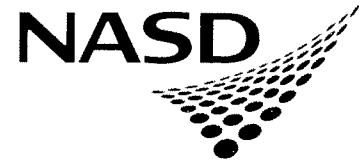


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January 12, 2007

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: File No. SR-NASD-2003-141 – Second Response to Comments on Additional Mark-Up Policy For Transactions in Debt Securities

Dear Ms. England:

In SR-NASD-2003-141, NASD proposes a second interpretation to NASD Rule 2440, IM-2440-2, to provide guidance on mark-ups in transactions in debt securities, except municipal securities (“Proposed Interpretation” or “Proposal”). NASD is responding to the comment letters submitted to the Securities and Exchange Commission (“SEC” or “Commission”) in response to the SEC’s second publication of the rule filing for notice and comment.¹

¹ Securities Exchange Act Release No. 54799 (November 21, 2006), 71 Fed. Reg. 68856 (November 28, 2006). The comment period closed on December 19, 2006. In January 2007, Nancy M. Morris, Secretary, SEC, received four comment letters regarding the proposed rule change from: (1) Mary S. Kuan, Vice President and Assistant General Counsel, the Securities Industry and Financial Markets Association (“SIFMA”), dated January 3, 2007 (“SIFMA 1 Letter”); (2) Robbin Connor, Vice President and Assistant General Counsel, SIFMA, dated January 4, 2007 (submitted on behalf of the Mortgage-Backed Securities and Securitized Products Division, SIFMA) (“SIFMA 2 Letter”); (3) Edward F. Greene, General Counsel, Corporate and Investment Banking, Citigroup, dated January 5, 2007 (“Citigroup Letter”); and (4) Robyn A. Huffman, Managing Director and Associate General Counsel, Goldman, Sachs & Co., dated January 5, 2007 (“Goldman Letter”).

In 2005, the SEC first published the proposed rule change for notice and comment. Securities Exchange Act Release No. 51338 (March 9, 2005), 70 Fed. Reg. 12764 (March 15, 2005) (incorporating the changes proposed in Amendment No. 1 and Amendment No. 2 to SR-NASD-2003-141) (“March 2005 Notice”). At that time, the SEC received a comment letter from a predecessor organization to SIFMA, The Bond Market Association (“TBMA”), and two additional comment letters from The Asset Managers Forum (“AMF-TBMA”) and The Asset Securitization Forum (“ASF-TBMA”), two groups organized by TBMA. (The SEC also received three other comment letters on the

The commenters raise several issues relating to the Proposed Interpretation: expanding the definition of market maker; providing dealers more guidance on the meaning of contemporaneous cost; providing them more flexibility in applying contemporaneous cost or using other measures to determine prevailing market price, including restoring the size proposal described below (“Size proposal”); and clarifying a provision regarding the impact of the dissemination of news in the marketplace. In addition, all of the commenters favor expanding the provision to exempt certain transactions in debt securities between qualified institutional buyers (“QIBs”) and dealers from NASD Rule 2440, NASD IM-2440 and the Proposed Interpretation (“QIB exemption”); SIFMA offers three different proposals to broaden the QIB exemption.

Expanding the QIB exemption and restoring the Size proposal are the two issues raised in the comment letters that have not been discussed extensively in prior solicitations of comment. These issues are discussed below. In addition, NASD discusses a question concerning the dissemination of news or other information in the marketplace, which relates to the process used to correctly identify the prevailing market price.

Proposed QIB Exemption. Under the proposed QIB exemption, for purposes of NASD Rule 2440, NASD IM-2440-1 and the Proposed Interpretation, “customer” does not include a QIB that is purchasing or selling a non-investment grade debt security when the dealer has determined, after considering the factors set forth in NASD IM-2310-3, that the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment to enter into the transactions.² In the SIFMA 1 Letter, the commenter urges NASD to expand the QIB exemption to apply to all transactions originally issued pursuant to the exemption from registration provided by Section 4(2) and transacted between a dealer and a QIB pursuant to Rule 144A, without regard to the debt securities’ rating.³ In the SIFMA 2 Letter, a SIFMA committee urges NASD to expand the QIB exemption as set forth above *and* to further expand the exemption to include all transactions between dealers and QIBs in securitized products that are rated investment grade.⁴

proposed rule change at that time.) NASD responded to the comments submitted in 2005 on October 4, 2005 (“2005 NASD Response”).

² See Proposed Interpretation, paragraph (b)(9). For purposes of the proposed exemption, “non-investment grade debt security” is defined broadly.

³ See also Citigroup Letter, p. 2; Goldman Letter, p. 2.

⁴ A third proposal was offered by the SIFMA Asset Management Group in the SIFMA 1 Letter. The SIFMA Asset Management Group suggests that the QIB exemption be expanded even further to exempt all transactions in all debt securities, however rated, between a dealer and any “professional customer,” and all registered investment advisers, even if the registered investment adviser is not a QIB. SIFMA 1 Letter, n. 16.

The proposed QIB exemption, which excludes certain customer transactions in debt securities from the protections of NASD Rule 2440, NASD IM-2440 and the Proposed Interpretation, is, in our view, a significant advancement upon NASD's self-regulatory approach to generally extend the requirement and proscriptions of all rules to *all* customers without differentiation as to the nature of the customer. NASD believes it is important to see how the market adjusts to this significant change in employing differentiated regulation in the case of mark-up rules with respect to QIBs in respect of the transactions enumerated in the proposal, and thereby gain regulatory experience in this approach, before considering any further reduction in the protection afforded to customers by NASD Rule 2440 and the interpretations thereunder. At this time, NASD declines to amend the QIB exemption.

Size Proposal. In the SIFMA 1 Letter, the commenter requests that NASD restore the Size proposal.⁵ The Size proposal provided generally that "a large or a small transaction executed at a price away from the prevailing market price of the security, as evidenced by certain contemporaneous transactions, is an instance where it may be appropriate for the dealer to show that its contemporaneous cost (proceeds) is not indicative of prevailing market price."⁶ Upon further consideration, NASD has determined that the Size proposal is an inappropriate basis to demonstrate that contemporaneous cost (proceeds) is not indicative of prevailing market price. First, such a provision would allow dealers to purchase large institutional-sized positions and resell them in small retail-sized transactions without reference to its contemporaneous costs, a practice that raises significant investor protection concerns. Secondly, the removal of the Size proposal is in keeping with the premise of the Proposal that a dealer may avail itself of the spread before employing a mark-up where it is a market maker as a matter of law. Where it is not a market maker, a dealer must use either contemporaneous cost (proceeds) or other prices as the prevailing market price as provided in the Proposal. Thus, where a dealer acquires a large institutional-sized position, it may depart from its contemporaneous cost in the event of news, rating change, etc., as provided in the Proposal.

News. NASD clarifies that the proposed provision in paragraph (b)(4)(iii) of the Proposal about news that "was issued or otherwise distributed and known to the marketplace that had an effect on the perceived value of the debt security after the dealer's contemporaneous transaction" *does* include news that may be about other issuers. In the 2005 NASD Response NASD stated, "NASD agrees that the news developments [such as news about pending or contemplated legislation that may affect issuers or industry sectors] may change the prices of bonds although the news may not apply specifically to the issuer, or apply only because all

⁵ A second commenter requests that NASD address the impact of the price of block trades by interpretation, rather than restore the Size proposal. Goldman Letter, p. 3.

⁶ See Amendment No. 3 to SR-NASD-2003-141, filed on October 11, 2005, and Amendment No. 4 to SR-NASD-2003-141, filed on November 22, 2005, for the full text and discussion of the Size proposal.

companies within an industry sector appear to be impacted, although by varying amounts.”⁷ The commenter also asks if news that is not broadly disseminated and is distributed through “narrower channels” qualifies under paragraph (b)(4)(iii) of the Proposal. A dealer is not permitted to use news that is distributed through “narrower channels” and not “broadly disseminated” under paragraph (b)(4)(iii). As stated in the Proposal, the news must be issued or otherwise distributed and known to the marketplace. NASD does not believe that it is appropriate to permit dealers to base significant pricing changes on news that is not broadly disseminated nor widely available and, therefore, may not, as a matter of natural market forces, have a material impact upon market pricing because of the narrow dissemination of such information.

Other Comments. The remaining issues raised in the comment letters were raised and extensively commented upon previously by SIFMA (formerly, TBMA), the two groups organized by and affiliated with TBMA, and other commenters,⁸ and NASD has responded fully.⁹ These issues include the definition of market maker for purposes of debt securities transactions; providing more guidance on the term contemporaneous cost; providing dealers more flexibility to use measures other than contemporaneous cost/proceeds to determine the prevailing market price; and related documentation issues. This response does not contain a repetitive recitation of the commenters’ arguments and positions regarding these issues and NASD’s previously filed response regarding such issues. Over the course of a decade, these issues have been discussed repeatedly by publication for comment in an NASD Notice to Members and the Federal Register and NASD’s response, and have been otherwise thoroughly vetted.¹⁰

⁷ 2005 NASD Response, p. 9, n. 28, and p. 23, Exhibit A, Item 3. The change referenced in the 2005 NASD Response was incorporated in Amendment No. 3 to the Proposed Interpretation, filed on October 11, 2005.

⁸ See the comment letters of TBMA, its affiliated groups, and others filed in 2005 in response to the March 2005 Notice.

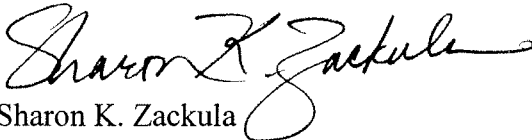
⁹ See 2005 NASD Response.

¹⁰ See Notice to Members 94-62 (August 1994) and the comments submitted thereto. See SR-NASD-97-61 (Debt Mark-Up Interpretation) and the comments submitted in response to the publication of the rule filing for notice and comment in the Federal Register in Securities Exchange Act Release No. 40511 (September 30, 1998), 63 Fed. Reg. 54169 (October 8, 1998). (SR-NASD-97-61 was withdrawn on September 16, 2003, when SR-NASD-2003-141 was filed.)

Katherine A. England
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If you have any questions, please contact me at (202) 728-8985 or Sharon.Zackula@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,



Sharon K. Zackula

cc: Catherine McGuire
Richard Strasser
Kristina Fausti