SIFMA™

Securities Industry and Financial Markets Association

January 3, 2007

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

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

Dear Ms. Morris:

The Securities Industry and Financial Markets Association ("SIFMA")[1] is pleased to submit this comment letter to the Securities and Exchange Commission ("SEC" or "Commission") in connection with the National Association of Securities Dealers, Inc.'s ("NASD") proposed interpretation concerning the application of its mark-up policy to transactions in debt securities (the "Proposed Interpretation" or "Proposal"). The Proposal recently was amended and published for comment by the SEC.[2]

SIFMA appreciates the NASD's response to industry concerns relating to earlier iterations of the Proposal. SIFMA also commends the NASD's recognition that a

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[1] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] Notice of Filing Amendments Nos. 3, 4, and 5 to a Proposed Rule Change Relating to Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities, Exchange Act Rel. No. 54799 (Nov. 21, 2006), 71 Fed. Reg. 68856 (Nov. 28, 2006) (the "Proposing Release"). The NASD originally filed the Proposal with the SEC on September 17, 2003. The NASD filed two amendments to the Proposal in 2004, which the SEC published for comment in 2005. *See* 70 Fed. Reg. 12764 (Mar. 15, 2005). The Bond Market Association ("BMA"), a predecessor association to SIFMA, commented on the Proposal, as amended, by letter from Mr. Micah S. Green, President, BMA and Ms. Michele C. David, Vice President, and Assistant General Counsel, BMA to Mr. Jonathan G. Katz, Secretary, SEC (Apr. 5, 2005) ("BMA 2005 Letter"). The NASD responded to the BMA 2005 Letter and other comment letters by letter from Ms. Sharon Zackula, Associate General Counsel, NASD, to Ms. Katherine A. England, Assistant Director, Division of Market Regulation, SEC (Oct. 4, 2005) ("Zackula Letter"). The NASD filed Amendment Nos. 3, 4, and 5 to the Proposal in October 2005, November 2005, and October 2006, respectively. The SEC published these amendments on November 21, 2006.

dealer's relationships with institutional customers are qualitatively different from its relationships with retail customers, and supports the NASD's proposal to exempt from NASD Rule 2440 and IM-2440 ("Mark-Up Policy") certain trades between dealers and qualified institutional buyers ("QIBs"). This aspect of the Proposal represents a tremendous step forward that substantially addresses dealers' concerns with earlier iterations of the Proposal.

SIFMA applauds the NASD's positive efforts in these respects. SIFMA also requests that a number of areas be clarified or expanded. SIFMA respectfully requests that the NASD: (1) expand the exemption from the Mark-Up Policy to include transactions by dealers with QIBs in certain additional securities; (2) provide dealers with more guidance regarding the definition of "contemporaneous cost", including restoring the "size" proposal; (3) allow for a more flexible and nuanced approach in determining prevailing market price where the dealer establishes that contemporaneous cost is not the best evidence of the prevailing market price; and (4) expand the discussion of the situations in which a bond dealer may consider itself a market maker.[3] As described more fully below, we believe these changes would significantly enhance the efficient pricing of debt instruments, promote liquidity in the bond markets, and provide meaningful, practical guidance that is consistent with the manner in which dealers and institutional investors make pricing determinations. Further, given the significance of the Proposal, we respectfully request that the SEC expedite its review and consideration of these comments.

SUMMARY OF THE PROPOSAL

Under NASD rules, dealers are required to transact with customers at prices reasonably related to the prevailing market price of the security.[4] Under the Proposal, "[a] key step in determining whether a mark-up (mark-down) is fair and reasonable is correctly identifying the *prevailing market price* of the security. . . . "[5] The Proposal contains a presumption that contemporaneous cost is the best evidence of prevailing market prices for non-market makers. The Proposal then specifies three exclusive factors that a dealer may use to overcome the presumption that its contemporaneous cost is not indicative of the prevailing market price: (1) interest rate changes after the dealer's contemporaneous transaction that would reasonably cause a change in pricing; (2) significant credit quality changes after the trade; or (3) news issued or distributed and known to the marketplace that had an effect on the perceived value of the security after the dealer's contemporaneous transaction.

The Proposal next specifies a hierarchy (the "Hierarchy") that dealers must use to determine the prevailing market price if the dealer has presented evidence sufficient

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[3] SIFMA notes the Zackula Letter has discussed the status of bond dealers as market makers. *See, infra*, n. 29.

[4] NASD Rule 2440 and IM-2440.

[5] Proposing Release, at 68858 (emphasis in original).

to overcome the presumption that contemporaneous cost or proceeds is the best evidence of prevailing market price, or if the dealer establishes that its costs are not contemporaneous.[6] The Hierarchy requires dealers to look at three factors in a particular order and prohibits reference to a subsequent factor if an earlier factor is present. First, dealers must look at the pricing of contemporaneous interdealer transactions in the same security. Second, in the absence of interdealer transactions, dealers must look to the prices of contemporaneous dealer purchases from institutional accounts with which any dealer regularly effects transactions in the same security. Third, if neither of the prior two factors is available, dealers must look to contemporaneous bid (offer) quotations for the security in question for proof of the prevailing market price if the securities are "actively traded" and such quotations are made through an interdealer mechanism through which transactions generally occur at the displayed quotations.

If none of the above three factors in the Hierarchy is available, the dealer then may take into consideration a non-exclusive list of four factors to establish prevailing market price, focusing on contemporaneous transactions in similar securities.[7] If none of these four factors is available, then a dealer may consider prices or yields derived from economic models that take into account various specified measures, including credit quality, interest rates, time to maturity, and optionality. Further, in any instance where the dealer is using something other than contemporaneous cost to establish the prevailing market price, the dealer must be prepared to provide evidence to establish the basis for the dealer's pricing determination.

Importantly, the Proposal exempts from the definition of "customer" QIBs meeting certain suitability requirements that are purchasing securities that are or would be rated below investment grade or unrated privately placed securities, regardless of credit quality.[8]

<u>DISCUSSION</u>

I. SIFMA Commends the NASD for Providing a Limited Carve Out for Certain Transactions By QIBs, But Urges the NASD to Extend this Exclusion to All Private Transactions Between Dealers and QIBs Pursuant to SEC Rule 144A or the So-Called Section 4(1 $^{1/2}$) Exemption.

As discussed above, SIFMA strongly supports the NASD's proposed "carve

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[6] Unless otherwise noted, the discussion of mark-ups and contemporaneous cost in this letter also applies to mark-downs and contemporaneous proceeds.

[7] These four factors relate to yields and prices on certain trades in similar securities.

[8] QIB is defined in Rule 144A under the Securities Act of 1933, as amended ("Securities Act"). Rule 144A, adopted in 1990, exempts from the registration requirements of Section 5 of the Securities Act resales to QIBs under certain circumstances, based on the idea that the QIBs are sufficiently sophisticated and have sufficient ability to analyze information that they do not need the protections afforded by the Securities Act. *See, infra,* n. 14.

out" of suitable QIBs from the definition of "customer" for purposes of its Mark-Up Policy. This carve out is consistent with the well-recognized principle that a dealer's relationships with institutional customers are qualitatively different from its relationships with retail customers.[9]

Currently, the proposed carve out only applies to trades by QIBs in "non-investment grade debt securities." The Proposal defines "non-investment grade securities" as securities that: (1) a nationally recognized statistical rating organization ("NRSRO") has assigned a rating lower than one of the four highest generic rating categories (*e.g.*, below BBB or Baa); (2) if the security is unrated, either the dealer has analyzed the security as non-investment grade, retains credit evaluation documentation and demonstrates to NASD (using credit evaluation or other demonstrable criteria) that the security's credit quality in fact is equivalent to a non-investment grade debt security; or (3) if the security is unrated, the security was initially offered and sold and continues to be offered and sold pursuant to an exemption from registration under the Securities Act of 1933 ("Securities Act").

SIFMA requests that the NASD revise the Proposal to expand the exclusion from the definition of customer to apply to all bond trades originally issued pursuant to the exemption from registration provided by Section 4(2) of the Securities Act and transacted between a dealer and a QIB pursuant to Rule 144A under the Securities Act or the so-called Section $4(1^{1/2})$ exemption, regardless of the debt securities' rating.[10] The NASD's rationale for excluding trades by QIBs in non-investment grade debt securities would appear to apply equally to these transactions. Specifically, as set forth in the Proposing Release, the basis for the carve out for non-investment grade securities is two-fold. First, securities "that are sold pursuant to an exemption from registration under the Securities Act, and thereafter continue to be resold in private transactions rather than in the public markets, often may yield little or no pricing information that a

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[9] *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).

[10] The so-called "$4(1^{1/2})$ exemption" essentially permits dealers to engage in private transactions on the same basis that an issuer would be permitted to engage in such a transaction. W. Hicks, Exempted Transactions Under the Securities Act of 1933, §9:109 (2005). SIFMA's ABS/MBS Division has submitted a separate comment letter to the Proposal . See Letter from Robbin Conner, Vice President and Assistant General Counsel, SIFMA, to Nancy M. Morris, Secretary, SEC, dated January [X], 2006. (the "SIFMA ABS/MBS Letter"). As explained in that letter, SIFMA believes there are unique issues for structured products that merit a broader exemption from the definition of customer for trades in any structured product by a QIB, regardless of registration status and regardless of credit rating.

dealer may use with confidence to determine the prevailing market price and a fair mark-up or mark-down for such debt securities transactions."[11] Second, "[m]any large institutional investors have sufficient knowledge of the market or certain sectors of the market to trade debt securities with broker-dealers at prices negotiated at arms length, reducing the need for such customers to be protected with respect to every transaction under Rule 2440, IM-2440-1 and the Proposed Interpretation."[12]

We believe these principals apply equally to situations where a QIB engages in bond transactions pursuant to Rule 144A or Section 4(1$^{1/2}$), regardless of the rating of the debt security. With regard to the first point articulated by the NASD, even if securities sold pursuant to 144A or Section 4(1$^{1/2}$) are investment grade rated, there may be little or no pricing information regarding them and tend to be less liquid than registered bonds.[13] This is particularly the case with bonds transacted pursuant to the 4(1$^{1/2}$) exemption. Also, the rationale for excluding QIBs because of their level of sophistication should apply equally to trades in investment grade rated private bond securities that are executed pursuant to Rule 144A or the Section 4(1$^{1/2}$) exemption. Indeed, in proposing and adopting Rule 144A, the SEC recognized that — as a general matter — different standards should apply to private trades by QIBs. In doing so, the SEC did not distinguish between different types of private bond transactions, but rather noted that, as a general matter, certain sophisticated investors do not need the same protections afforded to retail investors.[14]

Similarly, in the context of suitability interpretations, the NASD has recognized that institutional and retail investors are qualitatively different. In providing special guidance for assessing the suitability of recommendations to institutional customers, the NASD did not differentiate between institutional investors, based on the type of security traded.[15] In that regard, the regulatory history of the NASD's institutional suitability interpretation 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

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[11] Proposing Release, at 68861-2.

[12] Proposing Release, at 68861-2.

[13] Among other things, the NASD has proposed to exclude QIBs from the definition of "customer" if they trade unrated securities that initially were sold and continue to be sold pursuant to an exemption from registration under the Securities Act.

[14] Securities Act Rel. No. 6806 (Oct. 25, 1988), 53 Fed. Reg. 44016, 44022 (Nov. 1, 1988). "Congress and the Commission historically have recognized the ability of professional institutional investors to make investment decisions without the protections mandated by the registration requirement of the Securities Act. The Commission has not until now, however, formally addressed the difference between the institutional and public resale markets. The institutional resale market for restricted securities has evolved to a point where its existence should be acknowledged." *Id.*

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

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 information from multiple dealers as well as trading screens on which they may do comparative requests for quotations among their dealers. As such, SIFMA does not see the basis for distinguishing between investment grade and non-investment grade private bond transactions in determining whether a QIB should be considered a customer for purposes of the NASD Rule 2440.

Finally, it is important to emphasize that an extension of the carve out, as we have proposed, would not result in a negative effect for unsophisticated, retail customers because, by definition, these persons would not qualify as QIBs. Also, TRACE transaction reports are not publicly disseminated for private bond transactions and, as such, prices established pursuant to such transactions should not impact publicly available data regarding securities prices. For these reasons too, SIFMA believes that bond transactions with suitable QIBs pursuant to Rule 144A or Section 4($1^{1/2}$) should be outside the scope of the Proposal, regardless of rating. To be sure, with an expanded carve out, the institutional investors would be protected because in order for the carve out to apply, dealers would need to establish a reasonable basis for concluding that the QIB is making independent investment decisions and is capable of independently evaluating investment risk.[16]

II. The NASD Should Provide More Guidance to Dealers About Which Trades May or May Not Be Considered Contemporaneous and, In Doing So, Should Reinstate the Size Proposal and Clarify the Scope of the News Exception.

The prevailing market price provides the baseline from which the dealer must calculate any mark-up. The method for determining prevailing market price, therefore, is critical to any mark-ups analysis. The Proposal presumes that contemporaneous cost is the best evidence of prevailing market price. The meaning of contemporaneous cost, then, is equally critical. In response to earlier comments, the NASD provided a definition of “contemporaneous cost.” While SIFMA appreciates the NASD’s efforts to provide guidance on this difficult concept, we are concerned that the proposed definition lacks objective standards and will be difficult to apply. As such, SIFMA requests that the NASD (1) clarify the meaning of contemporaneous cost as set forth below, (2) reinstate the size proposal, and (3) clarify the scope of the “news” exception

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[16] In this regard, it is worth noting that SIFMA’s Asset Management Group (“AMG”) supports concepts in this letter, and additionally supports an exemption from the NASD’s Mark-Up Policy for professional customers. The AMG has stated that such an exemption also should include all registered investment advisers, regardless of whether the adviser meets the QIB definition.

as discussed below.

A. The Definition of "Contemporaneous Cost" is Difficult to Apply.

SIFMA appreciates the NASD's provision of a definition of "contemporaneous cost" in the Proposal, but urges the NASD to provide additional clarification because this definition will be difficult for dealers to apply. In particular, SIFMA requests that the NASD provide additional guidance on the meaning of "contemporaneous," including (1) clarifying that time is not the only factor that may cause trades to not be contemporaneous, (2) clarifying that a dealer's good faith determination that trades are not "contemporaneous" will be presumptively respected , and (3) establishing that trades that are separated from each other by a certain amount of time are presumptively not contemporaneous.

SIFMA believes these clarifications are critical because the proposed definition of contemporaneous is circular and subjective. The word contemporaneous means "originating, existing, or happening during the same period of time."[17] Under the Proposal, a dealer's cost is "considered contemporaneous if the transaction occurs *close enough in time* to the subject transaction that it would reasonably be expected to reflect the current market price for the security . . . ."[18] As such, contemporaneous transactions are close enough in time if they happen during the same time period, a circular definition that is difficult for dealers to apply. Further, the passage of time appears to be the only factor in determining whether or not a prior trade is considered contemporaneous with a subsequent trade.

As a matter of logic, it must be the case that as more time passes between transactions, the less likely the transactions would be deemed to be contemporaneous. The amount of time that must elapse, however, appears to be an elastic concept, based on "reasonable expectations." In this regard, the NASD has stated that:

> Whether a cost (or price) is contemporaneous to the transaction for which the mark-up (mark-down) is being calculated is a facts-and-circumstances test determined by the trading patterns of, and liquidity in, the subject security over time and during the period in question, and other factors. There are no absolute temporal standards used to determine if a transaction and the dealer's cost (proceeds) are "contemporaneous" to the subject transaction. . . .[19]

It must be understood that this circular definition combined with the lack of objective standards for determining whether transactions are contemporaneous makes the

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[17] THE AMERICAN HERITAGE COLLEGE DICTIONARY (4th ed. 2002).

[18] Proposing Release, at 68857 (emphasis added).

[19] Zackula Letter, at 7.

definition quite difficult to apply in practice. Accordingly, a dealer's good faith determination that a prior trade is not contemporaneous should presumptively be respected.[20]

B. The Size Proposal Should Be Restored.

In Amendment Nos. 3 and 4 to the Proposal, the NASD proposed that dealers may be able to show that contemporaneous cost (or proceeds) are not indicative of prevailing market price if, among other things, the size of the transaction (either large or small) caused the transaction to be executed at a price away from the prevailing market price of the same security, as evidenced by contemporaneous transactions in the same securities or similar securities (the "Size Proposal").[21] The Size Proposal, thus, recognized the economic reality that for small sell transactions, counterparties will typically pay a premium, whereas for large sell transactions, counterparties will typically pay a discounted price (the vice versa being true for purchases). In Amendment No. 5, however, the NASD withdrew the Size Proposal, on the basis that it no longer would be necessary in light of the proposed carve out for certain trades by QIBs.

As described above, the carve out for certain trades by QIBs is a welcome proposal. However, because this carve out covers a limited universe of transactions, the Size Proposal is still necessary for those trades that do not involve QIBs, or do not involve non-investment grade securities. For this reason, SIFMA urges the NASD to reinstate the Size Proposal, and allow dealers to disregard, for purposes of determining prevailing market price, the discount or premium inherent in pricing small or large bond transactions.

The size proposal is significant for both small trades and large trades. In the corporate markets, trades of relatively small size may trade at a discount (for customer sells) or premium (for customer purchases), given the paucity of demand for small lots relative to larger, round lots. Since these small transactions generally are not with QIBs and do not involve bonds rated below investment grade, the exception for qualifying QIBs will not resolve these issues. SIFMA is concerned that dealers will be required to use the discounted or premium prices resulting from small bond trades as the prevailing market price from which they would be required to compute markups on subsequent, round lot trades. This could put dealers in a difficult position, requiring them to sell bonds at a price that is lower than the prevailing market price, or buy bonds at a price that is higher than the prevailing market price. Therefore, we request that the NASD recognize the differences in pricing between round lots and odd lots.

Similarly, with large blocks dealers may negotiate discounts or premiums, and this may occur for both investment grade and non-investment grade bonds. Requiring

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[20] *See* BMA 2005 Letter, at n.57 (noting a settlement finding that trades 38 days apart were contemporaneous, in *In re Howe, Soloman & Hall*, Exchange Act Rel. No. 40038 (May 28, 1998)).

[21] *See* Proposing Release, at 68862.

the dealer to use the discounted or premium price as the prevailing market price for the next trade could put the dealer in a difficult position for the reasons discussed above. The QIB exception is helpful with respect to QIBs trading non-investment grade debt, but not with respect to investment grade debt.

C. The NASD Should Clarify that "News" that May Affect Prevailing Market Price May Be Distributed Through a Variety of Channels and May Encompass Different Types of Information, and Clarify Documentation Issues.

SIFMA welcomes the NASD's inclusion of language recognizing that a dealer's (near) contemporaneous cost may not be indicative of the prevailing market price of a security when news that has an effect on the perceived value of the security has subsequently been disseminated to the market. As the NASD states, such a provision is necessary, since certain significant news would not be captured by previously proposed language which was limited to a recognition that interest rate changes and credit quality changes may affect the price of a debt security.

SIFMA asks the NASD, however, to clarify that such news may be distributed through a variety of channels, and is not limited to information that has been broadly disseminated or made widely available to the marketplace, such as by means of a press release carried over a major news service, a major news publication, or a public filing made with a regulatory agency.[22] In that regard, the distribution of information through narrower channels may affect the price of a debt security, even if such information has not been broadly disseminated to the marketplace. For this reason, the NASD should clarify that dealers may be able to rely on information distributed through a variety of channels in proving and documenting that contemporaneous cost may not be reflective of prevailing market price

In addition, SIFMA requests clarification that "news" includes information that may not directly impact the issuer but may still impact the price of the issuer's debt securities. For example, news may come out that a security with similar characteristics is being issued by a different issuer. This may reduce the demand for the first issuer's bonds, although the news about the new issue would not affect the issuer of the first bond per se. We believe that the rule as written is broad enough to encompass this scenario, as the news of the new issue could have an effect on the perceived demand for

[22] For instance, dealers may also receive news from subscription-based services such as Debtwire or from paid consultants who analyze and report on the content of public filings. SIFMA requests that the NASD clarify that information from such sources may qualify as "news" for purposes of the Proposal. The SIFMA ABS/MBS Letter additionally requests that the NASD clarify that "news" includes (1) news relating to other factors that may affect a security (*e.g.*, news that may affect the collateral underlying a structured product), and (2) any information or events that may affect expectations about the value of a structured product or collateral pool.

the issuer's debt securities, and hence the perceived value of the existing debt security. However, we would appreciate it if the NASD would confirm this understanding.[23]

Finally, the NASD should clarify how a dealer may consider news to rebut the contemporaneous cost presumption in the context of illiquid securities. Since transaction data and contemporaneous quotes may not be available in the post news period for such securities, a change in market perception about value of the relevant securities may be difficult to document. In effect, the dealer's transaction could be the first transaction to "price in" such news. While dealers may be able to demonstrate the news, it may be more difficult for dealers to demonstrate how the news affected the "perceived value" of the debt security. As such, the NASD should clarify that dealers are permitted to use alternatives to contemporaneous cost whenever intervening news would reasonably be expected to have a material effect on the value of a security without being required to separately demonstrate that effect.

III. The Hierarchy for Determining Prevailing Market Price Is Overly Rigid and Does Not Reflect the Way the Institutional Debt Trading Markets Operate.

As described above, the Proposal allows dealers to: (1) establish evidence to overcome the presumption that contemporaneous cost is the best evidence of prevailing market price in three limited instances; and (2) establish that the passage of time has rendered a prior trade not contemporaneous. The Proposal requires dealers to follow a strict, defined process to determine prevailing market price in these instances (*i.e.*, the Hierarchy). SIFMA is concerned that a strict application of the Hierarchy may lead to inaccurate determinations of prevailing market price because it requires dealers to ignore important pricing information. A strict application of the Hierarchy also will be difficult for dealers to apply in practice because it does not fully reflect the way that dealers and institutional investors make pricing determinations. For these reasons, SIFMA believes the Hierarchy should be modified to allow dealers to exercise more discretion in determining whether there are other factors that are relevant to pricing decisions.

A. The Hierarchy Should Be More Flexible, and Allow Dealers to Consider Other Information Relevant to Pricing Determinations.

The rigidity of the Hierarchy will require dealers consciously to ignore information that is relevant to their pricing decisions in determining prevailing market

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[23] As discussed below, dealers also receive a great deal of bid and offer information throughout the trading day, including information from interdealer brokers and customers for securities that the dealers own and for similar securities. This information also may affect the perceived value of the security and, thus, its price. In a sense, this information too could be viewed as news affecting the perceived value of an issuer's securities. In addition, certain news, such as news of tax law changes or accounting changes, may impact the perceived value of certain types of debt securities, without regard to any particular issuer or industry group. While it would appear that news of such changes would be included in the Proposal as drafted, SIFMA requests clarification that this is the case.

price where dealers establish that contemporaneous cost is not the best evidence of prevailing market price or that prior trades are not contemporaneous. SIFMA fears that expecting dealers to ignore information that they believe in good faith to be relevant is not realistic and would expose them to risk, leading to increased bid-offer spreads and worse prices for customers. In determining fair levels at which to trade bonds, dealers are focused on the market risk involved in establishing or terminating positions. While the factors specified contain important information for dealers in managing their risk, other information may be equally or more important to dealers, such as quotation information or indications of interest in the same or similar securities. The Hierarchy, however, permits traders to use this information *only* in very specific circumstances. As such, dealers in possession of such information are required to ignore it if the information does not fit into the Hierarchy, or if it fits in a different order in the Hierarchy – even if they, in good faith, consider it important in determining the prevailing market price.

In particular, dealers should have greater flexibility to consider quotation information when determining prevailing market price. In that regard, dealers receive a plethora of bid and offer information throughout the trading day, including information from interdealer brokers and customers for securities that the dealers own and for similar securities. Dealers may receive this information orally or electronically (*e.g.*, via facsimile, Bloomberg or other electronic messaging systems, or website access). Dealers view this quotation information as critical in assessing the current market price for a bond because it reveals the demand and supply for a particular security or type of security, which – according to basic economic principles – determines price. In some instances, this information may be more important than prior trades, especially given the open-ended nature of the definition of "contemporaneous cost." Under the Proposal, however, dealers may use quotation information only if the first three factors in the Hierarchy are not present, and then only if the securities are considered "actively traded."

While SIFMA appreciates that quotations are not always reliable indications of the current market, we believe it is not appropriate to require dealers to disregard relevant quotation information in all instances that do not comport with the Hierarchy. The legal basis underlying the Hierarchy was developed in connection with the equity markets, and largely in the context of "pump and dump" schemes perpetrated by penny stock boiler rooms on retail customers.[24] In contrast to the debt markets, in the equity markets there are registered market makers, consolidated quotation information, and fewer securities. Market makers in equity securities determine prevailing market prices based on current, consolidated quotes, which generally reflect very recent trades. In the debt markets, however, quotations are not published in a consolidated manner (if at all), there are many more securities (most of which trade infrequently), and the market maker concept is more constrained. It is inappropriate, therefore, to import the legal structure developed in the equity context into the very different debt markets. By

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[24] *See, e.g., First Independence Group Inc. v. SEC*, 37 F.3d 30, 32 (2d Cir. 1994); *Barnett v. U.S.* 319 F.2d 340, 344 (8th Cir. 1963); *In the matter of Alstead, Dempsey & Co.*, Exchange Act Release No. 20825 (Apr. 5, 1984).

requiring dealers to look to quotation information *only* if other factors are not present and *only* if the securities are "actively traded," the Proposal would require dealers to ignore information that they consider to be critical in pricing securities.

SIFMA therefore requests that the NASD permit dealers to utilize quotation information in situations where (1) the dealer regularly trades in the particular security or class of securities as principal and provider of liquidity, and (2) the dealer has a good faith belief in the independence and validity of the quotes. Given the differences between the manner of disseminating quotation information in the equity and debt markets, dealers' use of quotation information should not be limited to information for actively traded securities provided through quotation mediums or inter-dealer quotation systems.

B. As a Separate Matter, the Hierarchy Also Is Not Practical, Given the Realities of the Way the Debt Markets Operate.

Given the fast pace and high-pressure nature of most bond trading desks, it is difficult (if not impossible) to imagine a dealer actually going through the steps outlined in the Proposal. Specifically, each time a trader buys or sells a bond from a customer, the trader would need to undergo a formalistic process *before* engaging in the trade. To a trader, this process is a rigid construct that does not reflect the way the debt markets operate or the manner in which dealers and institutional investors determine pricing:

- First, the trader must determine if there are any "contemporaneous" trades in the security.

- Next, the trader must determine whether there are any credit events, news events, or interest rate changes that might negate the presumption that contemporaneous cost is the best evidence of prevailing market price.

- Third, the trader must: (1) identify interdealer trades (if any); (2) if there are none, identify institutional trades (including determining that the customer's trade qualifies under the rule); (3) if there are none, determine whether the market is "active" and if so, whether there are any "qualifying" quotes.

- If none of these factors is available, the trader must look at: (1) prices of interdealer trades in similar securities; (2) prices of institutional customer trades in "similar securities" (as that term is defined under the Proposal); (3) yields from interdealer trades; (4) yields from institutional customer trades (including determining that the customer's trade qualifies under the Proposal); and (5) yields computed from validated quotes.

- Finally, if (and only if) none of these factors is available, the dealer may look to economic models.

Also, in applying the Hierarchy, the trader would be required to consciously disregard other available information – even if the trader has a good faith belief that such information is relevant to a pricing determination.

SIFMA believes that it is unrealistic to expect that dealers will go through the detailed process described above, while at the same time ignoring information that they may believe is important to pricing. As such, the Proposal would place supervisors and compliance officers in a very difficult position because it would result in their conducting after-the-fact reviews of trades, working to fit particular trades into the Hierarchy on a post hoc basis. Supervisors and compliance officers conducting after-the-fact reviews of trades may face situations where, based on all relevant pricing factors, the firm's pricing seems appropriate, although a strict application of the Hierarchy may suggest a different result. For these reasons, too, SIFMA requests that the NASD provide additional flexibility to permit dealers to take into account size, quotes, and other appropriate criteria in determining prevailing market price in situations where the dealer has established that contemporaneous cost is not the best evidence of prevailing market price.

IV. The Proposed Interpretation Should Acknowledge the Critical "Market-Making" Role Played by Dealers in the Bond Markets and Expressly Recognize Precedent Related to that Definition.

SIFMA requests that the NASD further clarify that debt dealers may be market makers, as the market maker concept is important in determining prevailing market price other than based on contemporaneous cost.

A "mark-up equals the price charged to the customer minus the . . .[bond's] . . . prevailing market price"[25] 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 are 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."[26] 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

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

[26] In a proposed disclosure statement for retail investors, the NASD equated this term with "a fair price reasonably related to then current market prices." NASD NTM 05-21, at 15 (2005).

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."[27]

As described in the BMA April 2005 Letter, bond dealers regularly risk their capital to facilitate customer transactions, and regularly provide quotes to customers and in the interdealer market. SIFMA continues to believe that dealers in debt securities may, under certain circumstances, be market makers. Further, SIFMA continues to believe that the NASD should take into account structural differences between the equity and bond markets in determining whether a debt dealer may be a market maker. SIFMA has in the past requested that the NASD's mark-up proposal provide specific interpretive guidance on when a dealer in the debt markets may be considered a market maker, continues to believe that such an approach is appropriate and urges the NASD to reconsider its position on this point.[28] While the current proposal does not contain any such guidance, SIFMA applauds the NASD for recognizing the market maker concept in the Proposing Release.[29]

Further, SIFMA applauds the NASD for recognizing, in the Zackula Letter, legal precedent for the definition of market maker that has application in the current, decentralized, over-the-counter bond markets, including *Adams Securities Inc.*,[30] *Raymond James & Associates, Inc.*, [31] and *C.R.A. Realty Corporation v. Tri-South Investments*.[32] SIFMA, however, believes that these points are of sufficient significance to its members that the NASD should expressly include its recognition of the relevant precedent in its discussion in its Statement of the Purpose of, and Statutory

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

[28] *See, e.g.,* BMA 2005 Letter, at 17 ("The Association believes the NASD should specify that dealers that devote substantial capital to provide liquidity to investors are market markers within the meaning of 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 counterparty. . . .").

[29] *See* Proposing Release, at 68858, n.8. *See also*, Zackula Letter, at n.17 ("NASD continues to embrace the concept of market makers in the debt markets").

[30] *Adams Securities*, *Inc.*, Admin. Proc. File No. 3-7624, 1993 SEC LEXIS 506, at *6 (March 9, 1993) ("whether a dealer is acting as a market maker depends on the particular facts and circumstances.");

[31] *Raymond James Assoc., Inc.*, Admin. Proc. File No. 3-8801, 1997 SEC LEXIS 1581, at *9-10. The SEC held that Raymond James acted as a market maker in direct participation programs: (i) where it "did not sell these securities to dealers other than [wholly owned subsidiaries] during the two-monthly period under review . . . ."; (ii) where its advertising literature referred to the firm as a market maker; (iii) where it did not furnish quotations in an interdealer quotation system, although no such system existed and the firm made extensive efforts to distribute its quotes widely; and (iv) where it incurred market risk and added liquidity to a largely illiquid market.

[32] *C.R.A. Realty Corp. v. Tri-South Investments,* 738 F.2d 73 (2nd Cir. 1984) (for purposes of Section 16 of the Exchange Act, a broker-dealer was a market maker in convertible debentures (and the equity security to which debentures were convertible) in an OTC market in which there was no centralized mechanism for publishing bids and offers).

Basis for, the Proposal. By doing so, the NASD's views would be reflected clearly in a single document that will be part of the SEC's approval process and that market participants will regularly consult for guidance. SIFMA believes that such a statement of the NASD's views is particularly important in light of statements in settled NASD enforcement actions that appear to take a narrower view of the availability of the market maker definition in the debt markets.[33]

CONCLUSION

For the reasons discussed above, SIFMA believes that the NASD should expand the exemption for QIBs to cover all transactions pursuant to Section $4(1^{1/2})$, regardless of rating; provide dealers with more guidance about the meaning of contemporaneous cost; restore the size proposal; permit a more flexible application of the hierarchy; and clarify the concept of market making. Further, given the significance of the Proposal, we respectfully request that the SEC expedite is review and consideration of these comments.

We appreciate this opportunity to comment on the Proposal. If you have any questions concerning these comments, or would like to discuss these comments further, please feel free to contact me at 646.637.9220 or via email at mkuan@sifma.org.

Sincerely,

Mary Kuan
Vice President and
Assistant General Counsel

cc: Mary L. Schapiro, Chairman and CEO, NASD
Marc Menchel, General Counsel, NASD
Stephen Luparello, Senior Executive Vice President, Regulatory Operations, NASD
Sharon Zackula, Assistant General Counsel, NASD
Erik R. Sirri, Director, Division of Market Regulation, SEC
Robert L.D. Colby, Deputy Director, Division of Market Regulation, SEC
Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, SEC
Katherine A. England Assistant Director Division of Market Regulation, SEC

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[33] *See* BMA 2005 Letter, at 15-16.