committee") has come to its conclusion before moving ahead with the fixed income reporting and dissemination proposal (currently referred to as "TRACE").

The Association firmly believes that the proposal imposes no burden on competition not necessary in furtherance of the purposes of the Exchange Act. First, the proposal in fact does not give the NASD a monopoly over data collection. The proposed rules continue not to specify or in any way limit the means by which members may report trades to the NASD, and thus allow

members to submit required trade reports directly to the NASD over Computer To Computer Interface ("CTCI") or the Internet, or indirectly through vendors or other entities, who in turn have links into the NASD. *See* proposed Rule 6230(a)(1)(B).

Second, the NASD will not sell unconsolidated data at all and will not compete in the market for the resale of consolidate data. In this connection, it is important to note that, unlike for reported equities, there is no rule that restricts dealers' abilities to disseminate their own data for sale to anyone to whom they choose to disseminate, including vendors (*see* Exchange Act Rule 11Ac1-1(c)(4) for reported equities), and there is no rule requiring that vendors sell consolidated data in addition to unconsolidated data (*see* Exchange Act Rule 11Ac1-2(b)(2) for reported equities). In recognition of the limited role the Association will play and seek to play in the future, the NASD is no longer seeking registration as the exclusive processor of these bond transaction reports.

Third, the Exchange Act requires the NASD to submit proposed TRACE fees to the Commission for approval. In reviewing a fee proposal, the Commission must determine if the proposed fees are fair and reasonable, and in this connection may insist upon a full cost accounting. The statute, in other words, specifically contemplates the type of fee setting and Commission review thereof contemplated here. While the commenters suggest that Commission review of proposed TRACE fees will be problematic, they have not presented any arguments or data indicating why the established statutory scheme for review of any fee proposals in connection with TRACE will not operate as contemplated and as well as it has in the equities context.

While some commenters suggest that the NASD will find a way to subsidize Nasdaq's non-TRACE costs through these fees, these commenters ignore the fact that Nasdaq's sole remaining role is to operate the TRACE computers, which will be owned by the NASD, so that Nasdaq will have absolutely no role in setting TRACE fees. Such commenters also totally discount the Commission's ability to fully and fairly assess the information concerning costs that the NASD will provide to the Commission in support of any TRACE-related fee proposal. As the rule filing points out, the NASD *does* expect to recover partially the NASD's cost of regulating the bond markets through TRACE fees, which the Commission has indicated is an entirely appropriate basis for setting market data fees. Like the Commission, the NASD believes it is inaccurate to characterize any such regulatory cost recovery as a "cross-subsidization" of regulation because regulation contributes directly to the integrity and reliability, and, therefore, to the value, of market data. Finally, the NASD notes that the proposal does not in fact seek to establish any fees. Any fee proposal would be filed with the Commission, subject to comment, and subject to approval by the Commission under the relevant statutory standard.

Some commenters suggested that the NASD wait until the Market Information Committee completes its work with respect to equity market data before the NASD moves forward with the proposal. As discussed above, the NASD believes that the proposal imposes no burden on competition not necessary in furtherance of the purposes of the Exchange Act.

Moreover, should the Market Information Committee develop a market-driven approach to equities market data that can be applied to bond market data, as the NASD indicates in Amendment No. 4, the NASD intends to cease functioning as a consolidated information disseminator and limit its role to bond market regulation.

In sum, the amended proposal allows for competition in the collection of bond data and limits the NASD's role to those functions necessary to provide for consolidated bond market trade reports, or specifically to: (1) collecting trade reports directly from only those members that choose to report directly to the NASD; (2) consolidating trade reports for regulatory purposes; and, (3) disseminating the consolidated data to broker-dealers and to those seeking to compete in the resale of these data, with the NASD not competing in the resale market. Any fees the NASD seeks to impose for performing these functions will be subject to SEC review and approval under the standards set forth for these purposes under Sections 11A and 15A of the Exchange Act. Most importantly, the NASD intends to withdraw completely from the real-time dissemination function, and to limit its role to receiving bond transaction data for regulatory purposes only, as soon as a practicable, market-driven, system for processing and disseminating a reliable and uniform consolidated stream of bond trading data can be developed. Until such a system is developed and ready to be implemented, the NASD believes that our proposal represents in fact the least anti-competitive approach to producing consolidated bond data that is reliable enough for public dissemination in the near term.¹

Comments Regarding Operational Issues.

The Association received a number of comments relating to the technological and operational issues that relate to TRACE or upon which TRACE-mandated changes may have an impact. The commenters generally suggested that the industry should not be required to file duplicate clearing reports with the NASD. The commenters also stated that the industry should not be required to make systems, technical, operational or other changes related to TRACE beyond those required to support reporting within one-hour of a trade if such changes would impede the industry's efforts in achieving the clearance and settlement of a transaction one day after the trade is executed ("T + 1") or within an even shorter period ("straight-through processing" or "STP"). Instead, the commenters stated that the NASD should integrate its TRACE-related changes with those being developed to achieve T + 1, and should build upon those requirements, systems and operational links already in place in the fixed income markets and used by market participants, rather than create redundant or duplicative requirements and require the industry to create redundant systems and linkages.

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As at least one commenter points out, the statute does not require that the NASD's proposal reflect the least anti-competitive approach, but rather requires that the proposal impose no burden on competition not necessary or appropriate in furtherance of the purposes of the Act. See letter from Bloomberg L.P. to Jonathan Katz, dated December 22, 2000, p. 4. Nonetheless, the NASD believes, for the reasons stated above, that our proposal not only satisfies the statutory test but also in fact represents, under current circumstances, the least anti-competitive approach to achieving reliable consolidated corporate bond transaction information dissemination.

Fifteen Minute Reporting Period. In Amendment No. 2, the NASD stated its intent to reduce the period for reporting a transaction from 1 hour to 15 minutes three months after the start of Phase II, “subject to the ability of firms to comply technologically and operationally.” (This would occur six months from the start of Phase I of TRACE.) Several commenters noted that reducing the reporting period to 15 minutes would require technological and operational changes that would overlap with, but not add any efficiencies to, the industry’s efforts to begin the processing of a trade immediately upon execution in order to accomplish T + 1 clearance and settlement. (The infrastructure needed to achieve T + 1 post-trade processing could be used to accomplish transaction reporting within a period of less than 15 minutes.)

As noted in Amendment No. 4, the NASD did not actually propose in Amendment No. 2, and is not now proposing, 15 minute reporting. Rather, we are proposing only that the transaction reports be submitted within one hour of a trade. Any proposal to move to 15 minute reporting, either as a part of T+1 initiatives or otherwise, would have to be filed separately with the Commission, published for comment, and then approved by the Commission if it can determine that it is consistent with the Exchange Act. Thus, at this time, it is neither necessary nor appropriate for the NASD to respond to comments specifically objecting to a 15 minute reporting period.

Registered Clearing Agency Data Forwarded to NASD. In Amendment No. 2, the NASD proposed that a member would provide to the NASD the same data on TRACE-eligible securities transactions that the member provided to its registered clearing agency, within the same time frame, and to the extent possible, in the same format. The commenters objected to the additional regulatory burden set forth in proposed Rule 6231 because it would require a firm to proceed with two rather than one development efforts to comply with the TRACE rules. Some commenters indicated that it would be less burdensome to change Rule 6230 to require that both the buy- and sell-sides of a transaction report a transaction to the NASD (“dual trade reporting”) if the NASD believed that such information was necessary to create an audit trail for market surveillance purposes.

In response to such comments, the NASD proposed to delete the requirement that had been set forth in proposed Rule 6231. Instead, in order to preserve the integrity of the data stream, the NASD has filed, concurrently with the filing of Amendment No. 4, a separate rule filing in which the NASD requests that the Commission approve a rule change that would require dual trade reporting. The rule filing will be published for notice and comment. See SR-NASD-01-04.

The NASD Should Integrate TRACE Requirements with T + 1 Industry Efforts And Not Require Duplicative Systems, Linkages, or Other Infrastructure. Several commenters urged the NASD to work to ensure that TRACE mandates would fit within ongoing industry efforts to consolidate and expedite all post-trade processing functions across all fixed income markets. The industry noted that, ultimately, T + 1 will allow for global data transmission, and requested that the NASD and the Commission not adopt TRACE rules and mandates that would hinder,

duplicate, or impose unnecessary costs or systems burdens on, such efforts. In addition, the commenters also asked that the NASD align the timetable for TRACE with the timetable for implementation of the industry's preferred model for post-trade processing across all markets. The commenters urged the NASD to work with various industry committees so that uniform, rather than duplicative processes, processing structures, and formats, would be developed and implemented to fulfill TRACE mandates and, as implemented later, to achieve operational changes needed in other post-trade processing functions to implement T + 1.

In response to the comments, the NASD has, as noted above, determined that any consideration to shorten the currently proposed one hour reporting period must be vetted with the industry and the public through an additional rule filing. In developing any such proposal, the Association will give substantial weight to the industry's timeline for implementing T+1. In addition, throughout the extended period prior to and after the rule filing during which TRACE has been discussed, the NASD has consulted continuously with registered clearing agencies, other self-regulatory organizations, other organizations currently involved in the collection and dissemination of market data, and various industry associations about the operational aspects of the proposal, including various issues that overlap with T + 1 industry efforts. NASD has considered T + 1 operational issues carefully in proposing TRACE, and the Association will continue to ensure that its systems remain flexible and capable of being quickly and efficiently adapted to later developed standards and protocols.

Other Comments.

Bond Transaction Reporting Committee. The NASD received certain comments on the composition of the Bond Transaction Reporting Committee ("BTRC"). In Amendment No. 2, the NASD described the BTRC and provided other background about the BTRC for informational purposes. However, the existence of the BTRC, its role, and its composition are not technically part of the rules for which the NASD seeks the Commission's formal approval. Thus, the NASD does not believe it is necessary or appropriate to respond to comments concerning this internal NASD matter.

Optional Clearing Function. Several commenters indicated that the NASD should not be allowed to compare fixed income securities transactions, even if the comparison function was a voluntary or optional feature of TRACE. The NASD is not currently proposing to engage in comparison. If the NASD determines to offer comparison services at a later date, the NASD would be required to file a rule filing with the SEC, which would be subject to notice and comment. Thus, at this time, it is neither necessary nor appropriate for the NASD to respond to comments about offering voluntary comparison.

If you have any question concerning the above, please call Sharon Zackula, Office of General Counsel, NASD Regulation at 202-728-8985; email-sharon.zackula@nasd.com.

Sincerely,

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