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THE BOND MARKET ASSOCIATION

April 5, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: File No. SR-NASD-2003-141
Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities

Ladies and Gentlemen:

The Bond Market Association (the "Association") welcomes the opportunity to comment on the interpretation proposed by the NASD concerning the application of its mark-up policy to transactions in debt securities (the "Proposed Interpretation"). The Proposed Interpretation was recently published for comment by the Securities and Exchange Commission (the "SEC").[1]

EXECUTIVE SUMMARY

By its terms, the Proposed Interpretation addresses only (1) the manner in which dealers may determine a bond's "prevailing market price" and (2) when, if ever, a dealer may use information about a "similar" security in connection with that determination. In reality, the effects of the Proposed Interpretation — read together with informal legal guidance issued in settlements — would be far reaching. If adopted without substantial revision, the Proposed Interpretation would accomplish neither its stated purpose nor its statutory obligation to "remove impediments to and perfect the mechanism of a free and open market."[2] The SEC should reject the Proposed Interpretation and direct the NASD to propose an interpretation that relies instead on competitive forces and improvements in bond market transparency. Alternatively, the SEC should require the NASD to modify its proposal substantially and report on the competitive burdens it would impose.

[1] 70 Fed. Reg. 12,764 (Mar. 15, 2005).

[2] Exchange Act § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6).

- **Adverse Effect on Liquidity**. As a recent NASD report observed, the bond markets depend on the liquidity provided by dealers risking capital to facilitate customer trading.[3] The Proposed Interpretation and other informal NASD guidance threaten this liquidity by calling into question when, if ever, bond dealers would be entitled to be compensated for capital risk in the same manner as equity market makers — *i.e.*, by measuring the amount of "mark-up" (if any) from the prices at which dealers are willing to buy or sell a security rather than from a security's "contemporaneous cost." Coupled with the absence of guidance on when a trade would be considered "contemporaneous" (and hence the presumptive "prevailing market price") — and in the face of prior guidance suggesting trades as far back as *thirty-eight days* can be deemed to have been "contemporaneous" — the Proposed Interpretation risks deterring bond dealers "from taking the risk of maintaining a market or position in a security and, consequently, would impair market liquidity."[4] Additional work is needed to ensure that the NASD's efforts to regulate bond mark-ups do not result in a flight of dealer capital from the bond markets. The Association recommends the adoption of a safe harbor for debt market makers based on capital at risk and block positioning activities.

- **Overemphasis on Equity Market Constructs**. Guidance in the Proposed Interpretation and in NASD settlements is predicated on the erroneous view that the bond markets have the same type of established inter-dealer market and two-way quotation practices as exist in the domestic equity markets. But aside from the markets for government and agency debt securities, there are not well-developed inter-dealer markets for most classes of bonds. Nor do bond dealers quote two-way prices for most bonds. Bond dealers do, however, stand willing to buy or sell at particular prices, typically on request, and many of the largest dealers devote substantial capital to maintaining positions in debt securities. Requiring bond dealers to measure a mark-up from a bond's "contemporaneous cost" unless they point to an inter-dealer trade or establish that they quoted two-way prices in an inter-dealer system discriminates against bond dealers.

- **No Guidance on the Meaning of "Contemporaneous Cost."** The Proposed Interpretation establishes a rule for non-market maker dealers that a bond's "contemporaneous cost" is the best evidence of its "prevailing market price." The proposal, however, neither defines the term nor provides any constructive guidance on how the NASD intends to interpret it. Off-the-run U.S. government securities and corporate debt securities do not trade every day. Figures for corporate debt securities reported to TRACE indicate that roughly two thirds of bonds trade less frequently

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3 Report of the Corporate Debt Market Panel 6 (Sept. 2004) (noting that institutional investors were concerned about a "reduced appetite for facilitating customer transactions by employing capital").

4 In re Peter J. Kisch, Exchange Act Rel. No. 19005 (Aug. 24, 1982).

than once every five days.[5] Nevertheless, figures provided to the BMA indicate that high yield, distressed, and emerging market bonds are subject to significant price volatility in periods lasting five or fewer days. Bond dealers should not be required to use stale trade data as the best evidence of the "prevailing market price."

- **The Proposed Interpretation's "Hierarchy" of Permissible Pricing Considerations Is Overly Rigid and Is Inconsistent with the Practicalities of the Bond Markets.** The Proposed Interpretation fails to provide meaningful guidance for dealers to follow when pricing at-risk trades in unique, illiquid securities aside from a "Hierarchy" of likely inapplicable considerations. A "Hierarchy" that requires bond dealers to look sequentially at (1) inter-dealer trades, (2) trades in the same or similar security with a defined subset of institutional customers, and (3) quotations on an inter-dealer system for actively-traded bonds is of little use to bond dealers trading many types of debt securities.

- **The Proposed Interpretation Substantially Restricts the Use of Helpful Concepts Such as "Similar Securities," "Specified Institutional Trades," and "Economic Models."** The Proposed Interpretation so constrains the permissible use of "similar securities," "specified institutional trades," and "economic models" to determine a bond's prevailing market price that they would, as a practical matter, be unavailable for dealers in illiquid securities.

- **The Proposed Interpretation Presents Special Problems for the Market for Illiquid Debt Securities**. Dealers in high yield, distressed, emerging market, and many types of structured debt securities trade in markets that are not typified by inter-dealer trading, "similar" securities, or actionable quotations. For example, structured debt securities, including asset-backed securities (ABS), mortgage-backed securities (MBS), and collateralized debt obligation securities (CDO), make up a large portion of the bond markets. Many of these structured products are highly customized based on the needs of the investors and, as a result, are generally illiquid, particularly those that are private securities and/or carry a below investment grade credit rating. Trades may occur infrequently, and pricing tends to be model-driven and not predicated upon the price of the most recent transaction. Moreover, the market for such securities consists almost exclusively of highly sophisticated institutions that have the ability and the incentive to assess pricing (and regularly assess value using their own models). In light of the complexity of these unique securities, requiring dealers to constrain pricing determinations to contemporaneous cost, the proposed "Hierarchy," or any other rigid set of metrics would threaten not only the liquidity of the secondary market, but the ability of issuers to meet their short- and long-term financing needs through this market.

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[5] Published TRACE data reflect that, during the 5 trading days beginning March 14, 2005, 8,611 different CUSIP numbers traded at least once and, during the 5 trading days beginning February 14, 2005, 8,766 different CUSIP numbers traded at least once. These numbers constitute 29.7% and 30.2% of the 29,000 TRACE-eligible debt securities.

- **The Proposed Interpretation Presents Special Problems for Retail Bond Dealers**. If adopted, the NASD's proposal would present special and difficult problems for retail bond dealers in light of the increased prevalence of non-traditional brokerage fee arrangements that result in TRACE-reported prices that do not reflect transaction-based compensation. The Proposed Interpretation also fails to permit retail dealers to consider the size of a retail transaction when determining the prevailing market price of a bond.

Section I addresses the NASD's continued and exclusive focus on dealer profit rather than fair pricing. Because "the basic criterion for judging markdowns or markups is fairness to the customer,"[6] the regulatory scheme should focus instead on a bond's effective yield. The SEC endorsed this approach in connection with debt securities when the Municipal Securities Rulemaking Board adopted Rule G-30 and should do so here.

Section II discusses the differences between market making functions in the equity and debt markets. The NASD's proposal fails to state whether bond dealers performing these functions are similarly entitled to calculate a bond's "prevailing market price" using something other than "contemporaneous cost." Informal NASD legal guidance, however, suggests an unwillingness to treat bond dealers as "market makers" unless they publish quotations "'in the inter-dealer market on a regular or continuous basis.'"[7] Any such blanket limitation on bond dealers would be inconsistent with the Exchange Act definition (which is not so limited), with SEC caselaw (which has held to the contrary),[8] and with other definitions of the term in SEC regulations (which are not so limited).[9]

Section III addresses the Proposed Interpretation's undue emphasis on a bond's "contemporaneous cost" as the presumptive measure of its prevailing market price, subject to only very limited exceptions. There is no support for the establishment of such a heavy presumption outside the context of riskless principal transactions. The NASD should also provide additional guidance to dealers pricing inactively traded securities for which there are no contemporaneous trades, no inter-dealer transactions, and no "similar securities" and expand the circumstances in which dealers may use economic models to price bonds.

Section IV discusses the need for the NASD to clarify that a "riskless principal" transaction requires that a dealer have a firm order in hand and to acknowledge that many considerations bear on the fairness of a mark-up in such a transaction, including specialized services offered by a dealer as well as risks other than loss of capital, such as settlement

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6 In re Wheeler Municipals Corp., Exchange Act Rel. No. 28510 (Oct. 3, 1990).

7 In re Citigroup Global Markets Inc., NASD AWC No. CMS 040113, at 4 n.6 (July 28, 2004).

8 In re Raymond James & Assocs., Inc., Exchange Act Rel. No. 38893 (Aug. 1, 1997).

9 Exchange Act Rule 11Ac1-2(a)(13); Order Execution Obligations, Exchange Act Rel. No. 37619A, 61 Fed. Reg. 48,290, 48,318 (Sept. 12, 1996).

risks. These considerations are far less prevalent in the equity markets and may, in particular circumstances, justify a mark-up in excess of five percent.

Section V commends the NASD's acknowledgement that certain institutional trades warrant special treatment, but points out that two limitations in the proposal are overly restrictive. This Section also urges expanding the concept to match aspects of the NASD's institutional suitability rules.

Section VI discusses the problems presented by the proposal's contemporaneous cost presumption for integrated and retail bond dealers in light of nontraditional, fee-based brokerage accounts for which reported prices do not include any transaction-based compensation. This Section also recommends the extension of the "Specified Institutional Trade" concept to permit retail dealers to take into account the comparative size of any "contemporaneous" trades when determining the prevailing market price of a retail lot.

Sections VII and VIII take issue with the accuracy of the NASD's categorical observation that "mark-ups for transactions in common stock are *customarily higher* than those for bond transactions of the same size"[10] and points out the unfairness of the proposal's burden-shifting presumptions and restrictions on the ability of dealers to rebut them.

Finally, Section IX details the ways in which the proposal fails to comply with the Exchange Act and other federal statutes.

DISCUSSION

I. The Association Continues To Believe that the Proper Focus of Debt Mark-Up Policy Should Be on Fair Pricing, Not Simply an Examination of Dealer Compensation.

The Association believes that a regulatory scheme that focuses exclusively on the amount of dealer compensation received in connection with a particular trade inappropriately equates fair pricing with dealer profit and would not necessarily further the protection of investors.[11] As the SEC has repeatedly made clear, "the basic criterion for judging markdowns or markups is fairness to the customer."[12] For the vast majority of bonds, the touchstone for the fairness of a price is the effective yield to maturity (or call date), which is readily apparent to customers and is disclosed on the confirmation for each

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10 Proposed Interpretation, 70 Fed. Reg. at 12,766 (emphasis added) (citing IM-2440-1(b)(1)).

11 The Association addressed this concern at length in its letter commenting on the NASD's proposed debt mark-up interpretation filed in 1998. Letter from Paul Saltzman, Sr. Vice President and General Counsel, Bond Market Association, and George P. Miller, Vice President and Deputy General Counsel, Bond Market Association, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Dec. 16, 1998).

12 In re Wheeler Municipals Corp., Exchange Act Rel. No. 28510 (Oct. 3, 1990).

transaction. Even for those few classes of bonds that do not trade on the basis of yield, other indicia are better suited to an assessment of fairness than dealer profit.

The Proposed Interpretation affords the SEC an opportunity to reconsider the NASD's apparent conclusion that concepts and principles developed in the context of the U.S. equity markets should be imported into the vastly different market for debt securities — at a time when market transparency and trading practices continue to evolve and respond to regulatory initiatives that, unlike the Proposed Interpretation, introduce and strengthen competition among dealers to the benefit of investors generally. The debt markets are extremely competitive markets characterized by a significant institutional investor component and fungibility among securities within most fixed-income sectors. Customers are generally quite capable of comparing and choosing among investment alternatives on the basis of yield. Under these circumstances, mark-up regulatory policy should not simply follow a model established for the equity markets. The Association believes that judgments about fair prices for fixed-income securities in the competitive and increasingly transparent bond markets are determinations that are best left to market participants to resolve through commercial interaction.

A debt mark-up interpretation that acknowledges the primacy of "fairness to the customer" should focus on a bond's yield rather than a dealer's trading profit in order to match the regulatory scheme with bond customers' investment objectives. The Municipal Securities Rulemaking Board ("MSRB"), an independent body charged with developing rules that govern trading in municipal debt securities, has rules in place that follow just this approach. Rather than focusing exclusively or even primarily on the amount of dealer compensation on a given trade, the MSRB has stated that, under Rule G-30, "the most important factor in determining whether the aggregate price to the customer is fair and reasonable is that the yield should be comparable to the yield on other securities of comparable quality, maturity, coupon rate, and block size then available in the market."[13] To be sure, other factors – including whether dealer compensation is "excessive" – need to be considered under Rule G-30. But the MSRB has cautioned that overattention to dealer compensation risks losing sight of the primary concern – ensuring customers receive a market yield.[14]

The Association is committed, however, to providing constructive comments to the NASD's Proposed Interpretation within the framework of Rule 2440, IM-2440, and prior NASD and SEC guidance. The comments that follow specifically address the particular provisions of the Proposed Interpretation as well as other, informal legal guidance regarding debt mark-ups that was issued by the NASD during the past year outside the current rulemaking and not subject to the notice-and-comment process. The Association also intends to provide a description of the secondary market in bonds as a supplemental filing to this letter. This description may be useful to the SEC in determining that aspects of the

[13] MSRB, Review of Dealer Pricing Responsibilities, 2004-3 (Jan. 26, 2004).

[14] *Id.* ("However, it is also possible for a dealer to restrict its profit on transactions to reasonable levels and still violate G-18 or G-30 because of inattention to market value.").

bond markets are different from the equity markets and therefore justify a different approach to mark-up regulation.

II. The Proposed Interpretation Would Threaten Market Liquidity By Failing To Acknowledge the Critical "Market-Making" Role Played by Dealers in the Bond Markets.

Bond dealers regularly risk their capital to facilitate customer transactions and either earn or lose money based on the difference between the price at which they were willing to buy or to sell bonds for their own account. These dealers — whether by acting as block positioners or by holding themselves out as willing to buy or sell for their own account — act as "market makers." The SEC has stated that a dealer's status as a market maker depends not on specific quotation obligations or inter-dealer activity, but rather on the "specific context" of the market in which a dealer provides liquidity.[15]

A "mark-up equals the price charged to the customer minus the [bond's] prevailing market price"[16] and, pursuant to the NASD's Mark-Up Policy, dealers must transact with customers at prices reasonably related to this "prevailing market price." Dealers risking capital in connection with market making activities may, subject to certain conditions, treat the prices at which they were willing to buy (in the case of a customer sale) or to sell (in the case of a customer purchase) as a security's "prevailing market price."[17] Dealers that are not engaged in this type of market making activity generally must instead, under the Proposed Interpretation, use a bond's "contemporaneous cost" as the presumptive measure of its prevailing market price. In its simplest terms, the NASD's Mark-Up Policy permits dealers engaged in market making activities to "mark-up" from the prices at which they stand willing to transact (as a block positioner or otherwise) rather than from their contemporaneous cost. Accordingly, when a dealer is engaged in market making activities, the NASD's so-called five percent "guideline" applies to the mark-up (if any) from a dealer's bid or offer price and not from the acquisition price of the bond. The SEC has stated that, without this special accommodation to dealers that risk capital, dealers would be deterred "from taking the risk of maintaining a market or a position in a security and, consequently, would impair market liquidity."[18]

The Proposed Interpretation threatens the traditional role that capital commitment has played in determining a bond's "prevailing market price" by mandating the use of a dealer's "contemporaneous cost" unless a dealer meets the NASD's narrow interpretation of the Exchange Act's market maker definition.[19] This definition, however, has never before

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15 *See, e.g.*, In re Adams Securities, Inc., Exchange Act Rel. No. 31971 (Mar. 9, 1993).

16 Banca Cremi, SA v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1033 (4th Cir. 1997).

17 In a proposed disclosure statement for retail investors, the NASD equated this term with "a fair price reasonably related to the then current market price." NASD NTM 05-21, at 15.

18 In re Peter J. Kisch, Exchange Act Rel. No. 19005, 1982 WL 529109, at *5 (Aug. 24, 1982).

19 Proposed Interpretation, 70 Fed. Reg. 12,764, 12,766 n.12 (Mar. 15, 2005). Exchange Act § 3(a)(38) provides:

been used to restrict consideration of dealer risk in the context of debt mark-up regulation and, if interpreted narrowly, would run counter to the very precedent cited by the NASD.[20] The Association believes that, although the NASD proposes to permit only a specially defined class of "market makers" to be compensated in a manner that takes into account dealer risk, the Exchange Act and its legislative history require that the term be interpreted to include those bond dealers that regularly place capital at risk to facilitate customer trades.

Dealers performing "market making" functions are treated differently because they risk their own capital to provide much needed liquidity to the market. (Point II.A, below.) Many bond dealers, whether by acting as block positioners or by holding themselves out as being willing to buy or sell bonds for their own account, perform market making functions and are entitled to be treated as "market makers" when pricing bonds in at-risk trades. (Point II.B, below.) Should the NASD interpret the Exchange Act definition of "market maker" to require bond dealers to perform functions historically performed only by equity market makers in the Consolidated Quotation System or on Nasdaq, the result would be a loss of liquidity in those sectors of the bond markets where dealer capital is needed the most. (Point II.C, below.) The SEC should reject as incorrect the NASD's informal legal guidance on this issue. (Point II.D, below.) Finally, the NASD should adopt a safe harbor that recognizes that dealers devoting substantial capital to providing market liquidity would be deemed to be "market makers" within the meaning of the NASD's debt mark-up interpretation. (Point II.E, below.)

A. Dealers performing "market making" functions are treated differently in connection with mark-up analysis because they risk their own capital to provide liquidity to the market.

The NASD should return to the principles underlying the different treatment afforded to market makers. For over forty years, the SEC and the NASD have acknowledged that the extent to which dealers risk capital to facilitate customer trading bears on the fairness of a

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> The term "market maker" means any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.

15 U.S.C. § 78c(a)(38).

[20] In the years since its adoption as part of the Securities Acts Amendments of 1975, the Exchange Act definition has been used on occasion in SEC and NASD mark-up cases as a starting point in evaluating whether dealers in equity securities were market makers. *See, e.g.*, In re Adams Securities, Inc., Exchange Act Rel. No. 31971 (Mar. 9, 1993); In re Century Capital Corp., Exchange Act Rel. No. 31206 (Sept. 21, 1992); In re James E. Ryan, Exchange Act Rel. No. 18617 (Apr. 5, 1982); see also In re R.B. Webster Investments, NASD Compl. No. C07920035, 1994 WL 1067291 (NBCC July 28, 1994).

particular price or mark-up.[21] Generally speaking, dealers undertaking some form of market risk are entitled to be compensated for that risk. Accordingly, whether phrased in terms of a dealer's spread or, more technically, as the ability to compute mark-ups from some benchmark other than a dealer's contemporaneous cost, mark-up cases have long distinguished between riskless transactions and transactions involving dealer risk. SEC and NASD mark-up cases, which have focused overwhelmingly on trades in equity securities, have often used a dealer's status as a market maker as a way to distinguish between those dealers that commit capital to facilitate customer transactions and those dealers that, instead, act solely as market intermediaries executing trades risklessly.[22] There is no support, however, for the proposition that unless a bond dealer performs the mandatory functions associated with an *equity* market maker in the CQS or Nasdaq, it must measure a bond's "prevailing market price" by reference to its contemporaneous cost. When Congress first amended the Exchange Act in 1975 to include a statutory definition of "market maker," it did so with the expressed desire to "foster the risk-taking function of market makers" and warned that regulation should not "make them all do business in the same way."[23]

The reason for permitting dealers that perform market making functions to calculate their "mark-ups" from something other than their contemporaneous cost stems from concerns that to do otherwise "would deter market makers from taking the risk of maintaining a market or a position in a security and, consequently, would impair market liquidity."[24] In other words, the SEC has recognized that a dealer performing market making functions is generally entitled to a "dealer's turn" — the difference between the price at which it is willing to buy or to sell a security — and that a regulatory scheme that did not permit compensation for this service would threaten market liquidity.[25]

By recognizing that dealers that commit capital to facilitate customer trades should be permitted to be compensated as a "market maker," mark-up regulation has incentivized dealers to place capital at risk. The need for dealer liquidity is particularly acute in the bond

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[21] Report of the Special Study of the Securities Markets of the SEC, H.R. Doc. No. 95, 88th Cong., 1st Sess. 649-52 (1963) (discussing differing views on the role that dealer risk should play in determining prevailing market price).

[22] In re LSCO Securities, Inc., Exchange Act Rel. No. 28994 (Mar. 21, 1991); In re D.E. Wine Investments, Inc., Exchange Act Rel. No. 39517 (Jan. 6, 1998); In re Alstead, Dempsey & Co., Exchange Act Rel. No. 20825 (Apr. 5, 1984).

[23] Securities Acts Amendments of 1975, Report of the Comm. on Banking, Housing and Urban Affairs of the U.S. Senate To Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess. 14-16 (Apr. 14, 1975). The statutory definition was adopted in connection with various amendments to the Sections 11A and 15 of the Exchange Act designed to foster the development and regulation of a national market system.

[24] In re Peter J. Kisch, Exchange Act Rel. No. 19005, 1982 WL 529109, at *5 (Aug. 24, 1982).

[25] In re Adams Securities, Inc., Exchange Act Rel No. 31971 (Mar. 9, 1993) ("The difference between the market maker's bid and offer, or the 'dealer's turn,' is appropriate compensation for market makers because, by acting as market makers, they provide a liquidity service to the marketplace.").

markets. Indeed, a recent survey commissioned by the NASD's Corporate Debt Market Panel suggested a continued need to incentivize, or, at the very least, not penalize, dealers' willingness to risk capital. In its September 2004 Report, the Panel noted that its survey showed that institutional investors were concerned about bond dealers' "reduced appetite for facilitating customer transactions by employing capital."[26]

The SEC has recognized that the manner in which dealers perform market making functions varies depending upon the type of security and market. Equity market makers have access to well-developed electronic quotation platforms that permit inter-dealer trading and are subject to detailed rules governing their obligations and practices. The same obligations and practices may not be observed or even possible in connection with trading in other types of securities, including most classes of debt instruments. As a result, the SEC has refused to apply a formalistic approach when evaluating whether dealer activities outside the traditional equities context constitute market making. For example, the SEC found that a dealer in direct participation program ("DPP") securities acted as a market maker, notwithstanding the absence of inter-dealer activity or actionable quotations, based largely on the fact that the firm committed capital to facilitate customer trading:

> Raymond James held itself out as a market maker for DPP securities. Raymond James' advertising literature referred to the Firm as a market maker in limited partnership units. . . . Moreover, Raymond James incurred market risk and added liquidity to a largely illiquid market.[27]

The SEC made this functional conclusion notwithstanding the NASD's prior position that "generally speaking, dealers in the DPP secondary market do not act as 'market makers' as that term is defined in the Securities Exchange Act of 1934 and interpreted by case law."[28]

The federal courts have confirmed that the Exchange Act definition calls for a functional analysis of whether a dealer has held itself out as willing to buy or sell securities for its own account and not simply a yes-or-no analysis of whether a dealer publishes quotations in an inter-dealer system. For example, in *C.R.A. Realty Corp. v. Tri-South Investments*, the Second Circuit recognized that Drexel Burnham Lambert had acted as a "market maker" in high yield convertible debentures notwithstanding "the sporadic

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[26] Report of the Corporate Debt Market Panel 6 (Sept. 2004); see also NASD NTM 05-21, at 15 ("Additionally, bonds that are less frequently traded may be subject to wider 'spreads' in the secondary market . . . .").

[27] In re Raymond James & Assocs., Inc., Exchange Act Rel. No. 38893 n.14 (Aug. 1, 1997) (noting that, although "[w]hether a firm is buying and selling to other broker-dealers is evidence of whether [a] firm is a market maker for a particular security," Raymond James had no such transactions with unaffiliated dealers).

[28] Secondary Market in Direct Participation Program Interests, NASD Notice to Members 91-69 (Nov. 1991).

character of Drexel's listings and transactions."[29] The Second Circuit rejected the contention that Drexel's failure to hold itself out as a market maker *in an inter-dealer quotation system* (in that case, the Yellow Sheets) precluded a finding that it met the requirements of Exchange Act Section 3(a)(38). The Court found instead that "a firm can be a market maker without so stating in the Yellow Sheets" and that market participants "dealt with and recognized Drexel on this basis."[30]

These principles make clear that mark-up law treats "market makers" differently not because of a mechanical, formalistic measure of quotations or inter-dealer transactions, but rather because they provide a source of liquidity through a willingness to commit capital. In the words of the statute, a market maker is [1] "any dealer acting in the capacity of a block positioner" or [2] "any dealer who with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system *or otherwise*) as being willing to buy and sell such security for his own account on a regular or continuous basis."[31] Although definitions vary, a block positioner generally acts as a market maker "by committing its own capital to fill part of a customer's block sale order or effecting a short sale (or sale from inventory) to fill part of a customer's block purchase order."[32] With respect to dealers acting as market makers under the second prong, the statute does not prescribe any specific quotation obligation. Consistent with the Congress' desire not to require market makers to "all do business in the same way," the statutory provision is phrased disjunctively, permitting a dealer to hold itself out by using an inter-dealer quotation system "or otherwise." For this reason, among others, the SEC has cautioned against applying the Exchange Act's "market maker" definition woodenly.[33]

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[29] 738 F.2d 73, 74, 78-79 (2d Cir. 1984).

[30] *Id.* at 78.

[31] Exchange Act § 3(a)(38), 15 U.S.C. § 78c(a)(38) (emphasis added).

[32] Securities Confirmations, Exchange Act Rel. No. 15219, 43 Fed. Reg. 47,495 (Oct. 6, 1978) (noting that "[a] determination as to whether a quantity of a security is a block necessarily rests to some degree on the purpose for which the determination is being made"); *see also* Securities Transactions by Members of National Securities Exchanges, Exchange Act Rel. No. 15533 (Jan. 29, 1979) (stating that block positioners "position[] at least some part of the block — that is, by purchasing securities for its own account to fill all or part of a customer's block sale order, or by selling securities for its own account, as either a short sale or a sale from its inventory, to fill all or part of a customer's block purchase order"); Exchange Act Rule 3b-8(c) (defining "qualified block positioner"). The New York Stock Exchange similarly has rules governing block positioning exchange-traded equity securities. *See* NYSE Rule 127; NYSE Rule 97.

[33] *See, e.g.*, In re Adams Securities, Inc., Exchange Act Rel. No. 31971 (Mar. 9, 1993) ("The application of this [Exchange Act] definition [of 'market maker'] is affected by the specific context in which the issue arises.").

B. Many bond dealers perform market making functions that warrant treatment similar to that afforded to equity market makers.

With these principles in mind, the NASD should recognize that bond dealers can and do perform core market making functions that warrant similar treatment. Dealers in fixed-income securities perform a number of trading functions, none of which is typically priced or provided on a fee or per-use basis. These services include:

- *Providing Quotations, Levels, and Market Intelligence*. Bond dealers regularly develop lists, by sector, of bonds and the price ranges within which their traders believe that the bonds are likely to trade. These lists are often referred to as "axe sheets." These lists may reflect securities in which a particular trading desk is prepared to commit its capital or in which there is a general or stated customer or market interest. Depending on the desires of their particular customers, bond sales staff typically communicate some or all of the substance of these lists to the customers that they cover through a combination of phone calls, faxes, Bloomberg and other electronic messaging systems, and through website access. Traders also communicate portions of these lists to inter-dealer brokers, or so-called "brokers' brokers," which are, in turn, communicated in a consolidated fashion across a number of different bond dealers. Dealers in certain types of structured products, such as CDOs, often make their models available to customers.
- *Market Making Activity*. Some institutional customers rely upon bond dealers' ability and willingness, upon request, to provide one- or two-sided markets, supported by the extension of a firm's capital, in many classes of fixed-income securities. Retail trading desks similarly provide liquidity to support customer transactions in particular bonds upon request. Bond dealers, of course, do not make and communicate markets in the same style or manner as Nasdaq market makers, which must follow rules developed by the NASD for that purpose. But bond dealers in even the most fragmented, opaque sectors of the fixed-income markets stand ready, willing, and able on a daily basis to commit capital to facilitate customer trading.

C. The Proposed Interpretation would threaten much needed market liquidity if it were to be applied to refuse a dealer spread to bond dealers that did not perform market making functions in the same manner as equity market makers.

Should the Proposed Interpretation be applied to deny bond dealers the ability to earn a dealer's spread in connection with market making activity, the likely result will be a reduction in market liquidity in those areas of the market that rely most heavily on the commitment of dealer capital. Prior efforts by the NASD to define and categorize the activities of debt "market makers," however imperfect, consistently recognized that many bond dealers performed market making functions and, in certain circumstances, were entitled to be compensated on the basis of the difference between the prices at which they were willing to buy or sell.[34] The Proposed Interpretation, however, offers no guidance as to how the NASD intends to apply the Exchange Act's "market maker" definition to bond dealers, or even whether it continues to embrace the concept of a market maker in the debt markets. Denying the capital-committing dealer the opportunity to profit from the difference between the prices at which they were willing to buy or sell would interfere with its very willingness to commit capital to such customer-facilitation transactions, and would diminish market liquidity.

The Association believes that the Proposed Interpretation should be amended to reflect the special characteristics of the debt markets:

- *The NASD should recognize that, in addition to inter-dealer transactions, bond dealers engaged in market making activities may use contemporaneous sales to institutional customers to establish a basis for determining a bond's prevailing market price*. The Proposed Interpretation fails to set forth a rationale for treating *inter-dealer* trades as a better indicator of a bond's prevailing market price than trades with customers. For most corporate debt securities inter-dealer transactions may be rare or non-existent, rendering the ability to use inter-dealer transactions as evidence of the prevailing market price of little value. Moreover, the NASD's TRACE system does not differentiate between inter-dealer trades and customer trades in its disseminated reports, making the identification of an inter-dealer trade difficult. Unfortunately, neither the 1998 Proposal nor the Proposed Interpretation addresses the relevance of a bond dealer's performance of market making functions when there are no contemporaneous inter-dealer transactions in the same security. The NASD should revise the Proposed Interpretation to recognize that a bond dealer performing market making functions may use contemporaneous sales to institutional customers (by itself or as reported by other dealers) to establish a basis for determining a bond's prevailing market price in the absence of inter-dealer transactions in the same security.

- *The NASD should recognize that bond dealers engaged in market making activities may, in the absence of inter-dealer or institutional sales, use the bid or offer side of the market to establish a basis for determining a bond's prevailing market price*. Caselaw involving equity market makers has held that dealers in active, competitive markets may "use the bid or offer-side of the market (as appropriate and if validated)

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34 The 1998 Proposal provided the following definition of a market maker in the debt markets:

> In the debt securities markets, a market maker is a dealer who, with respect to a particular security, furnishes bona fide competitive bid and offer quotations on request and is ready, willing, and able to effect transactions in reasonable quantities at his or her quoted prices with other brokers or dealers.

1998 Proposal, 63 Fed. Reg. 54,169, 54,170 (Oct. 8, 1998).

for determining the prevailing market price."[35] A bond dealer that routinely commits capital to facilitate customer trading should similarly be entitled to calculate its mark-ups from the offered side of the market, as that "offered" side is established in the context of that particular class of debt security.[36] Government and many investment grade debt securities can be readily traded off of quotations made available by dealers that provide liquidity in those bonds. For debt securities that trade by reference to a benchmark or similar security an objective check exists on the bona fide nature of the dealer's offered side quotation. Less liquid securities — such as high yield, distressed, and emerging market bonds and certain types of structured debt securities — may trade only in a negotiated fashion and tend not to trade in relation to a benchmark or similar security. In light of the tremendous risks associated with market making activity in these less liquid classes of debt securities, the NASD should recognize that, in the absence of inter-dealer or institutional sales of a given bond, dealers placing capital at risk to facilitate customer transactions are entitled to use the prices at which they are willing to buy or sell, as well as quotations, to determine a bond's prevailing market price.[37]

- *The NASD should recognize that bond dealers may engage in market making activities across a wide range of similar securities without being required to provide quotations affirmatively or to effect transactions in any particular security within that broader category*. The Exchange Act definition of "market maker" should not be interpreted by the NASD to require a bond dealer to provide quotations or effect transactions in each and every security for which it may be ready, willing, and able to risk capital to facilitate trading. Although security-specific determinations of market maker status makes sense in the context of the equity markets, where there are a far fewer number of individual securities, dealers perform market making functions differently in the bond markets. Bond dealers, for example, may act as market makers (either by acting as block positioners or holding themselves out as willing to buy or sell for their own account) across a spectrum of government or agency debt securities that trade at spreads to certain benchmark securities or other types of investment grade corporate bonds. These types of bonds tend to exhibit comparable trading and pricing characteristics that correlate to credit and yield characteristics. In other classes of illiquid debt securities, such as distressed, high yield, and certain types of structured securities, bond dealers may hold themselves out as willing to perform market making functions in some or all of the bonds in a

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[35] In re Raymond James & Assocs., Inc., Exchange Act Rel. No. 38893 (Aug. 1, 1997); *see also* In re Alstead, Dempsey & Co., Exchange Act Rel. No. 20825 (Apr. 5, 1984).

[36] Compare NASD NTM 05-21, at 17 (stating that "if you sell a bond, a dealer will offer you a price that includes a mark-down from the price that the dealer believes that he can sell the bond to another dealer or another buyer").

[37] *See* In re A. Bennett Johnson, Exchange Act Rel. No. 10258 (June 29, 1973) ("In this case, we find that the District Committee's decision not to use the firm's costs as a basis for computing markups appropriate in view of the surrounding circumstances. A dealer's own contemporaneous cost is not representative of the prevailing market in such special circumstances as where he acquired the securities in a distress sale or obtained a special price concession because of a large purchase.").

particular issuer's capital structure,[38] a particular type of structured security, or across several issuers in a troubled industry sector.

The Proposed Interpretation, to the extent that it continues to rely solely upon the Exchange Act definition of "market maker" to govern whether bond dealers are entitled to a dealer's spread, must be interpreted in a manner that takes into account the unique character of the bond markets. Regrettably, the Proposed Interpretation offers no guidance whatsoever on how the NASD intends to apply this critical standard and, as set forth below, informal NASD legal guidance runs counter to the Exchange Act and SEC pronouncements.

D. Informal guidance issued by the NASD outside the rulemaking that limits the circumstances in which a bond dealer may be considered a "market maker" reflects neither existing law nor current market practice.

Although the SEC previously has cautioned that the application of Exchange Act definition "is affected by the specific context in which the issue arises,"[39] statements summarizing the legal standard for market making included in a group of four NASD settlements this past summer call into question whether the NASD continues to accept the premise that "market makers" exist outside the confines of today's equity over-the-counter markets. Any adopted debt mark-up interpretation should correct the informal guidance set forth in these settlements that reflects neither existing law nor current market practice.

First, NASD statements in settlements suggest that the provision of quotations and one- and two-sided markets to institutional customers do not constitute market making activity unless they were made available to an inter-dealer market:

> Legal authority, however, provides that, to be considered a market maker, a dealer "must be willing to buy and sell the security at issue *in the inter-dealer* market on a regular or continuous basis."[40]

This is an incorrect statement of the law and misconceives the very nature of the inquiry. Exchange Act Section 3(a)(38) provides that a market maker must hold itself out as being

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38 Indeed, as an issuer's outstanding debt securities become increasingly distressed, certain series of bonds with different coupons and maturities may "collapse" and trade together based on expected recovery rates.

39 In re Adams Securities, Inc., Exchange Act Rel. No. 31971 (Mar. 9, 1993); *see also* In re Raymond James & Assocs., Inc., Exchange Act Rel. No. 38893 (Aug. 1, 1997).

40 In re Deutsche Bank Securities Inc., NASD AWC No. CMS040105, at 5 n.6 (July 28, 2004) (emphasis in original) (quoting In re Strategic Resource Mgmt., Inc., Exchange Act Rel. No. 36618 (Dec. 21, 1995) and citing Exchange Act § 3(a)(38)). Virtually identical statements were included in three other settlements announced the same day. *See* In re Goldman, Sachs & Co., NASD AWC No. CMS 040106, at 5 n.5 (July 28, 2004); In re Citigroup Global Markets Inc., NASD AWC No. CMS 040113, at 4 n.6 (July 28, 2004); In re Miller Tabak Roberts Securities, LLC, NASD AWC No. CMS 040112, at 4 n.6 (July 28, 2004).

willing to buy and sell a security for its own account "by entering quotations in an inter-dealer communications system *or otherwise*." There is no standard template for market making activity, and cases arising out of the equity context should not be construed as having created such a checklist of mandatory functions. That is why, for example, the SEC was able to find that Raymond James was a "market maker" in DPP securities notwithstanding the fact that it had never had any sales to unaffiliated dealers and "did not publish quotations in an inter-dealer quotation system."[41]

Second, in the same group of settlements, the NASD stated categorically that "[b]uying from one customer for resale to another customer does not constitute market making."[42] This, too, is an incorrect statement of the law. For example, the SEC has recognized that "dealers that internalize customer order flow in particular stocks, by holding themselves out to customers as willing to buy and sell on an ongoing basis, would fall within the [market maker] definition even though they may not hold themselves out to all other market participants."[43] Nor does Exchange Act Rule 11Ac1-2(a)(13) restrict the term in the manner stated by the NASD. Nothing in this rule suggests that the SEC has countenanced an interpretation of Exchange Act Section 3(a)(38) that refuses to recognize market making efforts outside the context of the inter-dealer market. Indeed, the SEC found to the contrary in *Raymond James* and instructed the NASD to do the same.

E. The NASD should adopt a "safe harbor" for debt market makers.

The determination of whether a dealer should be entitled to calculate the mark-up using the "offered" side of the market as the reference point for determining prevailing market price (in the case of sales to customers) should be based on whether the dealer in fact is prepared to commit its capital by buying securities or selling them short without having an identified counterparty to relieve it of the risk. The objective fact that a firm from time to time takes on a proprietary position (short or long) in classes of fixed income securities offers readily verifiable evidence that a dealer is prepared to commit capital and should be expressly recognized as a highly probative of a bond dealer's entitlement to a dealer's spread.

The Association believes the NASD should specify that dealers that devote substantial capital to provide liquidity to investors are market makers within the meaning of

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[41] In re Raymond James & Assocs., Inc., Exchange Act Rel. No. 38893 (Aug. 1, 1997) (noting, however, that the firm "published offer quotations in the Weekly Investment Digest; distributed, on a regular basis, offer sheets among other dealers; and sought to have its quotations available in financial publications").

[42] *See* In re Citigroup Global Markets Inc., NASD AWC No. CMS 040113, at 4 n.6 (July 28, 2004); In re Deutsche Bank Securities Inc., NASD AWC No. CMS040105, at 5 n.6 (July 28, 2004); In re Goldman, Sachs & Co., NASD AWC No. CMS 040106, at 5 n.5 (July 28, 2004); In re Miller Tabak Roberts Securities, LLC, NASD AWC No. CMS 040112, at 4 n.6 (July 28, 2004).

[43] Order Execution Obligations, Exchange Act Rel. No. 37619A, 61 Fed. Reg. 48,290, 48,318 (Sept. 12, 1996).

the Mark-Up Policy. The definition of market maker in the debt markets should not be tied to particular securities, but rather to broad classes of securities in which the dealer holds itself out as ready to act as a counterparty. Unlike the equity markets, where market makers are designated for particular securities, in the debt markets, dealers provide liquidity in broad categories of securities. There are a number of bases on which a safe harbor could be crafted, including the absolute amount of capital required by a dealer to maintain its positions, market share, and/or performance of block positioning functions.[44] For example, with respect to capital, the SEC has reported that, according to March 31, 2003 FOCUS filings, 28 registered broker-dealers reported that they had tentative net capital of at least $1 billion and net capital of at least $500 million.[45] These numbers may understate the positions maintained by market-making dealers, because the SEC net capital requirement is reduced by the fact that dealers hedge their risk positions.

Capital is an easily identifiable measure of risk. The SEC's net capital requirement applies from the moment the dealer establishes a long or short position, because the SEC recognizes that risk inheres in every position. Dealers that hold positions for a few hours, not to mention a few days, subject themselves to substantial market risk. The NASD has access to information about market shares in the secondary market. For example, the NASD has reported that ten dealers are responsible for approximately 60 percent of the volume reported on the TRACE system and that the top 25 participants are responsible for approximately 85 percent of the reported volume.[46] For dealers that act as block positioners, the safe harbor would treat as a block-sized transaction any at-risk trade in excess of $1 million face amount, provided the dealer has no offsetting order at the time the dealer initially committed capital.

III. The Proposed Interpretation Places Undue Emphasis on a Bond's "Contemporaneous Cost" in Determining Its Prevailing Market Price and Fails To Set Forth a Workable Definition of the Term.

The Proposed Interpretation establishes a presumption that "the prevailing market price for a debt security is established by referring to the dealer's contemporaneous cost as incurred or contemporaneous proceeds as obtained."[47] Although the Proposed Interpretation acknowledges that such a presumption would not apply to "a market maker" in a debt security, neither caselaw nor the practicalities of the current debt markets support the establishment of such a presumption outside the context of riskless principal transactions. (Point III.A, below.) Moreover, the NASD should define "contemporaneous cost" to avoid its misinterpretation or application as simply a bond's acquisition cost. (Point III.B, below.)

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[44] Exchange Act Rule 3b-8(c) incorporates many of these concepts in its definition of "Qualified Block Positioner.").

[45] Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Exchange Act Rel. No. 48690, 68 Fed. Reg. 62,872, 62,889 (Nov. 6, 2003).

[46] NASD, TRACE Update (June 3, 2004) (presentation at BMA Ethics and Compliance Conderence).

[47] Proposed Interpretation, 70 Fed. Reg. at 12,764 n.12.

Finally, although the Proposed Interpretation's recognition that economic models may play an important role in a bond dealer's pricing decisions is a positive step forward, the NASD should provide additional guidance to dealers pricing inactively traded securities for which there are no contemporaneous trades, no inter-dealer transactions, and no "similar securit[ies]." (Point III.C, below.)

A. Other than for riskless principal transactions, a bond's contemporaneous cost should be treated as one of many factors bearing on an assessment of its prevailing market price.

The Proposed Interpretation's use of "contemporaneous cost" as the default standard for a bond's prevailing market price represents a continued retrenchment from the NASD's prior position that, in the absence of inter-dealer transactions, a number of other factors should be considered "before contemporaneous cost is used for determining the prevailing market price."[48] The establishment of such a default standard is misplaced. Neither the authority cited by the NASD nor any other authority of which we are aware supports the establishment of a mechanical, default presumption for trades in debt securities outside the context of riskless principal transactions. Contemporaneous cost should instead be one of several factors that dealers should consider when making an assessment of a bond's prevailing market price.

The NASD cites the SEC's opinion in *In re F.B. Horner & Assocs., Inc.* for the establishment of a general contemporaneous cost standard for debt mark-ups. That case, however, involved a dealer's trades "made on a riskless principal basis" and decidedly did not involve either a dealer's market making activity or any other risk of dealer capital.[49] Other cases in which the SEC has embraced a contemporaneous cost standard to measure the fairness of bond prices have involved nominally at-risk trades for which no other credible explanation was proffered as an alternative basis for assessing the prevailing market price.[50] In any event, these cases by no means establish the type of mechanical analysis suggested by the Proposed Interpretation's "presumption."

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48 NASD Solicits Member Comments On The Application Of The NASD Mark-Up Policy To Transactions In Government And Other Debt Securities, NASD Notice To Members 94-62 (Aug. 1994).

49 In re F.B. Horner & Assocs., Inc., Exchange Act Rel. No. 30884, at n.6 (July 2, 1992), *aff'd*, 994 F.2d 61 (2d Cir. 1993).

50 *See, e.g.*, In re DMR Securities, Inc., Exchange Act Rel. No. 16322 (Nov. 6, 1979) (finding that the "contemporaneous" trades in municipal bonds were inter-dealer trades occurring within 1 day of the challenged transactions); In re Thomas F. White & Co., Exchange Act Rel. No. 33477 (Jan. 14, 1994) (finding that the firm was not a market maker and had purchased bonds from another dealer solely to meet known customer demand in an attempt to benefit from the other dealer's bid-ask spread); In re First Honolulu Securities, Inc., Exchange Act Rel. No. 32933, at n.10 (Sept. 21, 1993) (finding that evidence offered that another dealer's quotations were the best evidence of the prevailing market price was insufficient in light of the dealer's own inter-dealer trades at lower prices occurring closer in time).

For a number of reasons, contemporaneous cost should not be treated as the presumptive standard for determining the prevailing market price of fixed income securities. As previously acknowledged by the NASD, other factors should be given at least equal evidentiary weight. Depending upon the circumstances, factors such as a bond's interest rate or coupon, its credit quality, its call risk, its position in the capital structure of the issuer, and other characteristics of the bond (such as the size of the float, the number of holders, and the frequency with which a particular bond trades) have as much or more influence on a bond's market price as a dealer's "contemporaneous" acquisition cost. Current information about these factors are appropriate considerations to a bond dealer when ascertaining a bond's "prevailing market price" and should not be forbidden (or subject to extraordinary evidentiary obligations) simply because the dealer acquired the a bond at a particular price an hour (or a day, or a week, or a month) earlier. A bond's contemporaneous cost to a dealer is unquestionably an important criterion for determining the prevailing market price of a bond; but it is not — and should not be deemed to be — the best and, as a practical matter, the *only* criterion.

The Proposed Interpretation recognizes only two instances in which a dealer's contemporaneous cost "may" not reflect the prevailing market price for a debt security: First, when "interest rates or the credit quality of the security changed significantly after the dealer's contemporaneous trades," and, second, when a dealer is able to establish that the trade was with a particular type of institutional customer *and* point to an inter-dealer trade as a substitute benchmark.[51] This position understates the number of factors that bear on (1) whether a prior trade should be considered to be "contemporaneous" for the purpose of determining prevailing market price under the Proposed Interpretation and (2) whether some other measure of a bond's value better reflects a bond's prevailing market price. For example:

- *Interest rate fluctuations*. Whether or not a particular bond's interest rate has changed "significantly" is, of course, in the eye of the beholder. Even relatively minor movements in the rates for particular benchmark securities and spreads to benchmarks can and do have a dramatic effect on a bond's price. For example, in the aftermath of General Motors Corp.'s announcement of a forecasted first quarter loss on March 16, 2005, bond investors "fled to quality" driving up prices (and depressing yields) of Treasury securities.[52]

- *Changes in credit quality*. Again, whether a particular change in credit quality is "significant" is an unnecessarily subjective assessment. Undoubtedly the downgrade of an investment grade bond from BBB- to BB+ would be considered one such significant change. As an examination of the bond prices in the weeks prior to Enron's historic collapse shows, however, bond prices may reflect concerns about

[51] Proposed Interpretation, 70 Fed. Reg. at 12,764.

[52] Yield on 10 Yr Note Declines 7 BP to 4.48 Percent, Bloomberg News, Mar. 16, 2005 ("Investors sought government debt as a haven after GM's announcement sparked a decline in corporate bonds, emerging markets and benchmark stock indexes.").

credit quality not necessarily reflected in ratings assigned by nationally recognized statistical ratings organizations (NRSROs). These bonds began to trade at substantial discounts to par while still carrying an investment grade rating in the weeks prior to the company's default. Under the Proposed Interpretation, if a bond dealer had acquired a position in Enron BBB+ rated bonds on October 15, 2001 (the day before Enron announced a $1.1 billion charge to earnings), it would have had to use that price as the "prevailing market price" of the same BBB+ rated bonds on October 22, 2001 (the day the company announced that it was the subject of an SEC inquiry) unless the dealer had had other purchases or sales during that seven-day period.[53]

- *Changes in valuation assumptions*. Particularly with respect to distressed, high yield, and structured debt securities, the prices at which a dealer is willing to buy or sell bonds may reflect changing assessments of the value underlying the bonds (such as the likely value of an issuer's trade receivables or the assets underlying the structured security, the marketability of a major asset, the probability of a sale of the company, etc.), the likelihood of substantial changes to the issuer's capital structure (such as a reorganization or restructuring), the issuer's ability to improve its cashflow (for example, selling an operating unit or major asset to raise cash), or of changing perceptions as to litigation rights associated with the particular bond class (for example, the ability to participate on the creditors' committee). These changes may occur during a period during which the bonds remain in default and no interest is paid to bondholders. Moreover, certain types of structured debt securities may fluctuate in value based on prepayment trends, collectibility and default rates, and other developments affecting the underlying security or instrument. Although, as described below, the Proposed Interpretation acknowledges that a dealer's economic models may be relevant to pricing considerations in the absence of contemporaneous transactions, this formulation ignores that a dealer's changes in valuation assumptions or conclusions can and do bear on whether a prior trade should be considered "contemporaneous" for the purposes of determining a bond's "prevailing market price."

- *News affecting an issuer*. News about a particular issuer or industry sector may have an effect on the perceived value of a bond without ever affecting its credit rating, particularly for those categories of bonds that already trade at a discount to par or that may already be in default. For example, news about pending or contemplated legislation that may affect issuers or industry sectors regularly affects bond prices, particularly bonds trading at distressed levels. Examples include news about

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[53] If the NASD intends to construe "significant" changes in credit quality to include news or analysis affecting a dealer's (or the markets) perception of an issuer's creditworthiness short of a pronouncement by ratings agencies, it should clarify the Proposed Interpretation accordingly. The Proposed Interpretation acknowledges, in a different context, that a changes in a bond's rating outlook is one such consideration. Proposed Interpretation, 70 Fed. Reg. at 12,768. This concept should be expanded and recognized as applicable to an assessment of whether a trade is, in fact, contemporaneous.

legislative developments affecting asbestos claims and pension regulation.[54] This information regularly drives market momentum (on the buy or sell side) on certain issuers without any fundamental change in the credit quality of the company. Indeed, the price affect that such news can have on a bond's price is evidenced by hedge funds' retention of consultants to track congressional action.

- *Trading characteristics of particular debt securities*. The prices at which dealers may be willing to buy or sell certain categories of debt securities may fluctuate based on a dealer's understanding of the number of holders, their apparent intentions, and the size of the outstanding float. These considerations obviously play a much more significant role in the illiquid sectors of the bond markets, such as the markets for emerging market debt, structured securities, and high yield and distressed bonds. For example, if five institutional investors own the entire $30 million float of a defaulted corporate bond issuance, the perceived willingness of holders to buy or sell (and at what price) would affect the price at which a dealer would be willing to extend capital. That price may or may not be the price at which the bonds last traded and should — in an economically rational regulatory scheme — reflect the trader's assessment of the likelihood of resale at a profit.

These factors and others bear — and ought to bear — on a dealer's assessment of a bond's prevailing market price. The Proposed Interpretation recognizes their utility in connection with a determination of whether a bond is a "similar security," but precludes their consideration as a practical matter if a dealer has had a "contemporaneous" trade in the security.

B. The NASD should clarify the definition of "contemporaneous cost."

The NASD should make clear that contemporaneous cost is not simply a bond's acquisition cost and that there is no presumption that trades occurring within a particular period of time (or within a particular number of days) are "contemporaneous." The NASD should, however, recognize that the earlier or later in time a trade occurs, the less likely it is "contemporaneous" for the purposes of determining the prevailing market price.

Although the Proposed Interpretation makes a bond's "contemporaneous cost" the single most important criterion (and, for certain types of bonds, potentially the only criterion) for determining "prevailing market price," it does not define the term or endorse any definition of the term set forth in SEC or federal court cases. In its 1998 Proposal, the NASD proposed to define "contemporaneous cost" as follows:

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[54] *Hedge Funds Hire Lobbyists for Inside Tips on U.S. Legislation*, Bloomberg News, Mar. 16, 2005 ("Right now, investing in the bonds of one of the bankrupt asbestos-products makers such as Toledo, Ohio-based Owens Corning, the largest U.S. insulation producer, is risky because there's no guarantee the bonds will pay out. A hedge fund might take the gamble, for example, of buying an Owens Corning note, due in 2009, that Friday was selling for 63 cents on the dollar on a bet that a settlement will allow companies to recover and pay their debts."); Evan Perez, Airlines Lobby for Pension Relief, Wall St. J., Mar. 17, 2005, at B2.

> A transaction is "contemporaneous" if it occurs close enough in time to a later transaction that it would reasonably be expected to reflect the current market price for the security. Conversely, a transaction would not be contemporaneous if it is followed by intervening changes in interest rates or other market events that reasonably would be expected to affect the market price.[55]

This definition, although lacking in precision, at least expressly linked the term to an objective assessment of whether the "contemporaneous" transaction was likely to reflect the "current market price" of the bond. SEC cases have similarly recognized that, for a bond transaction to be "contemporaneous" for the purposes of assessing its prevailing market price, it must be sufficiently "closely related in time" to represent persuasive evidence of the market for the bond.[56]

A bond's prevailing market price does not remain static simply because of an absence of trading activity by a particular dealer for some arbitrary period of time, and yet simply equating a bond's "contemporaneous cost" with its "prevailing market price" is premised on just such an illogical assumption. The net capital rule and other mark-to-market regulatory requirements applicable to securities held by dealers squarely reject the premise that a bond's cost remains its market value unless and until the dealer executes a trade at a higher (or lower) price. Indeed, the widely accepted use of value-at-risk ("VaR") models to calculate net capital requirements — including the SEC's acceptance of VaR models for consolidated supervised entities — demonstrate the incoherence of using a bond's cost as a proxy for its "prevailing market price."

Accordingly, it is essential that the term "contemporaneous," as it is used in the Proposed Interpretation to evidence a bond's prevailing market price, not be applied by the NASD solely by reference to an arbitrary, temporal standard, such as a fixed number of days within which one transaction is deemed to be "contemporaneous" with another. Moreover, a dealer's burden to show that a particular "contemporaneous" trade is not reflective of a bond's prevailing market price should decline as the period of time between the two transactions increases. As the SEC has found, the farther removed one transaction is from another, it is less likely to be a reliable source of the prevailing market price — diminishing its evidentiary value for this purpose. Indeed, at some point in time, a dealer's acquisition cost should be completely disregarded as relevant evidence of prevailing market price.

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[55] 1998 Proposal, 63 Fed. Reg. 54,169, 54,172, 54,174 (Oct. 8, 1998).

[56] In re F.B. Horner & Assocs., Inc., Exchange Act Rel. No. 30884, at n.6 (July 2, 1992), *aff'd*, 994 F.2d 61 (2d Cir. 1993); *see also* In re DMR Securities, Inc., Exchange Act Rel. No. 16990 (July 21, 1980) ("While contemporaneous cost is not limited to same-day cost, the prices a broker-dealer pays must nevertheless be 'closely related in time' to the retail sales in question to constitute evidence of the market price at the time of those sales.").

Otherwise, "contemporaneous" may be given an unduly expansive regulatory interpretation.[57]

C. The NASD should expand the circumstances in which dealers may use economic models in connection with pricing decisions.

The Association is pleased that the Proposed Interpretation acknowledges the vital role played by economic models and similar valuation models in connection with bond dealers' pricing decisions. Regulators across the financial services industry have increasingly recognized the utility of economic models and quantitative analysis in connection with a variety of regulatory requirements.[58] The Proposed Interpretation, however, limits the consideration of economic models to debt securities for which there are (1) no contemporaneous trades in the same security, (2) no inter-dealer trades in the same security, and (3) no "similar securities" (those with comparable yields, credit ratings, and trading characteristics).[59] Models are commonly used to determine market value in illiquid bonds, particularly structured securities. Because a bond dealer's views on pricing premised upon analytical models is probative of a bond's market value irrespective of whether the so-called "Hierarchy" factors are present, the NASD should permit dealers to consider this data as one of many factors that bear on the pricing decision. Indeed, the "prevailing market price" for many types of structured debt products is, as a practical matter, the calculated result of economic models.

The Association is concerned, however, that the NASD not prescribe overly formalistic requirements for economic models or engage in a post hoc review of the substantive merits of any such models. As one would expect, the complexity and effort put into an economic model for particular types of debt securities, such as customized structured debt securities for which pricing depends heavily on the use of models, may be far greater than a model developed in connection with others.

The NASD should also make clear that a dealer entitled to rely on an economic model to determine the prevailing market price may use that price — and not its "contemporaneous cost" — to price a close-in-time transaction in that security. In other words, if a dealer using an economic model and trading as a principal determines pursuant to

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[57] The need for additional guidance on the operation of this standard is demonstrated by SEC cases finding that trades executed within 5 or fewer days apart were "contemporaneous," *see, e.g.*, In re Nicholas A. Codispoti, Exchange Act Rel. No. 24946 (Sept. 29, 1987), and a settlement finding that trades *38 days* apart were contemporaneous in light of the "lack of any significant intervening event," In re Howe, Solomon & Hall, Exchange Act Rel. No. 40038 (May 28, 1998).

[58] Under the SEC's alternative method for calculating net capital for broker-dealers that are part of a Consolidated Supervised Entity, a broker-dealer may use mathematical models to calculate net capital requirements for market and derivatives-related credit risk, subject to stated restrictions. For example, the model must be based on a 10-business-day movement in rates and prices and calculated using a 99% confidence level. The VaR measures then must be multiplied by a safety factor. Use of models is not limited to cases where the security has a ready market.

[59] Proposed Interpretation, 70 Fed. Reg. at 12,767.

the model that the price of a debt security should be 98, it may sell at an amount reflecting a mark-up measured from 98 and buy at an amount reflecting a discount from 98.

D. The NASD should provide additional guidance to dealers pricing inactively traded securities for which there are no contemporaneous trades, no inter-dealer transactions, and no "similar" securities.

Particularly in light of recent mark-up inquires in the debt markets[60] and settlements in the distressed and high yield context,[61] the NASD should provide some form of official guidance to dealers that must price bonds in the absence of a contemporaneous trade, in the absence of an inter-dealer transaction, and in the absence of a "similar security" as defined in the Proposed Interpretation. The Proposed Interpretation prescribes a single, exclusive course of action: dealers should use an undefined "economic model" to generate a presumptive price or trade subject to the risk of post hoc regulatory censure.

Prior to its most recent proposal, the NASD deleted the simple acknowledgement that "[w]hen debt securities trade inactively, inter-dealer transactions may be rare or non-existent, and establishing the prevailing market price in a transaction involving an inactively traded security may be difficult," because it did "not contain any helpful guidance."[62] The Proposed Interpretation should reiterate that the difficulty inherent in this analysis is a factor to be considered in any evaluation of a dealer's exercise of its good faith business judgment.

IV. The Proposed Interpretation Should Not Treat a Transaction as a Riskless Principal Transaction Unless, at the Time a Dealer Enters into a Transaction, It Already Holds an Offsetting Order.

When a non-market maker dealer executes a trade risklessly, the prevailing market price of a security is its contemporaneous cost or proceeds.[63] The NASD has stated its view

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60 Aaron Lucchetti, *Price Mark-Ups Get NASD Scrutiny*, Wall St. J., June 18, 2004, at C4 ("Regulators have opened 20 separate investigations into whether brokerage firms charged excessive markups on investors' bond transactions, an NASD official said, providing new information about the scope of the probe.").

61 *See* In re Citigroup Global Markets Inc., NASD AWC No. CMS 040113, at 4 n.6 (July 28, 2004); In re Deutsche Bank Securities Inc., NASD AWC No. CMS040105, at 5 n.6 (July 28, 2004); In re Goldman, Sachs & Co., NASD AWC No. CMS 040106, at 5 n.5 (July 28, 2004); In re Miller Tabak Roberts Securities, LLC, NASD AWC No. CMS040112, at 4 n.6 (July 28, 2004); In re Amroc Securities LLC, NASD AWC No. CAF0300004 (Jan. 29, 2003).

62 SR-NASD-2003-141, Amendment No. 1, at 2 (June 29, 2004).

63 The SEC has held that equity dealers that are market makers in particular securities may calculate the prevailing market price based on the offered side of the market, whether or not a particular trade is executed risklessly. *See, e.g.*, In re Strategic Res. Mgmt., Inc., Exchange Act Rel. No. 36618 (Dec. 21, 1995) ("A market maker may buy or sell a security at a time when it holds the opposite order from a customer and may offset that customer's order. Although such a transaction could be characterized as riskless, it is part of a market maker's normal function."). Bond dealers

that, for "riskless" trades, "the broker-dealer's contemporaneous cost is *always* the basis by which the mark-up should be measured."[64] The NASD should make clear whether riskless principal transactions are to be treated differently under its Proposed Interpretation and, if so, which trades are to be considered "riskless." (Point IV.A, below.) The NASD should also clarify its apparent position that mark-ups on riskless principal transactions may not exceed five percent "absent exceptional circumstances."[65] (Point IV.B, below.)

A. The NASD should make clear that the determination of whether a trade is "riskless" is not simply a function of the timing or apparent "matching" of trades.

The NASD should make clear that "riskless" or "riskless principal transactions" require firm orders, understood as such, on both sides of a contemplated transaction. The Proposed Interpretation does not define the term, but informal legal guidance in settlements this past summer treated as "riskless" transactions bond trades involving the "*virtually* simultaneous purchase and sale of the same face amount and same bond" on an "*essentially* riskless" basis.[66]

A riskless principal transaction should be regarded as the functional equivalent of an agency trade, in which (by definition) no principal risk attaches to the dealer effecting the transaction. It is particularly important that risk transactions not be regarded as "riskless" solely because of their timing, or definitional ambiguities about what constitutes an "order" in the debt securities markets. Dealers often acquire debt securities in the expectation that they will meet known or anticipated customer interest, and customer transactions involving those securities may be executed shortly after a dealer acquires a position, in the same face amount, in a manner that resembles a "matched" or "crossed" transaction. However, such expectations or expressions of customer interest are not "orders," and until the security is sold, the dealer is entirely at risk.

The SEC has previously emphasized the importance of an order in hand as a predicate to a "riskless" transaction:

> In the respects relevant here, a trade on a riskless principal basis should be treated similarly to an agency transaction, in which a firm may retain no more than a commission computed on the basis of its cost. As we have noted, a riskless principal

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performing market making functions in a particular security or category of securities should be treated similarly.

64 *See* In re Citigroup Global Markets Inc., NASD AWC No. CMS 040113, at 5 & n.8 (July 28, 2004) (citing In re Michael Novick, Exchange Act Rel. No. 34640 (Sept. 2, 1994); In re Kevin B. Waide, Exchange Act Rel. No. 30561 (Apr. 7, 1992)) (emphasis added).

65 *Id.*

66 In re Goldman, Sachs & Co., NASD AWC No. CMS 040106, at 4 (July 28, 2004) (emphasis added).

> transaction is the economic equivalent of an agency trade. Like an agent, a firm engaging in such trades has no market making function, *buys only to fill orders already in hand*, and immediately "books" the shares it buys to its customers. Essentially, the firm serves as an intermediary for others who have assumed the market risk.[67]

If a bond dealer is at risk — even under the Proposed Interpretation — it may demonstrate that a bond's prevailing market price is something other than its contemporaneous cost. The key element in establishing whether such a transaction is "riskless" is not whether a dealer's offsetting customer sale or purchase is contemporaneous, but whether the dealer was in fact exposed to any principal market risk associated with holding a long or short position in the security. The distinction is whether a dealer has both sides of a transaction in hand, in which case the transaction may properly be regarded as "riskless" for this purpose. It is inconsistent with the SEC's capital regime to have the prevailing market price determination turn on a post hoc assessment of whether a trade was "virtually simultaneous" or "essentially riskless" — a term that appears to equate the successful discharge of risk with the absence of risk. A trade is either riskless (because a dealer has actionable, firm orders in hand) or it is not (in which case the dealer's capital is exposed).

B. The NASD should reiterate in the Interpretation that a mark-up on a riskless principal transaction may be used to compensate a dealer for its efforts to locate willing buyers or sellers, for its expertise in the particular bond or issuer, and for risks (such as settlement risks) that are unrelated to capital commitment.

The Proposed Interpretation should provide guidance concerning when, if ever, the particular services undertaken by a bond dealer may be considered in pricing a riskless principal transaction, and, if so, whether a dealer's mark-up may exceed five percent in particular circumstances. The Proposed Interpretation's silence on the point stands in contrast to informal NASD legal guidance that "*absent exceptional circumstances*, the total compensation to the broker-dealer from a riskless principal trade (or customer cross) generally should not exceed five percent."[68]

Bond dealers in specialized debt securities provide a wide-ranging menu of services for which they should be compensated by their customers. Each of these services may, but need not, be implicated in connection with the execution of a given trade for a dealer to

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[67] In re Kevin B. Waide, Exchange Act Rel. No. 30561 (Apr. 7, 1992). Exchange Act Rule 10b-10(a)(2)(ii)(A) provides similarly.

[68] In re Citigroup Global Markets Inc., NASD AWC No. CMS 040113, at 5 (July 28, 2004) (emphasis added); *see also* In re Deutsche Bank Securities Inc., NASD AWC No. CMS040105, at 5 (July 28, 2004); In re Goldman, Sachs & Co., NASD AWC No. CMS 040106, at 6 (July 28, 2004); In re Miller Tabak Roberts Securities, LLC, NASD AWC No. CMS040112, at 5 (July 28, 2004).

factor them into the pricing decision.[69] SEC and NASD authorities have long acknowledged that dealers in less liquid markets, for example, may be compensated for the efforts and risks (including risks other than capital commitment) associated with trading these types of instruments. These efforts and risks include:

- *Locating and Educating Potential Buyers and Sellers*. Dealers in illiquid securities regularly act as a broker for customers, working on indications of interest or firm orders that are received from customers to buy or sell a particular bond at a particular price and quantity. Identifying and educating potential buyers and sellers about illiquid and/or inactive securities can be extraordinarily time consuming and require the expenditure of significant resources (*e.g.*, the use of a firm's research department, the retention of consultants with expertise in particular sectors, subscriptions to pricing services, the need to monitor bankruptcy dockets, the need to follow developments in foreign jurisdictions, *etc.*).
- *Settlement Risks*. Dealers in illiquid securities such as emerging markets debt, distressed debt, and certain types of high yield securities, regularly face significant settlement risks even when executing riskless principal transactions. Trades in these debt securities may present atypical settlement risks such as (a) whether a bond trades with accrued interest or "flat," (b) whether a bond trades with or without litigation rights, (c) whether the selling or buying party may vote the bonds in connection with a bankruptcy proceeding or proposed restructuring, (d) whether bonds have been suspended or are subject to court-ordered restrictions on trading, (e) whether a particular bond is subject to a minimum denomination trading requirement, (f) the effect, if any, of a payment of interest after the "record date" but before the expiration of a grace period, (g) whether an emerging market Brady bond trades with or without particular nonstandard rights, such as "Variable Recovery Rights (VRRs)," and many others.
- *Providing Investment Ideas*. Dealers in specialty markets regularly share investment and trading ideas with customers, bringing to their attention developments that may affect, positively or negatively, the market for bonds held in their portfolios. The traders and sales staff also identify new issues and bonds that may present attractive investment or trading opportunities for their clients.
- *Providing Pricing and Valuation Information*. Dealers regularly work with customers holding illiquid securities to help them value their portfolio holdings, assess the underlying or fundamental value of the particular bonds or issuers, and

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[69] *See* In re Wheeler Municipals Corp., Exchange Act Rel. No. 28510 (Oct. 3, 1990) ("Both the NASD and the MSRB have specifically identified services provided to a customer by a broker-dealer as one of the factors that may properly be considered in determining the fairness of prices in particular transactions. Moreover, rather than excluding from consideration services that are not strictly related to the transactions at issue, the interpretations promulgated by both organizations appear to include them. We have found no authority supporting the NASD's position that they must be excluded.").

understand the prices that they may receive should they determine to buy or sell particular portfolio holdings.

- *Providing Research Services*. Dealers in illiquid securities typically have a dedicated research group that requires specialized professional expertise over and above that required for covering more liquid corporate and government debt securities. Significantly, these research personnel may no longer be compensated on the basis of investment banking engagements.

The NASD should specifically acknowledge that the prices associated with particular types of debt securities may reflect compensation for dealer services and risks that may result in a mark-up at or exceeding five percent. Both the Exchange Act and NASD Rule 2440 prohibit the NASD from setting a five percent cap on dealer compensation. In light of statements in its 1998 Proposal and in the 2004 settlements, however, the NASD should provide guidance as to what types of factors would permit a bond dealer to conclude that its efforts in connection with a riskless principal transaction warrant a mark-up in excess of five percent, particularly for trades involving low-priced securities for which an additional fraction of a point may represent several percentage points of "mark-up." At the very least, the NASD should acknowledge that prior SEC and NASD authorities have in fact recognized that these factors are not merely hypothetical and can, in practice, be relied upon by dealers to justify that a particular mark-up exceeding five percent is fair.[70]

V. The Proposed Interpretation Should Expand the Circumstances in Which Trades with Sophisticated Institutional Customers May Occur At Negotiated Prices Above or Below the Contemporaneous Cost.

The Association commends the Proposed Interpretation's recognition that a bond's "contemporaneous cost" may not accurately reflect the prevailing market price in the case of certain trades with sophisticated institutional investors, so-called "Specified Institutional Trades." The Proposed Interpretation, however, limits the use of the Specified Institutional Trade exception exclusively to circumstances where the dealer is able to (1) identify an inter-dealer trade (2) in the same security (3) executed contemporaneously with the dealer's Specified Institutional Trade, and then only when (4) transactions of substantial size and risk are effected regularly with the institutional account in the same or a "similar" security. This formulation would preclude many dealers from ever being able to use this exception, particularly dealers active in illiquid markets that lack price transparency. The NASD should expand the circumstances in which a Specified Institutional Trade (however labeled) may be used to rebut the presumption that a bond's contemporaneous cost is the prevailing market price.

The Proposed Interpretation overly limits the circumstances in which the nature of an institutional counterparty may bear on the fairness of a dealer's price. (Points V.A and B,

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[70] *See, e.g.*, In re District Business Conduct Committee for District No. 7 v. Respondent Firm 1 and Respondent 2, Compl. No. C07950058, 1998 WL 1799047 (N.A.S.D.R July 2, 1998); In re Application of A. Bennett Johnson, Exchange Act Rel. No. 10258 (June 29, 1973).

below.) The NASD should follow the approach taken in its institutional suitability rules and develop a framework for mark-up regulation that acknowledges that many institutional customers are as sophisticated and experienced as dealers and this fact should be considered in connection with an evaluation of the fairness of a mark-up. (Point V.C, below.)

A. The NASD should eliminate the requirement to identify a contemporaneous, inter-dealer trade in the same security.

The proposed Specified Institutional Trade exception requires liquidity and transparency. As a result, dealers effecting transactions of substantial size and risk in certain illiquid securities with institutional accounts would rarely be able rely on this exception because contemporaneous, inter-dealer trades in the same security may be nonexistent. Because this limitation has no bearing on whether the transaction is indicative of the prevailing market price, the Association believes that the NASD should expand the circumstances where a dealer may rebut the presumption to address transactions for which there may be no inter-dealer trades, particularly transactions in illiquid debt securities.

B. The NASD should eliminate the requirement that "Specified Institutional Trades" require a longstanding, active customer.

The Proposed Interpretation limits the Specified Institutional Trade exception to transactions with "an institutional account with which the dealer regularly effects transactions in the same or a 'similar' security."[71] The NASD should treat similarly all transactions of significant size and risk with qualifying institutional customers.

Whether a dealer regularly effects transactions in the same or a "similar" security with a particular institutional account doubtfully has any bearing on whether a proposed price should be treated as the best evidence of a bond's prevailing market price. Dealers can and do effect transactions with institutional accounts irregularly in a given security, particularly in illiquid debt securities where sophisticated institutional accounts may seek out certain dealers known to have specialized expertise in that credit, industry, or type of security (*e.g.*, CDO, emerging market). For example, an institutional account may contact a dealer that served as the underwriter of the initial offering of the debt security, a dealer that regularly publishes research on the name, or a dealer that has worked with holders on a reorganization or work-out. Moreover, an institutional account may approach a dealer that it believes to be in the best position to effect a block-sized transaction in a tightly-held security, whether or not it "regularly effects transactions" with that dealer.

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[71] Proposed Interpretation, 70 Fed. Reg. at 12,764.

C. The NASD should develop a framework for mark-up regulation that acknowledges the sophistication and experience of certain institutional customers.

A dealer's relationships with institutional customers are qualitatively different from relationships with retail customers.[72] Indeed, the NASD provided special guidance for assessing the suitability of recommendations to institutional customers that are able to evaluate investment risk independently.[73] Pursuant to this interpretation, dealers need only establish a reasonable basis for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk.[74] The NASD should adopt a comparable interpretation here. Such an interpretation would address some of the inherent problems with imposing a consumer-protection model of fair pricing on the institutional market, while preserving the protections afforded to less sophisticated, retail customers under current mark-up law.

As the NASD's Fixed Income Committee has observed, "many institutions develop resources and procedures that provide them with the sophistication to make independent investment decisions and, in certain cases, the institution develops more sophistication than that maintained by the NASD member. [M]any such institutional customers do not rely on a particular member's recommendations, but only use the member as one source of market and/or product information and ideas for transactions."[75] If an institutional customer has the capacity to evaluate investment risk independently and exercise independent judgment in evaluating recommendations in specific securities transactions, that same institutional customer should also be deemed to have the capacity and ability to assess the fairness of a particular price in a given debt security, provided there is a basis for concluding that the institutional customer is able to evaluate the market for that security.

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72 *See* Exchange Act Rel. No. 37588, 61 Fed. Reg. 44,100, 44,111-12 (Aug. 27, 1996) ("The NASD acknowledges, as does the Commission, that the relationship between a broker-dealer and an institutional customer generally may be different in important respects from the relationship a broker-dealer has with a non-institutional investor. In the latter circumstance, a broker-dealer frequently has knowledge about the investment and its risks and costs that are not possessed by or easily available to the investor. Some sophisticated institutional customers, however, may in fact possess both the capability to understand how a particular securities investment could perform, as well as the desire to make their own investment decisions, without reliance on the knowledge or resources of the broker-dealer.").

More recently, the MSRB adopted the term "sophisticated municipal market professionals" for use in connection with its fair practice standards for particular transactions that acknowledges the relevance of the nature of the customer to a dealer's obligation. *See* Exchange Act Rel. No. 45849, 67 Fed. Reg. 30,743 (May 7, 2002).

73 *See* Suitability Obligations to Institutional Customers, NASD IM-2310-3, Preliminary Statement as to Members' Obligations.

74 *Id.*

75 *See* NASD Solicits Member Comments on the Application of the NASD Mark-Up Policy to Transactions in Government and Other Debt Securities, and Suitability Obligations to Institutional Customers in Debt and Equity Transactions, NASD Notice to Members 94-62.

The regulatory history of IM-2310-3 makes clear that many institutional accounts do, in fact, have the ability not only to assess the intrinsic value of particular debt securities, but also to evaluate independently the market for them. Certain institutional accounts that are active in the debt securities markets employ considerable in-house expertise evaluating potential investments — expertise that at times may be superior to those of bond dealers. These institutional customers include the asset management arms of virtually every multi-service financial services firm, large insurance companies, and hedge funds specializing in a wide range of liquid and illiquid debt instruments. These institutional customers also typically have sales and trading relationships across several investment banks, regularly possess internal research departments with specialized knowledge of the industry sectors in which they invest, contact issuing companies directly, and have access to their own capital in addition to the capital in the dealer market. They also have access to single-dealer trading screens as well as multi-dealer trading platforms on which they may do comparative requests for quotation among their dealers. As a result, and because of the lack of transparency in certain illiquid debt market, these institutional customers regularly have an informational advantage over dealers when determining the price range within which a particular security is likely to trade.

All dealers must deal fairly with all customers, including sophisticated customers, and that obligation includes the duty to price fairly.[76] A dealer's fair pricing obligation, however, may be fulfilled in a variety of ways. If dealers are able to conclude that an institutional customer has the capacity and ability to understand the pricing of a specific debt product, that dealer should be deemed to have satisfied its duty of fair dealing under NASD Rule 2440, subject only to compelling evidence that the dealer's pricing was abusive (for example, because of an informational advantage or through misrepresentations about the market for the security). The Association does not endorse a caveat emptor approach to mark-up regulation. But the regulatory scheme should not oblige a dealer to refrain from trading with a sophisticated counterparty at particular prices on the premise that a price would be "unfair" if that counterparty — in full awareness of the market of the security and in possession of its own internally-derived valuation analysis — believes that the price would be consistent with its investment objectives and understanding of the market for that security.

VI. The Proposed Interpretation Should Acknowledge and Address the Special Problems with a "Contemporaneous Cost" Presumption in the Retail Bond Markets.

The Proposed Interpretation's contemporaneous cost presumption fails to take into account the distortive affect that non-traditional fee-based brokerage arrangements have on bond prices; such a presumption is unfounded when the contemporaneous trade's price does not reflect fee-based dealer compensation. Brokerage firms have implemented an increasing number of fee-based brokerage arrangements with retail customers, pursuant to which customers pay a quarterly or semi-annual asset-based fee in lieu of transaction-specific

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76 *See e.g.,* In re William H. Keller, Jr., 38 S.E.C. 900, 906 (1959).

dealer compensation.[77] Unlike bond prices for trades in traditional brokerage accounts (which may reflect imbedded mark-ups or mark-downs), the prices for bond trades in fee-based accounts do not reflect any such mark-up or mark-down. Accordingly, reported net bond prices in trades for fee-based accounts executed may appear lower in the case of sales (or higher in the case of purchases) than identical trades in traditional brokerage accounts.[78] Bond dealers should not be forced to measure or justify the fairness of a particular mark-up from a "prevailing market price" based on a dissimilar (albeit "contemporaneous") trade. The fairness of an imbedded mark-up (or mark-down) on one trade should not be assessed by a comparison to a price that reflects no such mark-up (or mark-down). Integrated and retail dealers should be able to factor into the "prevailing market price" determination whether contemporaneous bond prices reflect special compensation arrangements that may distort a trade's net price.

Second, although the Proposed Interpretation acknowledges that certain institutional trades may occur at prices "away from the prevailing market price because of the size and risk of the transaction" (so-called "Specified Institutional Trades"), it makes no such accommodation for retail dealers. Retail bond dealers should be permitted to calculate the prevailing market price of retail bond lots by reference to comparably sized trades. Because many retail bond transactions occur in odd-lot sizes, dealers effecting those transactions should not be held to a presumption of contemporaneous cost based on round-lot or block-sized trades. Consistent with the existing Mark-Up Policy,[79] the NASD should create a retail counterpart to the Proposed Interpretation's "Specified Institutional Trade."

VII. The NASD's Categorical Observation That Mark-Ups on Stocks Are "Customarily Higher" Than Those on Bonds Should Be Modified To Reflect That, for Many Classes of Bonds, This Is Simply Not True.

The NASD's Statement of the Purpose for its Proposed Interpretation states categorically that "mark-ups for transactions in common stock are *customarily higher* than those for bond transactions of the same size."[80] The Association strongly objects to the inclusion of this statement in the NASD's filing. First, whatever validity this statement may have had at the time of its inclusion in the Mark-Up Policy in 1943 (or the decades that followed), it no longer remains accurate description, even as a generalization, of the way

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[77] The growth of fee-based brokerage arrangements stemmed, in substantial part, from SEC guidance on investment adviser registration requirements. *See* Certain Broker-Dealers Deemed Not To Be Investment Advisers, Exchange Act Rel. 42099 (Nov. 4, 1999).

By the end of the third-quarter 2003, total assets in fee-based brokerage accounts reached $201.5 billion. *See* John Churchill, Huge Growth in Fee-Based Brokerage, Registered Rep. (Mar. 12, 2004).

[78] *See* NASD Rule 6230(d)(1) (requiring dealers to report the price, which must include the mark-up or mark-down, for principal transactions in TRACE-eligible securities).

[79] NASD IM-2440(b)(4); *see also* In re Lehman Bros., Inc., Exchange Act Rel. 37673 (Sept. 12, 1996); In re Greenberg, 40 S.E.C. 133 (1960).

[80] Proposed Interpretation, 70 Fed. Reg. at 12,766 (emphasis added) (citing IM-2440-1(b)(1)).

bonds trade in a market that includes everything from Treasury bills and investment grade corporate bonds to CDOs, defaulted high yield bonds, and emerging market bonds. The perpetuation of such an overly simplistic and categorical statement would discriminate against a market that is far more complex than the equity market. Second, to the extent that the NASD intends this observation to operate as a meaningful enforcement principle, it directly conflicts with Rule 2440's requirement that whether a mark-up is excessive depends on the facts and circumstances associated with a particular debt securities transaction.

The NASD's statement inappropriately groups most types of debt securities together in an undifferentiated manner. In fact, the bond markets are a diverse group of markets that encompass a wide variety of securities and financial products. Similar statements made by the SEC and the courts occurred in the context of discussions of mark-ups on government and investment grade corporate bonds.[81] There are significant differences among the debt securities markets, as well as among individual debt securities (particularly with respect to the liquidity of such markets and securities), that readily justify differences in appropriate mark-up levels under Rule 2440. Where particular debt securities or markets are less liquid than equity markets, reasonable mark-up levels for debt securities may justifiably exceed the "customary" mark-up levels for most equity securities. For example, permissible mark-ups for relatively illiquid, thinly-traded fixed-income securities which may not trade on a daily, or even weekly, basis (including, but not necessarily limited to certain types of high-yield, emerging markets and structured debt instruments) should certainly not, as a general matter, be expected to be "customarily" lower than mark-ups on transactions in the equity securities of the same issuer.

VIII. The Proposed Interpretation Improperly Establishes a Number of Unfair Factual Presumptions and Burden Shifting Devices.

Under the Proposed Interpretation, a dealer that uses a measure other than contemporaneous cost to determine the "prevailing market price" of a bond is presumed to have mispriced the bond. If the difference between the bond's contemporaneous cost and the price believed by the dealer to be the prevailing market price is significant, the dealer will stand accused of collecting an "excessive" mark-up under Rule 2440, or having committed a fraud under Rule 2120, unless and until that dealer is able to persuade an examiner to the contrary — and then only by providing the specific evidence deemed relevant by the NASD.

The burden-shifting and evidentiary limitations called for by the Proposed Interpretation are unfair and demonstrate how far mark-up regulation has strayed from its core purpose: *Ensuring that customers are treated fairly*. If an ethically-minded bond trader can be presumed to have collected excessive or fraudulent mark-ups because he or she is unable to show that some other measure better reflects the market for a bond under the NASD's proposed "Hierarchy," then the current mark-up scheme teeters on the brink of incoherence. Similar efforts to apply these types of factual and legal presumptions to mark-

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81 *See, e.g.*, Zero Coupon Securities, Exchange Act Rel. No. 24368, 52 Fed. Reg. 15,575 (Apr. 21, 1987) (citing cases).

up practices in the fixed income markets have been rejected[82] and the SEC should reject them here.

IX. Unless Substantially Modified, the SEC's Approval of the Proposed Interpretation Would Violate the Exchange Act and Other Federal Laws Governing SRO Rulemaking.

The SEC's approval of the Proposed Interpretation would violate the Exchange Act, as well as other federal laws governing SRO rulemaking. First, these laws require, among other things, that the NASD and the SEC consider the burdens on competition presented by the Proposed Interpretation and whether its adoption would impede capital formation. Moreover, other federal statutes require the SEC to consider and quantify the effect that proposed SRO interpretive rules would have on small business entities, including broker-dealers and issuers of debt securities. To our knowledge, the NASD has failed entirely to compile a record that would permit the SEC to assess these burdens, much less approve the interpretation. Second, together with interpretive guidance issued outside the context of the current rulemaking, the NASD has posited a standard for treatment as a "market maker" in debt securities that is inconsistent with the Exchange Act definition. The SEC may not approve or countenance such an interpretation consistent with its obligations under Exchange Act Sections 15A(b)(2) and 19(b).

A. The Proposed Interpretation Would Result in Unnecessary Burdens on Competition and Threaten Capital Formation in Violation of Exchange Act Sections 3(f), 15A(b)(5), and 15A(b)(9).

Exchange Act Section 3(f) compels the SEC, whenever it reviews proposed NASD rules, to consider "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[83] Exchange Act Section 15A(b)(5) requires that NASD rules be designed "to remove impediments to and perfect the mechanism of a free and open market."[84] Similarly, Exchange Act Section 15A(b)(9) requires that NASD rules and interpretations "not impose any burden on competition not necessary or appropriate."[85]

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[82] Banca Cremi, SA v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1035-36 (4th Cir. 1997) ("We are acutely uncomfortable with this scheme. If the state of the law were actually as the Bank and the SEC contend, it is unthinkable that any dealer would ever fail to disclose any markup, no matter how minimal, and thereby risk a lawsuit that would inevitably lead to the expense and notoriety of a jury trial. . . . [I]t is very easy to accuse someone of fraud, and it is clear that the mere accusation of fraud can be damaging to a defendant's reputation. A plaintiff alleging fraud has both a heavy burden of pleading fraud with particularity and in proving each element of the cause of action.") (citation omitted).

[83] Exchange Act § 3(f), 15 U.S.C. § 78c(f).

[84] Exchange Act § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6).

[85] Exchange Act § 15A(b)(9), 15 U.S.C. § 78o-3(b)(9).

The Proposed Interpretation, unless modified, would threaten the willingness of dealers to commit capital in connection with trading in the secondary market for certain classes of debt securities, which would negatively impact the capital formation process by limiting the willingness of investors to invest in bonds issued by particular issuers and, in turn, curbing their access to the U.S. debt markets. Moreover, taken together with NASD interpretive guidance issued outside the context of this rulemaking, the Proposed Interpretation would (a) impose a number of new procedural and recordkeeping obligations that carry costs that far outweigh the generalized asserted benefits and (b) call into question the fairness of certain mark-ups used to compensate dealers for specialized services.

Federal law compels the SEC to consider the regulatory burdens associated with NASD proposals to adopt new rules and interpretations. These obligations are not discharged by accepting without question the perfunctory assertion by the NASD that it "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."[86] The Exchange Act provisions that oblige self-regulatory organizations to assess the consequences of new rules and interpretations require more. They were imposed and enhanced by the Securities Acts Amendments of 1975 and meant to preserve competitive forces in the securities markets with minimal regulatory intrusion.

The Proposed Interpretation was approved by the NASD without consulting member firms and filed without any reference to studies or assessments that would enable a meaningful review of the burdens and costs associated with the NASD's proposal. Consistent with its obligations under the Exchange Act and the Administrative Procedure Act, the SEC cannot and should not approve the Proposed Interpretation in the absence of a record that reflects its consideration of other, less burdensome alternatives and the reasons why it believes that no burdens on competition would be imposed. Among the concerns left entirely unaddressed by the NASD in its filing:

- Whether imposing a contemporaneous cost standard on at-risk trading threatens capital commitment by dealers in illiquid debt securities and, as a result, would further reduce market liquidity for high yield, distressed, and emerging market debt securities.

- Whether and how any reduction in the willingness of dealers to commit capital to facilitate customer trading in illiquid debt securities would impact the willingness of institutional investors to participate in primary offerings of domestic high yield and convertible debt issuers and, accordingly, impact capital formation.

- Whether restrictions on dealer compensation by the imposition of a contemporaneous cost standard would cause bond dealers to commit capital in connection with particular classes of debt securities only (or principally) through

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86 Proposed Interpretation, 70 Fed. Reg. at 12,768 (emphasis added).

proprietary trading operations and not as an incident to trading with customers, reducing the competition among those dealers willing to engage in such activity.

- Whether institutional customers that are active in particular classes of debt securities support (or would support) the Proposed Interpretation's requirements if they result in (a) dealers requiring trades in illiquid debt securities to be executed on an agency basis (treating the spread as a disclosed commission rather than a spread); (b) dealers limiting the circumstances in which they are willing to commit capital; or (c) dealers narrowing the number of debt securities they cover or are willing to trade (*e.g.*, refusing to trade debt securities with a float indicative of an "inactive" market).

- Whether restrictions on dealer compensation through the imposition of a contemporaneous cost standard would have a significant economic impact on a substantial number of small entities, such as (a) the small to mid-size bond dealers that have existing business models predicated on the ability to offer specialized services at a premium cost or (b) the issuers of high yield and convertible debt securities that depend upon dealer liquidity to establish an aftermarket for their debt securities.[87]

- Whether the NASD's Proposed Interpretation, in light of informal NASD guidance issued outside the rulemaking on the meaning of the term "market maker" in the debt markets, treats dealers performing market making functions in debt securities differently than equity dealers performing comparable functions and, if so, whether that unequal treatment comports with the Exchange Act's "equal regulation" requirement.[88]

- Whether and how the dissemination of TRACE information affects the legitimacy of prohibiting bond dealers from considering evidence of other, more recent trades in the same security when determining a bond's prevailing market price.

- What types of "evidence," and in what form, must dealers create and maintain pursuant to the Proposed Interpretation's requirement that dealers "must be prepared to provide evidence that is sufficient to overcome the presumption that the dealer's contemporaneous cost provides the best measure of prevailing market price."

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[87] The NASD has not provided the SEC any basis to certify under the Regulatory Flexibility Act that the Proposed Interpretation will not have a significant economic impact on these small entities, 5 U.S.C. § 605(b), nor has the SEC completed an initial regulatory flexibility analysis, 5 U.S.C. § 603(a).

[88] *See* Exchange Act § 3(a)(36), 15 U.S.C. § 78c(a)(36) ("A class of persons or markets is subject to 'equal regulation' if no member of the class has a competitive advantage over any other member thereof resulting from a disparity in their regulation under this title which the SEC determines is unfair and not necessary or appropriate in furtherance of the purposes of this title.").

- Whether the obligation in the Proposed Interpretation to create "evidence" for inspection by NASD (and, presumably, SEC) examination staffs imposes warranted and necessary costs in light of the fact that dealers overwhelmingly do not have systems in place currently to capture and retain some of the information required by the rule (*e.g.*, information concerning historical inter-dealer quotations, data compilations of historical yields and spreads to benchmark securities, information about the general structural characteristics of a bond at a particular point in time, any "economic models" used by dealers in connection with pricing, *etc.*).[89]

The complete absence of any meaningful analysis of other, less burdensome alternatives to the Proposed Interpretation and the inclusion of a single, conclusory sentence about the proposal's effect on competition demonstrate that any court reviewing the SEC's approval of the NASD's proposal would simply not be in a position to "assess the justification for the balance the SEC has struck between the perceived anticompetitive effects of the regulatory policy at issue and the costs of doing so."[90]

B. As Reflected in Guidance Issued Outside of the Current Rulemaking, the NASD Has Proposed a Standard for "Market Making" at Odds with the Statutory Definition in Violation of Exchange Act Section 15A(b)(2).

Exchange Act Section 15A(b)(2) requires that NASD rules and interpretations "carry out" and "comply" with the provisions of the Exchange Act. As evidenced in informal legal guidance issued by the NASD this summer outside the context of the current rulemaking, the Proposed Interpretation's perfunctory statement that a bond dealer's status as a "market maker" would be governed by the statutory definition is simply not credible. The SEC must address whether the Proposed Interpretation, in light of this NASD guidance, fails to include an integral and related official interpretive position of the NASD and, if so, reject that interpretation as contrary to the Exchange Act.

As set forth in detail above, the standard for treating bond dealers as "market makers" under NASD's Proposed Interpretation — although ostensibly linked to the Exchange Act definition — has been interpreted by the NASD to require that a dealer "must

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89 The recordkeeping obligations in the Proposed Interpretation — generally described as requirements to "provide evidence" — may well raise issues under the Paperwork Reduction Act of 1995, 44 U.S.C. §§ 3501-3510. The SEC's approval of the Proposed Interpretation would create a new "collection of information" requirement by imposing a "recordkeeping requirement" on 10 or more persons. *See* 44 U.S.C. § 3502(3)(A)(i). The Proposed Interpretation does not set forth any representation that the proposed collection of information has been submitted by the NASD or the SEC to the Office of Management and Budget for review. *See* 5 C.F.R. § 1320.11(a).

90 Securities Acts Amendments of 1975, H.R. Rep. No. 94-229, 94th Cong. 1st Sess. 100 (May 19, 1975) ("For example, a self-regulatory organization's rule, after approval by the SEC, is reviewable in a court of appeals under the standard of the Exchange Act, i.e., whether it imposes a burden on competition which is neither necessary nor appropriate in furtherance of the purposes of the Exchange Act.").

be willing to buy and sell the security in the inter-dealer market on a regular or continuous basis."[91] Similarly, the NASD has suggested that efforts by dealers to hold themselves out as willing to buy or sell a security for their own account on a regular basis through quotes and markets issued to customers — although sufficient under Section 3(a)(38)[92] and other SEC rules and guidance concerning market making activities[93] — is *insufficient* under the NASD's interpretation of Rule 2440.[94]

These legal interpretations are contrary to the Exchange Act Section 3(a)(38) and other SEC rules and releases applying that provision. The SEC should not, and cannot consistent with its obligations under Exchange Act Section 15A(b)(2), adopt the Proposed Interpretation without changes addressing this provision.

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91 *See, e.g.*, In re Citigroup Global Markets Inc., NASD AWC No. CMS 040113, at 4 n.6 (July 28, 2004).

92 Exchange Act § 3(a)(38), 15 U.S.C. § 78c(a)(38) (defining a "market maker" as a "dealer who with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system *or otherwise*) as being willing to buy and sell such security for his own account on a regular *or* continuous basis") (emphasis added).

93 *See, e.g.*, Exchange Act Rule 11Ac1-2(a)(13) ("The term 'over-the-counter market maker' shall mean, with respect to any subject security other than a reported security, any broker or dealer which holds itself out as being willing to buy or sell such security on a regular and continuous basis otherwise than on an exchange in amounts of less than block size."); *see also* Order Execution Obligations, Exchange Act Rel. No. 37619A, 61 Fed. Reg. 48,290, 48,318 (Sept. 12, 1996) ("[D]ealers that internalize customer order flow in particular stocks, by holding themselves out to customers as willing to buy and sell on an ongoing basis, would fall within the definition even though they may not hold themselves out to all other market participants.").

94 In re Deutsche Bank Securities Inc., NASD AWC No. CMS040105, at 5 n.6 (July 28, 2004).

CONCLUSION

The Association appreciates the opportunity to provide its comments on the Proposed Interpretation. The Association would welcome the opportunity to provide any additional information concerning the issues discussed in this letter.

Sincerely,

/s/ Micah Green

Micah S. Green
President

/s/ Michele David

Michele C. David
Vice President and
Assistant General Counsel

cc: ***U.S. Securities and Exchange Commission***

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The Hon. Paul S. Atkins, Commissioner
The Hon. Roel C. Campos, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
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