

OMB APPROVAL

OMB Number: 3235-0045
Expires: June 30, 2007
Estimated average burden
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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No. SR - 2007 - 007

Amendment No.

Proposed Rule Change by Financial Industry Regulatory Authority

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial ☒ Amendment ☐ Withdrawal ☐

Section 19(b)(2) ☒ Section 19(b)(3)(A) ☐ Section 19(b)(3)(B) ☐

Rule

Pilot ☐ Extension of Time Period
for Commission Action ☐ Date Expires

☐ 19b-4(f)(1) ☐ 19b-4(f)(4)
☐ 19b-4(f)(2) ☐ 19b-4(f)(5)
☐ 19b-4(f)(3) ☐ 19b-4(f)(6)

Exhibit 2 Sent As Paper Document ☐Exhibit 3 Sent As Paper Document ☐**Description**

Provide a brief description of the proposed rule change (limit 250 characters).

Exemption from TRACE Trade Reporting Requirements

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name Last Name
Title
E-mail
Telephone Fax

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized officer.

Date By
(Name)

(Title)

NOTE: Clicking the button at right will digitally sign and lock
this form. A digital signature is as legally binding as a physical
signature, and once signed, this form cannot be changed.

PATRICE GLINIECKI,

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EDFS website.

Form 19b-4 Information

Add

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change

Add

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications

Add

Remove

View

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

Exhibit Sent As Paper Document

☐

Exhibit 3 - Form, Report, or Questionnaire

Add

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Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

Exhibit Sent As Paper Document

☐

Exhibit 4 - Marked Copies

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

Add

Remove

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

Partial Amendment

Add

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View

If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ Financial Industry Regulatory Authority (“FINRA”) (f/k/a/ National Association of Securities Dealers, Inc. (“NASD”)) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend: (1) NASD Rule 6230(e) to exempt from reporting to the Trade Reporting and Compliance Engine (“TRACE”) transactions in TRACE-eligible securities resulting from the exercise or settlement of an option or a similar instrument, or the termination or settlement of a credit default swap (“CDS”), other type of swap, or a similar instrument (“Derivative-Related Transaction”); and (2) NASD Rule 6210(c) to conform the definition of “reportable TRACE transaction” to exclude this class and any other class of exempted transactions from the defined term. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

6200. TRADE REPORTING AND COMPLIANCE ENGINE (TRACE)

6210. Definitions

The terms used in this Rule 6200 Series shall have the same meaning as those defined in [NASD’s By-Laws]FINRA’s By-Laws and NASD’s Rules unless otherwise specified.

¹ 15 U.S.C. 78s(b)(1).

(a) through (b) No Change.

(c) The term “reportable TRACE transaction” shall mean any secondary market transaction in a TRACE-eligible security except transactions exempt from reporting as specified in Rule 6230(e).[transactions in TRACE-eligible securities that are listed on a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934, when such transactions are executed on, and reported to the exchange and the transaction information is disseminated publicly.]

(d) through (j) No Change.

* * * * *

6230. Transaction Reporting

(a) through (d) No Change.

(e) Transactions Exempt From Reporting

The following types of transactions shall not be reported:

(1) through (4) No Change.

(5) Transactions resulting from the exercise or settlement of an option or a similar instrument, or the termination or settlement of a credit default swap, other type of swap, or a similar instrument.

(f) No Change

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The proposed rule change has been approved by the General Counsel of FINRA (or his officer designee) pursuant to delegated authority. No other action by FINRA is necessary for the filing of the proposed rule change.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 30 days following publication of the Regulatory Notice announcing Commission approval.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

FINRA proposes to amend NASD Rule 6230(e) to exempt transactions in TRACE-eligible securities that are Derivative-Related Transactions from the TRACE reporting requirements in NASD Rule 6230, and to make conforming amendments to NASD Rule 6210(c). (The TRACE reporting requirement does not exist in connection with *any cash-settled derivative*, even if the derivative, such as a CDS, refers to one or several securities that are TRACE-eligible securities.) Concurrently, FINRA withdraws SR-NASD-2006-103.² In addition, if the proposed rule change is approved, FINRA will

² SR-NASD-2006-103 was filed with the SEC on August 28, 2006. FINRA proposed NASD IM-6230 to provide exemptive relief from certain reporting requirements for transactions executed in connection with the termination or settlement of a CDS or a similar instrument ("CDS-Related Transactions") and an amendment to NASD Rule 6250 to exempt all Derivative-Related Transactions from dissemination. See Securities Exchange Act Release No. 54681 (November

rescind NASD Notice to Members 05-77 (November 2005), in which FINRA clarified members' obligations to report Derivative-Related Transactions to TRACE.³

FINRA believes that Derivative-Related Transactions, although technically transactions if they result in a change of beneficial ownership of TRACE-eligible securities, should not be reported for several reasons.⁴ Such transactions should be exempt from reporting because the information regarding price (and yield) being reported does not reflect a currently negotiated transaction price. The price of a transaction in a TRACE-eligible security executed in such circumstances is agreed upon at the time of the execution of a CDS or other derivative. In the event of a CDS, for example, the price is usually set at par. At the time of an event triggering a termination and settlement of a CDS such as a filing of bankruptcy, an issuer's bonds are very likely trading below par. Accordingly, the resulting Derivative-Related Transaction, if the CDS is physically settled, will be at a price that does not reflect current market conditions. FINRA recognized this in NASD Notice to Members 05-77, requiring that such transactions be reported using the "special price" flag or modifier, which is appropriately used when a

1, 2006), 71 FR 65555 (November 8, 2006) (Notice of filing of proposed rule change).

Among other things, in SR-NASD-2006-103, FINRA stated that the reporting requirement addressed previously in NASD Notice to Members 05-77 (November 2005) applies only to those derivative instruments that are terminated or settled in whole or in part by the purchase or sale of TRACE-eligible securities ("physical settlement"), and has no application to derivatives that are cash-settled.

³ See NASD Notice to Members 05-77 (November 2005) is attached as Exhibit 3a hereto.

⁴ Transactions that are not reported also are not disseminated.

transaction is executed at a price based on arm's length negotiation and done for investment, commercial or trading considerations, but does not appear to reflect current market pricing. In addition, the pricing and time of the reporting and dissemination of certain Derivative-Related Transactions, such as CDS-related transactions, not only *will not aid* in price discovery, but also may create significant investor confusion. For example, due to the basic structure of a CDS, all or many of such Derivative-Related Transactions in a single issuer likely would occur, and be reported and disseminated during the same period. Thus, a very large number of non-market priced transactions in the debt securities of the issuer likely would be reported and disseminated and create confusion in the marketplace, especially to retail investors who may expect pricing at par, and, in most cases, will receive quotes substantially below par. Accordingly, as prices from Derivative-Related Transactions do not contribute to price discovery, the costs of continuing to require such reporting, including potential investor confusion, argue in favor of the proposed exemption from TRACE reporting and dissemination.

Finally, the rationale underlying the proposed exemption from TRACE reporting and dissemination – price discovery does not occur and investor confusion is likely to occur – has been recognized previously by the Commission and FINRA as logical bases for exempting certain transactions from trade reporting and dissemination. For example, for many years FINRA had a similar trade reporting exemption for certain transactions in equity securities, such as transactions occurring as a result of the exercise of an over-the-

counter (“OTC”) option on an equity security.⁵ Transactions from Derivative-Related Transactions should be exempt for the same reasons that the Commission approved such trade reporting exemptions for transactions that occurred as a result of the exercise of the derivative OTC option.

FINRA also proposes to make conforming amendments to NASD Rule 6210(c), the term “reportable TRACE transaction.” The definition currently *restates* a trade reporting exemption in NASD Rule 6230(e) and states that these exempt transactions are not reportable TRACE transactions. FINRA proposes to substitute a general statement regarding exempted transactions for the specific reference, which would make “TRACE reportable transaction” consistent with proposed NASD Rule 6230(e) and eliminate the need to amend NASD Rule 6210(c) each time NASD Rule 6230(e) is amended. The amendment would restate “Reportable TRACE transaction” as “any secondary market

⁵ Historically, purchases and sales of equity securities that occurred as a result of the exercise of an OTC option were not required to be reported to FINRA. In 2006, FINRA amended its rules to establish “Reporting . . . for Purposes of Regulatory Transaction Fee Assessment” for such equity transactions (and certain other equity transactions). The rules were changed specifically to improve FINRA’s program regarding certain fees (“Section 31 fees”) payable to the SEC to improve FINRA’s collection of transaction-based fees; the changes were *not made* to further either the policy to improve market surveillance or to facilitate price discovery, which are primary policy objectives of trade reporting and dissemination. Due to the nature of such reports, they are not disseminated and a member does not pay the usual fees -- certain system usage fees -- charged for trade reporting. (Under Section 31 of the Act, FINRA is required to pay *transaction fees* and certain other assessments to the SEC that are designed to recover the costs related to the government’s supervision and regulation of the securities markets and securities professionals.) See Section 31 of the Act, 15 U.S.C. 78ee and Rule 31 thereunder, 17 C.F.R. 240.31; Securities Exchange Act Release No. 53977 (June 12, 2006), 71 FR 34976 (June 16, 2006) (order approving SR-NASD-2006-055, equity trade reporting amendments); and NASD Notice to Members 06-39 (August 2006).

transaction in a TRACE-eligible security except transactions exempt from reporting as specified in NASD Rule 6230(e).”

As noted in Item 2 of this filing, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 30 days following publication of the Regulatory Notice announcing Commission approval.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁶ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that Derivative-Related Transactions should be exempt from TRACE reporting because the reported information does not contribute to price discovery and the reporting and dissemination of such information may confuse market participants, particularly retail and non-professional investors, and investors and the public interest will be protected if the trade report information is not so reported and disseminated.

⁶ 15 U.S.C. 78o-3(b)(6).

4. **Self-Regulatory Organization's Statement on Burden on Competition**

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

5. **Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others**

Written comments were neither solicited nor received.⁷

6. **Extension of Time Period for Commission Action**

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.⁸

7. **Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**

Not applicable.

⁷ FINRA notes that one written comment letter was received by the Commission in response to SR-NASD-2006-103, the proposed rule change to provide exemptive relief from certain TRACE reporting requirements in NASD Rule 6230 for CDS-related transactions and to not disseminate transaction information under NASD Rule 6250 for Derivatives-Related Transactions. (The commenter filed comments although the Commission did not publish SR-NASD-2006-103 for notice and comment in the Federal Register.) The commenter requested that FINRA consider providing exemptive relief beyond that proposed in SR-NASD-2006-103, and supported the proposed amendment to Rule 6250 to not disseminate Derivative-Related Transactions, except if a member would incur additional costs by being required to designate in the report that certain transactions should not be disseminated. The commenter also stated its opposition generally to any reporting and dissemination of Derivative-Related Transactions. See letter to Nancy M. Morris, Secretary, SEC, from Mary Kuan, Vice President and Assistant General Counsel, Securities Industry and Financial Markets Association ("SIFMA"), dated December 8, 2006, attached as Exhibit 3b hereto.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2.

Exhibit 3.

Exhibit 3a. NASD Notice to Members 2005-77 (November 2005).

Exhibit 3b. Comment letter regarding SR-NASD-2006-103 to Nancy M. Morris, Secretary, SEC, from Mary Kuan, Vice President and Assistant General Counsel, Securities Industry and Financial Markets Association (“SIFMA”) dated December 8, 2006.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-FINRA-2007-007)

Self-Regulatory Organizations: Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Exemption From Reporting For Trace-Eligible Securities Transactions Resulting from Exercise or Settlement of Options, Termination or Settlement of Credit Default Swaps, Other Types of Swaps, or Similar Instruments

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on , Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend: (1) NASD Rule 6230(e) to exempt from reporting to the Trade Reporting and Compliance Engine (“TRACE”) transactions in TRACE-eligible securities resulting from the exercise or settlement of an option or a similar instrument, or the termination or settlement of a credit default swap (“CDS”), other type of swap, or a similar instrument (“Derivative-Related Transaction”); and (2) NASD Rule 6210(c) to conform the definition of “reportable TRACE transaction” to exclude this

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

class and any other class of exempted transactions from the defined term. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

6200. TRADE REPORTING AND COMPLIANCE ENGINE (TRACE)

6210. Definitions

The terms used in this Rule 6200 Series shall have the same meaning as those defined in [NASD's By-Laws]FINRA's By-Laws and NASD's Rules unless otherwise specified.

(a) through (b) No Change.

(c) The term "reportable TRACE transaction" shall mean any secondary market transaction in a TRACE-eligible security except transactions exempt from reporting as specified in Rule 6230(e).~~[transactions in TRACE-eligible securities that are listed on a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934, when such transactions are executed on, and reported to the exchange and the transaction information is disseminated publicly.]~~

(d) through (j) No Change.

* * * * *

6230. Transaction Reporting

(a) through (d) No Change.

(e) Transactions Exempt From Reporting

The following types of transactions shall not be reported:

(1) through (4) No Change.

(5) Transactions resulting from the exercise or settlement of an option or a similar instrument, or the termination or settlement of a credit default swap, other type of swap, or a similar instrument.

(f) No Change

* * * * *

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA proposes to amend NASD Rule 6230(e) to exempt transactions in TRACE-eligible securities that are Derivative-Related Transactions from the TRACE reporting requirements in NASD Rule 6230, and to make conforming amendments to NASD Rule 6210(c). (The TRACE reporting requirement does not exist in connection with *any cash-settled derivative*, even if the derivative, such as a CDS, refers to one or several securities that are TRACE-eligible securities.) Concurrently, FINRA withdraws SR-NASD-2006-103.³ In addition, if the proposed rule change is approved, FINRA will

³ SR-NASD-2006-103 was filed with the SEC on August 28, 2006. FINRA proposed NASD IM-6230 to provide exemptive relief from certain reporting requirements for transactions executed in connection with the termination or

rescind NASD Notice to Members 05-77 (November 2005), in which FINRA clarified members' obligations to report Derivative-Related Transactions to TRACE.⁴

FINRA believes that Derivative-Related Transactions, although technically transactions if they result in a change of beneficial ownership of TRACE-eligible securities, should not be reported for several reasons.⁵ Such transactions should be exempt from reporting because the information regarding price (and yield) being reported does not reflect a currently negotiated transaction price. The price of a transaction in a TRACE-eligible security executed in such circumstances is agreed upon at the time of the execution of a CDS or other derivative. In the event of a CDS, for example, the price is usually set at par. At the time of an event triggering a termination and settlement of a CDS such as a filing of bankruptcy, an issuer's bonds are very likely trading below par. Accordingly, the resulting Derivative-Related Transaction, if the CDS is physically settled, will be at a price that does not reflect current market conditions. FINRA recognized this in NASD Notice to Members 05-77, requiring that such transactions be reported using the "special price" flag or modifier, which is appropriately used when a

settlement of a CDS or a similar instrument ("CDS-Related Transactions") and an amendment to NASD Rule 6250 to exempt all Derivative-Related Transactions from dissemination. See Securities Exchange Act Release No. 54681 (November 1, 2006), 71 FR 65555 (November 8, 2006) (Notice of filing of proposed rule change).

Among other things, in SR-NASD-2006-103, FINRA stated that the reporting requirement addressed previously in NASD Notice to Members 05-77 (November 2005) applies only to those derivative instruments that are terminated or settled in whole or in part by the purchase or sale of TRACE-eligible securities ("physical settlement"), and has no application to derivatives that are cash-settled.

⁴ See NASD Notice to Members 05-77 (November 2005).

⁵ Transactions that are not reported also are not disseminated.

transaction is executed at a price based on arm's length negotiation and done for investment, commercial or trading considerations, but does not appear to reflect current market pricing. In addition, the pricing and time of the reporting and dissemination of certain Derivative-Related Transactions, such as CDS-related transactions, not only *will not aid* in price discovery, but also may create significant investor confusion. For example, due to the basic structure of a CDS, all or many of such Derivative-Related Transactions in a single issuer likely would occur, and be reported and disseminated during the same period. Thus, a very large number of non-market priced transactions in the debt securities of the issuer likely would be reported and disseminated and create confusion in the marketplace, especially to retail investors who may expect pricing at par, and, in most cases, will receive quotes substantially below par. Accordingly, as prices from Derivative-Related Transactions do not contribute to price discovery, the costs of continuing to require such reporting, including potential investor confusion, argue in favor of the proposed exemption from TRACE reporting and dissemination.

Finally, the rationale underlying the proposed exemption from TRACE reporting and dissemination – price discovery does not occur and investor confusion is likely to occur – has been recognized previously by the Commission and FINRA as logical bases for exempting certain transactions from trade reporting and dissemination. For example, for many years FINRA had a similar trade reporting exemption for certain transactions in equity securities, such as transactions occurring as a result of the exercise of an over-the-counter (“OTC”) option on an equity security.⁶ Transactions from Derivative-Related

⁶ Historically, purchases and sales of equity securities that occurred as a result of the exercise of an OTC option were not required to be reported to FINRA.. In 2006, FINRA amended its rules to establish “Reporting . . . for Purposes of

Transactions should be exempt for the same reasons that the Commission approved such trade reporting exemptions for transactions that occurred as a result of the exercise of the derivative OTC option.

FINRA also proposes to make conforming amendments to NASD Rule 6210(c), the term “reportable TRACE transaction.” The definition currently *restates* a trade reporting exemption in NASD Rule 6230(e) and states that these exempt transactions are not reportable TRACE transactions. FINRA proposes to substitute a general statement regarding exempted transactions for the specific reference, which would make “TRACE reportable transaction” consistent with proposed NASD Rule 6230(e) and eliminate the need to amend NASD Rule 6210(c) each time NASD Rule 6230(e) is amended. The amendment would restate “Reportable TRACE transaction” as “any secondary market transaction in a TRACE-eligible security except transactions exempt from reporting as specified in NASD Rule 6230(e).”

Regulatory Transaction Fee Assessment” for such equity transactions (and certain other equity transactions). The rules were changed specifically to improve FINRA’s program regarding certain fees (“Section 31 fees”) payable to the SEC to improve FINRA’s collection of transaction-based fees; the changes were *not made* to further either the policy to improve market surveillance or to facilitate price discovery, which are primary policy objectives of trade reporting and dissemination. Due to the nature of such reports, they are not disseminated and a member does not pay the usual fees -- certain system usage fees -- charged for trade reporting. (Under Section 31 of the Act, FINRA is required to pay *transaction fees* and certain other assessments to the SEC that are designed to recover the costs related to the government’s supervision and regulation of the securities markets and securities professionals.) See Section 31 of the Act, 15 U.S.C. 78ee and Rule 31 thereunder, 17 C.F.R. 240.31; Securities Exchange Act Release No. 53977 (June 12, 2006), 71 FR 34976 (June 16, 2006) (order approving SR-NASD-2006-055, equity trade reporting amendments); and NASD Notice to Members 06-39 (August 2006).

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 30 days following publication of the Regulatory Notice announcing Commission approval.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁷ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that Derivative-Related Transactions should be exempt from TRACE reporting because the reported information does not contribute to price discovery and the reporting and dissemination of such information may confuse market participants, particularly retail and non-professional investors, and investors and the public interest will be protected if the trade report information is not so reported and disseminated.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

⁷ 15 U.S.C. 78o-3(b)(6).

C. **Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others**

Written comments were neither solicited nor received.⁸

III. **Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

⁸ FINRA notes that one written comment letter was received by the Commission in response to SR-NASD-2006-103, the proposed rule change to provide exemptive relief from certain TRACE reporting requirements in NASD Rule 6230 for CDS-related transactions and to not disseminate transaction information under NASD Rule 6250 for Derivatives-Related Transactions. (The commenter filed comments although the Commission did not publish SR-NASD-2006-103 for notice and comment in the Federal Register.) The commenter requested that FINRA consider providing exemptive relief beyond that proposed in SR-NASD-2006-103, and supported the proposed amendment to Rule 6250 to not disseminate Derivative-Related Transactions, except if a member would incur additional costs by being required to designate in the report that certain transactions should not be disseminated. The commenter also stated its opposition generally to any reporting and dissemination of Derivative-Related Transactions. See letter to Nancy M. Morris, Secretary, SEC, from Mary Kuan, Vice President and Assistant General Counsel, Securities Industry and Financial Markets Association ("SIFMA") dated December 8, 2006.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2007-007 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2007-007. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for

inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of FINRA.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2007-007 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁹

Nancy M. Morris

Secretary

⁹ 17 CFR 200.30-3(a)(12).

Notice to Members

NOVEMBER 2005

SUGGESTED ROUTING

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

KEY TOPICS

Credit Default Swaps
Debt Securities
Operations
Options
Rule 6200 Series
TRACE Rules
Transaction Reporting

GUIDANCE

Corporate Debt Securities

Transactions in TRACE-Eligible Securities That Occur in Connection with Options, Credit Default Swaps, Other Swaps or Similar Instruments Must Be Reported to TRACE

Executive Summary

NASD provides interpretive guidance under Rule 6230 on the obligation of members to report to the Trade Reporting and Compliance Engine (TRACE) transactions in TRACE-eligible securities executed in connection with the exercise or settlement of options; the termination or settlement of (or other events triggering a transaction in TRACE-eligible securities) credit default swaps or other types of swaps; or the exercise, termination or settlement of (or other events triggering a transaction in TRACE-eligible securities) similar instruments.

Questions/Further Information

Questions concerning this *Notice* should be directed to tracefeedback@nasd.com; Elliot Levine, Chief Counsel, Transparency Services, Markets, Services, and Information, at (202) 728-8405; or Sharon K. Zackula, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8985.

Interpretive Guidance

NASD has received inquiries regarding the reporting of transactions in TRACE-eligible securities that occur as a result of the exercise or settlement of options; the termination or settlement of (or other events triggering a transaction in TRACE-eligible securities) credit default swaps (CDSs) or other types of swaps; or the exercise, termination or settlement of (or other events triggering a transaction in TRACE-eligible securities) similar instruments.¹

05-77

A member that is a party to a transaction in a TRACE-eligible security that occurs pursuant to, or in connection with an option, a CDS, another type of swap, or a similar instrument must report the transaction to TRACE under Rule 6230. In addition, when such a transaction in TRACE-eligible securities is executed at a price that does not represent current market pricing, the transaction must be reported to TRACE using the "special price" modifier (or flag), as more fully described below.

Under Rule 6230(d)(4)(A), if "a transaction is not executed at a price that reflects the current market price," the reporting member must select the "special price" modifier.² NASD interprets the term current market price as an arm's length price agreed upon by a buyer and seller after considering current pricing factors and information, such as current quotes or indications, current transaction information or a current spread to a benchmark. Even if such price is substantially different from the last price, NASD considers such a price to be a current market price.

The "special price" modifier or flag is appropriately used when a transaction is executed at a price based on arm's length negotiation and done for investment, commercial or trading considerations, but does not reflect current market pricing.³ In this regard, a transaction in TRACE-eligible securities occurring as a result of an exercise or settlement of an option or similar right generally would be reportable to TRACE with a "special price" flag because, in general, options are structured such that the price of the later occurring transaction in TRACE-eligible securities does not reflect a then current market price for those securities. Similarly, a transaction in TRACE-eligible securities occurring as a result of the termination or settlement of (or other events triggering a transaction in, TRACE-eligible securities) CDSs or other types of swaps generally would be reported with a "special price" flag for the same reason. In these instruments and the other instruments referenced above, the parties to such agreements generally determine the terms of the price and/or the price of the TRACE-eligible securities at arm's length for investment, commercial or trading purposes in a manner that will not reflect current market price as of the day and time that the transaction or transactions will occur.

Endnotes

- 1 A CDS is an agreement where one party “sells” risk (the risk-protection buyer) and the counterparty “buys” the risk (the risk-protection seller). The risk-protection buyer, who often owns the underlying security (e.g., a debt security issued by a third party), pays a periodic fee to the risk-protection seller during the life of the CDS. In return, the risk-protection seller agrees to pay the risk-protection buyer a set amount in the event that a credit event occurs during the term of the CDS (e.g., a bankruptcy, default or a credit downgrade). A CDS can expire at the end of the pre-established term of the swap, or, in the event of a triggering credit event, when it is settled and then terminates.
- 2 A transaction is reported using the special price modifier by setting the “special price” flag to “Y.”
- 3 See also *Notice to Members 02-76* (November 2002), Q&A No. 13.

For example, broker-dealer X (BD X) is contacted by an institutional client (Client M) to enter into a CDS. Client M has credit exposure to an issuer and wishes to reduce such exposure (e.g., Client M owns a large number of bonds issued by an automobile industry sector company (e.g., ABC Autos), and Client M seeks to transfer some or all of the credit risk related to owning the ABC Autos bonds without actually selling the ABC Autos bonds). BD X enters into a CDS with Client M, under which Client M agrees to pay BD X a periodic fee. In exchange for the periodic fee, BD X agrees that, in the event of a credit event relating to ABC Autos (defined in the swap and including events such as a declaration of bankruptcy or a default), BD X will pay Client M a certain predetermined amount of cash, or will buy from Client M the ABC Autos bonds at par value.

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December 8, 2006

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

Re: File Number SR-NASD-2006-103, Proposed Rule Change Relating to TRACE
Requirements in Connection With the Exercise or Settlement of Options, Swaps, or
Similar Instruments

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”) in connection with the National Association of Securities Dealers, Inc.’s (“NASD”) Proposed Rule Change Relating to TRACE Requirements in Connection with the Exercise or Settlement of Options, Swaps, or Similar Instruments (the “Proposal”).²

I. Introduction and Background

We appreciate the NASD’s ongoing efforts to create a workable and fair rule governing the reporting and dissemination of secondary market trade information for corporate bonds and for giving attention to the special issues raised by the reporting of transactions that occur in connection with the settlement or termination of options, swaps or similar instruments (such transactions are referred to herein as “Triggered Transactions”).

By way of background, in November 2005, the NASD published Notice to Members 05-77 to provide interpretive guidance under the NASD’s TRACE rules. In that Notice to Members, the NASD stated that members must report to the NASD transactions in TRACE-eligible securities (generally, corporate bonds) executed in connection with: (1) the exercise or settlement of options; and (2) the termination or settlement of swaps, including credit default swaps (“CDS”) or similar instruments. Following the publication of Notice to Members 05-77, the Bond Market Association (“BMA”) submitted a letter to the NASD explaining why the

¹ The Securities Industry and Financial Markets Association 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 Securities Exchange Act of 1934 (“Exchange Act”) Release No. 34-54681, 71 F.R. 65555 (Nov. 8, 2006).

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Triggered Transactions should not be subject to TRACE reporting.³ The BMA also explained that guidance provided in Notice to Members 05-77 raised certain interpretive and logistical issues some of which the BMA is seeking to address by the Proposal.

SIFMA continues to believe, for the reasons described below, that reporting of Triggered Transactions should not be required. Further, to the extent reporting of Triggered Transactions is required, we believe that the Proposal continues to present certain logistical and interpretive issues. These issues relate to, among other things, the manner in which members are to identify Triggered Transactions in TRACE reports, the timing of TRACE reports of Triggered Transactions, the submission of reversal and cancel/correct reports and the dissemination of TRACE reports of Triggered Transactions. Moreover, participants in the CDS market, with the involvement of the International Swaps and Derivatives Association, Inc. and SEC staff, have recently established a protocol (the "CDS Protocol") to facilitate cash settlement at the termination of credit derivatives, including CDS. As described below, the CDS Protocol also raises issues under the Proposal.

II. Members Should Not Be Required to Report to the NASD Trades in Corporate Bonds Executed In Connection with the Termination or Settlement of an Option, Swap or Similar Instrument

SIFMA continues to believe that the NASD should not require the Triggered Transactions to be reported to TRACE. It is unclear how such reports facilitate the NASD's goals of investor protection and dissemination of helpful information to the marketplace. Further, given the nature of Triggered Transactions, SIFMA does not believe such transactions are secondary market transactions subject to reporting under TRACE.

A. Goals of TRACE

The two primary purposes of TRACE, as articulated in the SEC Release approving the implementation of TRACE⁴, are: (1) to permit the NASD to "take a proactive role in supervising the corporate debt market . . . to better detect fraud and foster investor confidence in the fairness of the corporate debt market"⁵ and (2) to increase transparency in the debt markets.⁶ SIFMA believes that any regulation with respect to TRACE should further such goals.

B. Unclear how Requested Information Facilitates Investor Protection

³ The Bond Market Association and the Securities Industry Association merged on November 1, 2006 to form SIFMA.

⁴ Exchange Act Release. No. 34-43873, 2001 WL 50697 (Jan. 23, 2001) ("Approving Release").

⁵ Approving Release, 2001 WL 50697, at *1. The BMA letter is located at <http://www.bondmarkets.com/assets/files/TRACESwapsOptions.pdf>.

⁶ Approving Release, 2001 WL 50697, at *9 and n.50.

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In explaining why Triggered Transactions should be reported to TRACE, the NASD states that it “requires the reports of CDS-related transactions in order to facilitate NASD’s surveillance of the corporate bond market for the detection of various fraudulent or manipulative acts or unfair practices.”⁷ However, it is not clear how reports of Triggered Transactions may promote this goal.

As the NASD describes in the Proposal, the Triggered Transactions “are terminations or settlements of executory contractual obligations that do not provide useful data in connection with price discovery, determining best execution, or assessing reasonable mark-ups (or mark-downs).”⁸ The NASD also states:

that the dissemination of pricing and other information on such transactions does not appear to provide market participants with information useful for price discovery purposes. NASD believes that this is due primarily to the fact that such options, CDSs, other types of swaps, and similar instruments are generally entered into significantly earlier than the occurrence of the option exercise and/or swap settlement. NASD notes that the agreements setting out the terms for these transactions generally determine the price of the TRACE-eligible securities at arm’s length for investment, commercial, or trading purposes in a manner that tends not to be reflective of the current market price of the TRACE-eligible security as of the day and time that the transaction or transactions in TRACE-eligible securities occur (e.g., at the option exercise and/or swap settlement), which may be several weeks, months or years later.⁹

Although the NASD makes these points in the context of trade dissemination, not trade reporting, these arguments support the view that the reporting of Triggered Transactions will not advance the NASD’s goal of detecting fraud, as the information reported will neither provide the NASD with information about the current state of the corporate debt market, nor provide it with benchmarks against which to measure other corporate bond activity that may be reported to TRACE at similar times.

In addition, the NASD does not explain how it would use the reports of the Triggered Transactions to monitor for fraudulent or manipulative practices, especially given that the reports themselves contain no current pricing information. Further, as an increasing number of CDS

⁷ Proposal, 71 F.R. at 65557. The NASD does not specify why it needs reports of Triggered Transactions in contexts other than CDS settlement, e.g., why it requires information regarding the settlement or termination of options.

⁸ Proposal, 71 F.R. at 65557.

⁹ Proposal, 71 F.R. at 65557-58.

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terminations are cash settled, the Triggered Transactions will represent a smaller percentage of total settlements occurring.¹⁰

Given that reporting Triggered Transactions to TRACE would not appear to further the goals of TRACE, SIFMA believes that the appropriate course would be for the NASD to interpret the TRACE rules so as not to require reporting of the Triggered Transactions.

C. The Triggered Transactions are Not Secondary Market Transactions

NASD Rule 6210(c) defines “reportable TRACE transaction” to mean “any secondary market transaction in a TRACE-eligible security” SIFMA believes, however, that the Triggered Transactions should not be viewed as secondary market transactions. In this regard, at the time of the Triggered Transactions, the broker-dealer is not involved in any price negotiation or price discovery and no agreement is reached by the parties as to price; rather, the Triggered Transaction represents the completion of a prior commitment at a pre-determined price. As the pre-determined price is unrelated to the current trading market for the security, the Triggered Transaction is not a transaction that is occurring in the secondary market and thus should not be TRACE-reportable. Further, at the time of the Triggered Transaction, the broker-dealer’s involvement is quite minimal. In this regard, the broker-dealer delivers (or receives) securities versus cash based on a triggered event in a previously negotiated contract. This is akin to settlement of a prior transaction based on a pre-existing price rather than commencement of a new transaction based on the current market for the security. As TRACE reporting is triggered by secondary market transactions at currently negotiating prices, SIFMA does not believe that TRACE reporting should be required in connection with the Triggered Transactions.¹¹

This view is consistent with guidance the NASD has previously supplied on the need to report (or not report) certain types of transactions involving TRACE-eligible securities. The NASD has stated that repurchase agreements in TRACE-eligible securities “are not viewed as transactions in the secondary market for the purchase and sale of corporate bonds, but, rather, as financing transactions for members.”¹² By contrast, the NASD has required reporting of issuers’ open market repurchases of TRACE-eligible securities even though such repurchases may occur at off market prices and at abnormal volumes, in part based on the fact that

¹⁰ The NASD has confirmed that the TRACE reporting rules have no application to CDS that are cash settled Proposal, 71 F.R. at 65556 n.4.

¹¹ The CDS Protocol does involve price discovery in order to establish a market clearing price for the cash settlement or physical settlement of CDS at termination. See Section IV.B, below. This discussion is limited to Triggered Transactions occurring outside the context of the CDS Proposal.

¹² See TRACE FAQ Rules & Compliance (“Are repurchase agreements (‘Repos’) reportable to TRACE if the securities involved are TRACE-eligible? For purposes of TRACE reporting, bona fide properly documented repo transactions are not viewed as transactions in the secondary market for the purchase and sale of corporate bonds, but, rather, as financing transactions for members.”)

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in such purchases and sales, market participants negotiate the price and other terms of the transaction . . . based on investment, commercial or trading considerations Even where an issuer, or a market participant on behalf of an issuer, determines to price and purchase a significant amount of a debt security, the price established for the transaction is determined with substantial reference to the current market price of the security and current market conditions. . . .¹³

However, with OTC options, CDSs and similar instruments, the price of the Triggered Transaction is not related to current market conditions.

As such, the NASD has excluded the delivery and receipt of TRACE-eligible securities in connection with repurchase agreements from reporting because they are not viewed as secondary market transactions, and has required reporting in the context of an issuer repurchase because the repurchases are based on current price negotiations. Consistent with this guidance, SIFMA believes that the Triggered Transactions should be viewed as occurring outside the secondary market for the securities because the prices are not based on current negotiations and thus transaction reporting should not be required.¹⁴

In addition, SIFMA notes that under NASD Rule 4632(e), the “purchases or sales of securities effected upon the exercise of an option pursuant to the terms thereof or the exercise of any other right to acquire securities at a pre-established consideration unrelated to the current market” are not required to be reported. SIFMA sees no additional risk imposed on investors in connection with debt options or CDSs that would warrant this increase in obligations.¹⁵

III. If Members Are Required to Report Triggered Transactions to TRACE, the Current Proposal Should be Amended in Several Respects

SIFMA believes that certain adjustments to the Proposal are appropriate. Certain aspects of the Proposal will be quite costly to the members, including the use of criteria to distinguish between different Triggered Transactions and, in certain circumstances, the suppression of

¹³ Letter from Sharon Zackula to Dennis C. Hensley (Nov. 13, 2002) (focusing on the NASD Rule 6230(e) exception for securities at trades “at a price substantially unrelated to the current market”).

¹⁴ In addition, such information does not reflect the timing or the price at which the CDS or option was entered into, but rather just the strike price at which the bond is being settled.

¹⁵ NASD’s trade reporting rules for equities, reflecting the Consolidated Tape Association Plan, do not require reporting of trades on the exercise of options. As the purposes underlying TRACE and the equity trade reporting rules are largely consistent – to provide market transparency and to facilitate regulatory activity – it is not clear why the NASD should, in this limited context, take a different approach for TRACE than for its other trade reporting rules. SIFMA notes NASD NTM 06-39 amends the rules relating to automated reporting of transactions of equity options, among other things, for purposes of regulatory transaction fees. However, the NASD has not indicated that regulatory transaction fees necessitate the Proposal.

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reversal and cancel/correct reports. SIFMA also believes that other aspects of the proposal, including the timing of and mechanism for reporting of Triggered Transactions, should be adjusted to further ease members' compliance burdens.

A. Use of Criteria for Determining Whether a Triggered Transaction Should be Excluded from Public Dissemination

i. Background

The NASD has proposed an amendment to NASD Rule 6250 to withhold reports of Triggered Transactions from public dissemination. The NASD proposed this because the derivatives contracts are entered into earlier in time than the termination of the swap or option, which means that the derivatives agreement determines the price of the Triggered Transaction and the price of the Triggered Transaction is generally not reflective of the current market price of the TRACE-eligible security.¹⁶ SIFMA is generally supportive of this approach for the reasons the NASD identifies.

The Proposal also requires that the option, swap or similar instruments have certain characteristics in order for the TRACE reports of the Triggered Transactions to be withheld from public dissemination. The NASD states that the specified characteristics are necessary to ensure that the swap or option is bona fide, and not structured to avoid TRACE reporting of what is essentially a current market transaction.¹⁷ The Proposal appears to require the members to distinguish derivatives contracts that have these characteristics from derivatives contracts that do not, in order for the members to identify to the NASD which TRACE reports of Triggered Transactions should be suppressed and which should be disseminated. In particular, for the TRACE reports to be withheld from public dissemination, the Proposal requires, among other things, that the CDS or option have a term of at least 20 business days, during which time it cannot be exercised, terminated or settled, and have an exercise or strike price that is fixed (or fixed by formula) and be out-of-the money by at least 10 percent at the date of issuance. SIFMA believes that the costs to the members of distinguishing between derivatives contracts will exceed the benefit to the NASD. Further, the criteria as proposed do not appear to be applicable to CDSs.

ii. The Costs of this Aspect of the Proposal Exceed the Benefits, Especially in the Light of the Increase in Cash Settlements

The application of the criteria will be quite costly for members. Firms do not currently track CDSs or options by these or any comparable criteria. As such, firms will be required to build systems, or alternatively, to manually review all option and CDS contracts, and implement operational processes to track these criteria. Firms will then need to apply these criteria to particular Triggered Transactions to determine whether the NASD should disseminate or

¹⁶ Proposal, 71 F.R. at 65557 (text following n.8).

¹⁷ Proposal, 71 F.R. at 65558.

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suppress the trade reports and then mark the trade report accordingly. Such tracking will be particularly challenging as members often handle derivative products such as CDSs and options and the cash market products related to the Triggered Transactions through distinct systems that are not integrated. Construction of an automated process would require building linkages between different systems that may not currently communicate with each other. If such tracking is accomplished manually, there may be heightened concerns regarding accuracy and timeliness of reporting and the cost.

Further, the CDS Protocol, designed to facilitate cash settlement, is expected to lead to an increase in cash settlements, a significant decrease in physical settlements, and hence fewer Triggered Transactions. As such, given the cost of constructing systems to apply the criteria, the expected diminishing number of Triggered Transactions and the fact that the reporting of Triggered Transactions does not appear to further TRACE's goals, it would seem that the costs of requiring firms to implement systems to track derivatives contracts based on the criteria would exceed the benefits. Accordingly, SIFMA requests that the NASD withhold from public dissemination all Triggered Transactions rather than requiring members to distinguish Triggered Transactions based on the characteristics of the CDS or option. Alternatively, although it is not the members' preference, SIFMA requests that all Triggered Transactions be disseminated by the NASD without further determinations by the members.

iii. Proposed Criteria Are Inapplicable to CDSs

The exercise or settlement of a CDS is automatically triggered by a credit event involving the issuer. As such, termination or settlement of a CDS contract could happen prior to 20 business days after the CDS contract is executed for reasons beyond the members' control or knowledge. Thus, this criteria would not ensure that a swap is bona fide and not structured to avoid TRACE reporting of what is essentially a current market transaction.

For similar reasons, the "out of the money" criteria are not applicable to CDSs. An option is in the money when the market price is higher (for a long call position) or lower (for a long put position) than the option's strike price. Such an option is considered "in the money" because were the holder to exercise the option, the holder would be able to realize an immediate profit. However, a CDS is not necessarily thought of as "in the money" or "out of the money." Rather, with a CDS, the difference between the price of the CDS and the settlement value of the bond is a measure of the parties' view of the risk that the issuer may default. The CDS is priced in such a way that if the credit event occurs, the holder of the CDS will obtain the credit protection embedded in the swap. In a sense, then, CDSs are always "in the money" because the price of the underlying bonds that are the reference obligation to the CDS will always be less than the settlement value of the security in the event of default.

Further, it would appear difficult, if not impossible, for parties to a CDS to structure a CDS to avoid TRACE reporting, as the event that triggers the transaction is not under the control of the parties to the CDS but rather turns on a credit event impacting the reference security. Thus, in the context of CDS it does not appear that there is a risk of the harm the NASD is seeking to avoid.

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B. The Mechanism for Members to Identify Triggering Transactions in TRACE Reports Should be Adjusted

Proposed IM-6230(a) states, among other things, that “[a] member must report such Triggered Transactions using the TRACE memo field and include a ‘CDS’ memo. NASD also requires that such transaction be reported using the ‘special price’ modifier or flag”¹⁸ This requirement has two purposes: “[T]o allow NASD to properly categorize such transactions for purposes of examining the member for compliance with its reporting obligations and, as discussed below, for decisions to not disseminate the transaction information.”¹⁹ Proposed amendments to NASD Rule 6250 provide that the NASD will not disseminate information on Triggered Transactions resulting from the exercise or settlement of an option or similar instrument, or of a CDS or any other type of swap. However, the NASD has not specified a mechanism for dealers to identify Triggered Transactions resulting from the exercise or settlement of options or similar transactions. SIFMA believes that the NASD should adopt a consistent method for members to use in identifying Triggered Transactions, regardless of whether the underlying contract is an option, CDS or similar instrument.

Further, SIFMA notes that the Proposal requires members to identify all Triggered Transactions resulting from the physical settlement of CDS, regardless of whether the derivatives contract meets the dissemination criteria discussed above. Thus, it is not clear how the NASD would use the information in the memo field to determine which reports to disseminate and which to suppress.

As a consequence, SIFMA believes that the NASD should use a single flag to identify any Triggered Transactions, and not rely on the entry of free text into the Special Memo Field to identify TRACE reports of Triggered Transactions. SIFMA believes that the NASD will be in a better position to more effectively suppress dissemination if such suppression is based on a distinct flag rather than on free text entries. The use of a free text field may lead to errors and failures to properly withhold Triggered Transactions, while a single flag may be easier to input and result in fewer errors.

C. Submission of Reversal and Cancel/Correct Trade Reports

The Proposal states that a member is not required to submit to TRACE reversal or cancel and correct reports if, after the member reports the Triggering Transaction to TRACE, the party with the delivery obligation substitutes another security of the same issuer for the security

¹⁸ Proposal, 71 F.R. at 65556. According to the TRACE User Guide at page 64, if the Special Memo field is filled in, the Special Price Flag must be checked. The Special Memo field is a fifty character alphanumeric field used to input the special conditions underlying a specified trade, and will be shown to the Contra side. The Proposal’s use of the term “memo” appears by reference to the Special Price Flag to mean the Special Memo field.

¹⁹ Id.

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already reported. SIFMA appreciates the NASD's flexibility in not requiring each substitution to be reported. However, SIFMA is concerned about two aspects of this part of the Proposal.

i. Reversals and Cancel/Corrects Involving Guarantees Should Not Be TRACE Reportable

SIFMA believes that the Proposal is overly narrow, as the relief from reporting reversals, cancels and corrects only applies if the substituted security is of the same issuer as the originally reported security. However, many CDS contracts permit delivery of securities issued by, or guaranteed by, the issuer experiencing the credit event. As such, a party may deliver a Notice of Physical Settlement ("NOPS") for a security of an issuer guaranteed by the entity experiencing the credit event, and then later substitute that security with a security of the issuer itself, or vice versa.²⁰ As currently written, the Proposal would require members to report the reversal, cancel and correction in these guarantee scenarios.

SIFMA believes that the NASD's rationale for not requiring TRACE reporting of reversal, cancel and correct reports is equally valid in the guarantee scenarios. The NASD explained its rationale for excluding substitutions from TRACE reporting by stating, "NASD believes that the reporting of transactions in TRACE-eligible securities in connection with the termination or settlement of a CDS provides important market surveillance information that is not changed materially even if, subsequently, one or more of the specific TRACE-eligible securities reported initially to the TRACE system is substituted and a different TRACE-eligible security of the same issuer is delivered to effectuate settlement." SIFMA suggests that if the bonds are sufficiently fungible that the parties to the CDS transaction view one as a substitute for the other, then the NASD's market surveillance information is equally unchanged by the delivery of one bond over the other. As such, SIFMA requests that the relief from reporting reversals, cancels and corrects should be expanded to include Triggered Transaction that involve the substitution of a TRACE-eligible security of, or guaranteed by, the same issuer as the security originally reported to TRACE.

ii. The NASD Should Clarify that the Relief is Optional

SIFMA would also like the NASD to clarify that the relief offered by this paragraph is optional. We note that as written, the IM-6230(c) states only that members are not required to report reversals, cancels and corrects, which suggests that members may report these reversals, cancels and corrects if they so choose. This option would permit firms to work within their existing infrastructure, and reduce unnecessary costs. Some firms may find it difficult operationally to report some Triggered Transactions and not others. In particular, members whose systems permit straight-through processing may have existing infrastructure that will automatically send reversal and cancel/correct reports to TRACE; these members would need to

²⁰ "When a CDS is subject to physical settlement, the buyer effects contract settlement by communicating to the seller, in a single or the first of two or more [NOPS] with a fixed period, the TRACE-eligible security or securities, by CUSIP, that the buyer will deliver to the seller. However, following delivery of the [NOPS], the buyer may have additional business days . . . to change the specific TRACE-eligible securities the buyer will deliver." Proposal. 71 F.R. as 65556.

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engage in costly reprogramming or would need to manually suppress such transmissions in order to comply with the Proposal. In contrast, firms that have manual systems would benefit from the Proposal, as it would mean that they would not need to engage in costly and potentially erroneous manual inputs each time a substitution referenced by the Proposal occurred. A selection either way would create burdens and costs on firms, and potentially result in increased errors and delays in reporting. Further, the costs to firms to build the systems necessary to suppress reports of reversals, cancels and corrects would seem to outweigh the benefits, given the expected decrease in Triggered Transactions resulting from the adoption of the CDS Protocol. As such, SIFMA requests that the NASD clarify that the exclusion from TRACE reporting reflected in IM-6230(c) is optional, not mandatory.

D. Reporting Time of Triggered Transactions

Proposed NASD IM-6230(a) requires members to report Triggered Transactions to TRACE: (i) before 8:15:00 a.m. E.T. on the next business day following receipt of the First NOPS; or (ii) before 6:30:00 p.m. E.T. on the next business day following receipt of the first NOPS, if the first NOPS was received on a non-business day. As such, Triggered Transactions would not be subject to the standard 15 minute reporting timeframe generally required by TRACE. Again, SIFMA applauds the NASD for its flexibility in this area. However, SIFMA believes that in all instances members should have until 6:30 p.m. on the day after receipt of the first NOPS to report transactions to TRACE, given the volume of transactions when a credit event occurs and the lack of apparent regulatory imperative to report transactions by a certain time.²¹

In agreeing to permit TRACE reporting to occur the day after the receipt of the first NOPS, the NASD explained that

the 'time of execution' for CDS-related transactions is of less regulatory importance than for other reported transactions in TRACE-eligible securities because the price of a transaction in a TRACE-eligible security executed pursuant to a CDS is arrived at under the terms of the CDS agreement that are established at the time the CDS is agreed upon by the parties. Consequently, NASD believes that a precise time of execution is not required for regulatory purposes²²

The NASD also explains that requiring 15 minute reporting imposes an unnecessary burden and that permitting next-day reporting will permit members to process the first NOPS efficiently.²³

²¹ SIFMA notes that the new ISDA auction protocol may reduce the number of physical settlements.

²² Proposal, 71 F.R. at 65556-57

²³ Id., 71 F.R. at 6557.

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SIFMA appreciates the NASD's flexibility, and supports the NASD's perspective. However, we believe that allowing members until 6:30 p.m. on the day after the receipt of the first NOPS (or any subsequent NOPS in the event of a substitutions) will further reduce unnecessary burdens and increase efficiency, without any negative impact on the NASD's regulatory goals. NOPS are delivered in response to credit events and are likely to be voluminous. While procedures may vary across firms, often the NOPS will be received by the documentation or other group, which then will forward the NOPS to the desk that transmits the execution and reporting of the Triggered Transaction. As such, it may take time for the NOPS, once received, to arrive at the desk responsible for reporting to TRACE. Compounding this, the firm may receive the NOPS late in the trading day, or after standard business hours when employees are no longer available to process the NOPS. As a result of the large volume and the uncertainty in place and time of receipt, reporting by 8:15 a.m. may be difficult. Members will be better able to process the trade reports accurately and in a timely fashion if they have until 6:30 p.m. on the next business day after receipt of the NOPS to report in all cases. Moreover, it does not appear that the NASD's rationale for permitting an exclusion from the 15 minute reporting requirement for Triggered Transactions is inconsistent with allowing firms until 6:30 p.m. on the business day after receipt of the NOPS to submit the TRACE reports.²⁴

Further, SIFMA requests that the NASD clarify that time frames for Trade Reporting apply to Triggered Transactions resulting from the CDS Protocol, as well as from other Triggered Transactions.²⁵

IV. Protocols for the Settlement or Termination of Swaps Will Reduce the Number of Physical Settlements Subject to the Proposal.

A. Background

As mentioned above, members recently established the CDS Protocol to facilitate the settlement of obligations under CDSs following a credit event. Market participants choose whether to adhere to the protocol on a credit event by credit event basis. The CDS Protocol includes an auction to set the market clearing price for the bonds underlying the CDS. Each participant in the CDS Protocol agrees to cash settle its obligations on a net basis, based on the price set at the auction. The parties net their obligations, with one party delivering cash to the other based on the price determined in the auction. Parties generally view cash settlement as desirable as it simplifies settlement, requiring one asset movement rather than two. As such, many market participants generally find participation in the auction to be beneficial.²⁶ In

²⁴ For firms that elect to report reversals, cancels and corrects, we would request that the NASD require such reports to be transmitted by 6:30:00 p.m. on the business day following the substitution. See III.C., below.

²⁵ We note that in the context of deliveries of bonds resulting from the CDS Protocol, given the specific mechanics involved, members may be able to report transactions by 8:15 after receipt of the NOPS or its equivalent.

²⁶ For example, in a recent CDS Protocol for bonds of Dura Operating Corp., 327 entities participated. Such entities included all dealers that had eligible trades and the majority of their buy-side counterparties.

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addition, the auction includes a process whereby parties may receive or deliver the underlying bonds at the price set in the auction in order to replicate the positions the party would have had if it had not participated in the auction. This aspect of the auction process involves the receipt of a document similar to the NOPS ("NOPS-equivalent") in the days following the auction, and permits the substitution of bonds in the same manner as a NOPS.

Members anticipate that the continued implementation of the CDS Protocol will significantly reduce the number of Triggered Transactions subject to the NASD's proposed rule because many market participants are expected to prefer net cash settlement to physical settlement. However, although we expect physical settlement to decrease considerably, physical settlement will continue to occur. First, parties to CDSs may choose whether to participate in the CDS Protocol and, depending on the circumstances surrounding a particular credit event, may choose not to participate. In such a situation, the parties will settle the CDS through a Triggered Transaction at the bond's par value, well above the expected secondary market value following a credit event.²⁷ Further, the CDS Protocol does not cover options on TRACE-eligible securities. Accordingly, obtaining the relief requested above, including relief from TRACE reporting of the Triggered Transactions in their totality, remains important and, in fact, is enhanced by the CDS Protocol. SIFMA questions whether the benefit of information regarding an increasingly diminishing segment of the market (i.e., physical settlements), which may not further the goals of TRACE, outweighs the cost of establishing infrastructure to provide such information.

B. Application of the Proposal to Deliveries Resulting from the CDS Protocol

As discussed above, delivery of bonds in the context of the CDS Protocol will occur at the price derived in the auction. As a result, unlike the Triggered Transactions, SIFMA does not object to the TRACE reporting of these deliveries of TRACE-eligible securities as they reflect market prices determined in the auction. However, the processes described for any required TRACE reports of Triggered Transactions should be applied to these deliveries.

Under the CDS Protocol, it would not be possible for a dealer to report to TRACE the bond deliveries in the context of the CDS Protocol prior to receipt of the NOPS-equivalent because no particular bond would have been identified to the dealer for delivery. Accordingly, firms need until 8:15 a.m. (or, if our earlier suggestion is adopted, 6:30 p.m.) on the day after the receipt of the first NOPS-equivalent.²⁸

With respect to dissemination, under the CDS Protocol, the NOPS-equivalent will be received after the auction. Thus, the dealer would not be required to report the transaction to

²⁷ We note that delivery of bonds may occur under the CDS Protocol at the price determined in the auction, rather than at par, and that this information is available publicly.

²⁸ In this context, firms believe that reporting by 8:15 a.m. the day after receipt of the NOPS-equivalent is feasible. However, SIFMA believe that NASD should have one rule on this point, and thus would request that the time be set for 6:30 p.m. the day after delivery of the NOPS, as with our request related to the Triggered Transactions.

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TRACE until days after the auction, at which time the auction price may no longer represent the secondary market price. Since the auction information, including the market clearing price, is publicly available on the day of the auction, and the market price may change before the TRACE report is made, SIFMA believes that the NASD should not disseminate trade reports resulting from Triggered Transactions occurring in the context of the CDS Protocol.²⁹ Further, given the expected limited number of physical settlements to be effected under the CDS Protocol, we request that in this context, the existing special price modifier continue to be used. Last, for the same reason that firms should not be required to report reversals, cancels and corrects resulting from substitutions of bonds to be delivered in Triggered Transactions, firms should not be required to report reversals, cancels and corrects related to substituted bond deliveries in the context of the CDS Protocol. As with Triggered Transactions, we request that this exception be expanded to include the guarantee scenario.

* * * * *

For the reasons discussed above, SIFMA believes that NASD members should not be required to report the Triggered Transactions to TRACE. However, should the NASD require such reporting, we believe that the Proposal should be amended to take the issues discussed above into account.

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: Michael Macchiaroli, Associate Director, SEC
Marc Menschel, General Counsel, NASD
Sharon Zackula, Assistant General Counsel, NASD

²⁹ Should the NASD choose to disseminate all Triggered Transactions, then the NASD should also disseminate bond deliveries occurring in the context of the CDS Protocol.