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

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[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).

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 TRACE[4], 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.

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

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[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.

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

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[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] <u>See</u> 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.")

> 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.

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.

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.

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

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[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.

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.

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 purposes . . . .[22]

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]

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[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.

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 buyside counterparties.

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

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[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.

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.

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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

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

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[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.