

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54681; File No. SR-NASD-2006-103)

November 1, 2006

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of a Proposed Rule Change Relating to TRACE Requirements in Connection with the Exercise or Settlement of Options, Swaps, or Similar Instruments

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on August 28, 2006, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

NASD is proposing: (1) to adopt NASD IM-6230, which would provide exemptive relief from various reporting requirements for transactions in TRACE-eligible securities executed in connection with the termination or settlement of a credit default swap or a similar instrument; and (2) to amend NASD Rule 6250 to not disseminate information on certain transactions in TRACE-eligible securities executed in connection with the exercise or settlement of an option or similar instrument or the settlement or termination of a credit default swap, any other type of swap, or similar instrument.

The text of the proposed rule change is available on NASD’s Web site at <http://www.nasd.com>, at NASD’s principal office, and at the Commission’s Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

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

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

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

1. Purpose

NASD is proposing NASD IM-6230, “Reporting Transactions Executed in Connection with the Termination or Settlement of a Credit Default Swap,” to provide exemptive relief from certain reporting requirements in NASD Rule 6230 for transactions in TRACE-eligible securities that occur in connection with the termination or settlement of CDSs or similar instruments. For certain transactions executed in connection with a broader class of instruments (options or similar instruments and CDSs, any other type of swaps, or similar instruments), NASD is proposing to amend its Rule 6250 to not disseminate information on transactions in TRACE-eligible securities executed in connection with the exercise, settlement, or termination of such instruments.

Background

When a CDS is subject to physical settlement, the buyer effects contract settlement by communicating to the seller, in a single or the first of two or more Notice(s) of Physical Settlement (or a similar document(s)) (“First NOPS”) within a fixed period, the TRACE-eligible

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17 CFR 240.19b-4.

security or securities, by CUSIP, that the buyer will deliver to the seller. However, following delivery of the First NOPS, the buyer may have additional business days (for example, three additional business days) to change the specific TRACE-eligible securities the buyer will deliver. Once the TRACE-eligible securities to be delivered are determined, the buyer delivers the TRACE-eligible securities to the seller and the seller delivers cash (e.g., the par value of the securities or some other pre-determined amount per debt security).

Proposed NASD IM-6230

In Notice to Members 05-77 (November 2005), NASD clarified that a member that is a party to a transaction in TRACE-eligible securities that occurs in connection with the termination or settlement of a CDS³ or a similar instrument must report the transaction to TRACE under NASD Rule 6230.⁴ Since publishing this Notice to Members, NASD has received inquiries regarding the application of certain reporting requirements, including requirements relating to the time of execution, the application of the 15-minute reporting period, and how to report transactions when, under certain often-used CDS documentation providing for termination or settlement, parties may be permitted to substitute one TRACE-eligible security

³ In a CDS, one party purchases protection from third-party credit risk from a counterparty seller. The purchaser of the protection is referred to as the “buyer” and the provider of the credit protection is referred to as the “seller” in proposed NASD IM-6230. Under a standard CDS agreement, an event such as a default is deemed a “credit event.” When a credit event occurs, a “credit event notice” is delivered by either the buyer or seller. Within a fixed period from the date a credit event notice is received (e.g., 30 days), the parties must communicate specific information needed to settle the CDS.

⁴ NASD Notice to Members 05-77 (November 2005), among other things, clarified that the reporting requirement applies only to those CDSs that are terminated or settled in whole or in part by the physical settlement involving TRACE-eligible securities, and has no application to CDSs that are cash-settled. NASD also addressed the TRACE reporting requirements for TRACE-eligible securities transactions executed in connection with a broader class of instruments – options and similar instruments, and CDSs, any other type of swaps and similar instruments – and not just those TRACE-eligible securities transactions executed in connection with CDSs.

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Timely Reporting

Under NASD Rule 6230, a member is required to provide timely reports for transactions in TRACE-eligible securities. In addition, in most instances, such transactions must be reported within 15 minutes of the time of execution to be considered timely.

NASD is proposing to provide exemptive relief from certain provisions of NASD Rule 6230 under proposed NASD IM-6230 for transactions that are executed in connection with the termination or settlement of a CDS, subject to certain conditions. Under proposed NASD IM-6230(a), such transactions would be deemed to be timely reported if they are reported before 8:15:00 a.m. E.T. on the next business day following receipt of the First NOPS, if the First NOPS was received on a business day, or before 6:30:00 p.m. on the next business day, if the First NOPS was received on a non-business day. In addition, a member would have to report such transactions using the TRACE memo field and include a “CDS” memo.⁵ The CDS memo would allow NASD to properly categorize such transactions for purposes of examining the member for compliance with its reporting obligations and, as discussed below, for decisions to not disseminate the transaction information.

NASD also proposes that the “time of execution” be construed as the time the transaction report is submitted. Under proposed NASD IM-6230(b), a member would enter as the “time of execution” the time that the member submits the transaction report.⁶

⁵ NASD also requires that such transactions be reported using the “special price” modifier or flag, which is appropriately used when a transaction is executed at a price based on arm’s length negotiation and done for investment, commercial, or trading considerations, but does not appear to reflect current market pricing. See Notice to Members 05-77 (November 2005).

⁶ If a transaction is reported before 8:15:00 a.m. E.T., NASD would assume that the First NOPS was delivered the prior business day. If a transaction is reported on or after

NASD believes that the reporting scheme in proposed NASD IM-6230(a) and (b) is appropriate for several reasons. NASD believes that the “time of execution” for CDS-related transactions is of less regulatory importance than for other reported transactions in TRACE-eligible securities because the price of a transaction in a TRACE-eligible security executed pursuant to a CDS is arrived at under the terms of the CDS agreement that are established at the time the CDS is agreed upon by the parties. Consequently, NASD believes that a precise time of execution is not required for regulatory purposes because such transactions are terminations or settlements of executory contractual obligations that do not provide useful data in connection with price discovery, determining best execution, or assessing reasonable mark-ups (or mark-downs). Rather, NASD requires the reports of CDS-related transactions in order to facilitate NASD’s surveillance of the corporate bond market for the detection of various fraudulent or manipulative acts and unfair practices. Therefore, NASD is proposing that the time of execution of such transactions mirror the time of reporting. Moreover, for the same reasons, NASD believes that applying the 15-minute reporting requirement to such transactions imposes an unnecessary regulatory burden at this time. In addition, NASD believes that waiving the 15-minute reporting requirement will allow CDS buyers and sellers to process the First NOPS in all cases efficiently at some time during the business day that the First NOPS is received or the following morning through the first 15 minutes that the TRACE system is open, or, if the First NOPS is received on a non-business day, throughout the next business day until 6:29:59 p.m. E.T. Finally, NASD represents that the substantial costs to NASD of receiving and reviewing for market surveillance purposes a large number of “late” transactions (and the related

8:15:00 a.m. E.T., NASD would assume that the transaction was not reported timely. Firms would be expected to retain documentation, including the First NOPS, for transactions reported in connection with the termination or settlement of CDSs.

“cancel/correct” late reports, as discussed below) and the substantial costs to members in respect of transactions where the time of execution is not critical for the purposes of NASD’s regulatory review are secondary, but significant, reasons for proposing the exemptive relief in proposed IM-6230(a) and (b).

Substitution of Securities; Exemption from Reporting; Exemption from Correction

NASD is also proposing that a limited group of transactions in TRACE-eligible securities that are executed in connection with the termination or settlement of a CDS be exempt from reporting and that a related group be exempt from the requirement to correct a previously transmitted erroneous trade report. Under proposed IM-6230(c), if a buyer submits the First NOPS and triggers the obligation of one or both parties to the CDS to report the TRACE-eligible securities transactions, and then substitutes another TRACE-eligible security for delivery, NASD would not require a member to submit a “reversal” trade report (to cancel the previously submitted report for a transaction in a TRACE-eligible security that did not occur as a result of the substitution and delivery of another TRACE-eligible security). In addition, NASD would not require the member to submit a transaction report (*i.e.*, a “cancel/correct” trade report using an as/of date) to report the transaction in the substituted TRACE-eligible debt security.

NASD believes that the proposed exemptive relief under NASD IM-6230(c) recognizes the nature of CDS-related transactions and provides for reporting, but does not affect adversely the settlement process or the market in CDSs. Several factors informed NASD’s proposed exemptive provision in NASD IM-6230(c). First, NASD notes that certain CDSs – sometimes referred to as “single name default swaps” – are not viewed as CDSs on a single debt security, but rather are considered a CDS on all of the issuer’s debt securities of similar credit and

seniority – i.e., securities that are pari passu.⁷ For purposes of a CDS, such debt securities of similar credit and seniority are viewed as virtually fungible within the issuer’s capital structure. As a result, a purchaser of a CDS often may be permitted to choose from among several debt securities that are pari passu to make good delivery. NASD believes that the reporting of transactions in TRACE-eligible securities in connection with the termination or settlement of a CDS provides important market surveillance information that is not changed materially even if, subsequently, one or more of the specific TRACE-eligible securities reported initially to the TRACE system is substituted and a different TRACE-eligible security of the same issuer is delivered to effectuate settlement.

Also, NASD has determined that any additional regulatory information and regulatory benefit obtainable from the “cancel/correct” trade reports and “late” reports (for any TRACE-eligible security delivered in substitution, as described above) are outweighed by the substantial costs that would be incurred by both NASD and members by requiring such follow-up reporting.

Proposed Amendments to NASD Rule 6250

NASD Rule 6250 currently requires that information on all transactions in TRACE-eligible securities be disseminated immediately upon receipt of the transaction report, except transactions in TRACE-eligible securities that are purchased or sold pursuant to Rule 144A of the Securities Act of 1933 (“Rule 144A transactions”). NASD proposes to amend its Rule 6250 to not disseminate information on certain transactions in TRACE-eligible securities executed in connection with the exercise or settlement of an option or similar instrument or the settlement or termination of a CDS, any other type of swap, or similar instrument (hereinafter, the exercise, settlement or termination of such instruments is referred to collectively as “option exercises

⁷ Securities that are pari passu are those that are entitled to be paid on an equal basis from

and/or swap settlements’’). NASD proposes that such information not be publicly disseminated because it does not contribute to price discovery and may cause investor confusion. NASD also proposes to re-number current NASD Rule 6250(b), the exception from dissemination that applies to Rule 144A transactions, as new NASD Rule 6250(b)(1).

As noted previously, NASD clarified that transactions in TRACE-eligible securities occurring as a result of such option exercises and/or swap settlements are required to be reported to TRACE.⁸ However, although reported, NASD believes that the dissemination of pricing and other information on such transactions does not appear to provide market participants with information useful for price discovery purposes. NASD believes that this is due primarily to the fact that such options, CDSs, other types of swaps, and similar instruments are generally entered into significantly earlier than the occurrence of the option exercise and/or swap settlement. NASD notes that the agreements setting out the terms for these transactions generally determine the price of the TRACE-eligible securities at arm’s length for investment, commercial, or trading purposes in a manner that tends not to be reflective of the current market price of the TRACE-eligible security as of the day and time that the transaction or transactions in TRACE-eligible securities occur (e.g., at the option exercises and/or swap settlement), which may be several weeks, months, or years later.

In addition, NASD is concerned that for some investors, especially retail investors, the dissemination of such pricing information may cause significant investor confusion. If a significant number of transactions occur in a specific TRACE-eligible security as a result of option exercises and/or swap settlements and, at the same time, other market participants are executing transactions in the same TRACE-eligible security, the pricing information that would

the same pool of assets.

be disseminated would reflect divergent prices for the same security during the same period. For example, if a credit event occurs with respect to the issuer of the TRACE-eligible security or securities that are the subject of a CDS, a number of transactions in such TRACE-eligible securities would be reported at par (*i.e.*, a price of 100) to TRACE and disseminated to the public when one or more CDSs are settled. At the same time, other transactions in the same TRACE-eligible security might be reported as executed at a price substantially discounted from par (*e.g.*, a price of 60) and immediately disseminated (unless they are Rule 144A transactions). NASD has seen several such scenarios unfold and believes that such price dissemination may confuse investors, particularly less sophisticated investors.

For these reasons, NASD proposes an exception to the general principle stated in NASD Rule 6250(a) requiring dissemination of transaction information of all TRACE-eligible securities except Rule 144A transactions. Proposed NASD Rule 6250(b)(2) provides that certain transactions that occur as a result of options exercises and/or swap settlements would not be disseminated. However, this proposed exception to dissemination is subject to certain important conditions. NASD represents that these conditions are intended to insure that the options, CDSs, other types of swaps, and similar instruments resulting in such transactions are bona fide and to limit the exception to TRACE transactions occurring as a result of instruments that, by the nature of their terms are not designed, at the time the agreement is entered into, to replicate, as option exercises and/or swap settlements, the then-current market price of the TRACE-eligible security.

First, the proposed exception to dissemination would apply only to options, CDSs, other types of swaps, or similar instruments that are in writing and express legal and enforceable contractual obligations. Second, such instruments must have a term of at least 20 business days

⁸ See supra note 4.

and could not be exercised, terminated, or settled earlier than the end of the 20th business day from the date of issuance. NASD represents that this condition is intended to limit the dissemination exception by excluding short-term options or similar instruments because they are more likely to be utilized as proxies for current market transactions in the underlying TRACE-eligible securities.

The third condition is that the instrument must have an exercise or strike price that is fixed and out-of-the-money by at least 10 percent at the date of issuance, or a price formula that is fixed and results in an exercise or strike price that is out-of-the-money by at least 10 percent at the date of issuance, or a price formula that is fixed and results in a final price – combining any premium, installment or similar payment, and any strike or exercise price or similar term – that is out-of-the money by at least 10 percent at the date of issuance. Like the second condition above, NASD represents that this condition is intended to limit the dissemination exception to transactions that are not based on a current market price or negotiation or are not intended as a proxy for a current market transaction. For example, an option written deep in-the-money would be considered a proxy for a current market transaction and the exercise-related transaction would not be eligible for the TRACE dissemination exception. Similarly, the exercise-related transaction of an option with a pricing formula that at exercise utilizes the current market price or calls for a negotiation at the current market would not be eligible for the TRACE dissemination exception.⁹ NASD believes that such formulas may result in transactions that provide important price discovery information to the market when disseminated and also are not

⁹ For example, a transaction in a TRACE-eligible security occurring as a result of the exercise of a “zero-strike” option, an option which simply tracks the value of the underlying instrument (in this case, a TRACE-eligible security) and expires (or is exercised) at the then current market value of the instrument it is tracking, would not be eligible for the TRACE dissemination exception.

likely to cause investor confusion if an investor seeks to determine the current market price of a particular TRACE-eligible security. Thus, as part of the third condition, NASD is proposing that the instrument be out-of-the money by at least 10 percent at issuance to ensure that instruments are not be written “near the money” to serve as proxies for current market transactions. This may occur when two parties enter into an instrument expecting that, after the option or similar instrument is in place, one of them (or another party, as directed) will be able to move the current market price of an illiquid TRACE-eligible security by executing one or a few transactions in the security, resulting in the option or similar instrument becoming “in-the-money” and being exercised.

NASD also proposes to re-number current NASD Rule 6250(b), the exception to dissemination that applies to Rule 144A transactions, as new NASD Rule 6250(b)(1).

Effective Date

NASD would announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval, if the Commission approves this proposal. NASD represents that the effective date of the proposed rule change would be not more than 90 days following publication of the Notice to Members announcing any Commission approval.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁰ which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the

¹⁰ 15 U.S.C. 78q-3(b)(6).

proposed limited, conditional exemptive provisions requiring the reporting of transactions executed in connection with the termination or settlement of a CDS or a similar instrument would protect investors and are in the public interest in that they would facilitate and enhance NASD's surveillance of the over-the-counter corporate debt market, while recognizing the particular characteristics of such transactions and practices relating to execution and settlement, and providing sufficient flexibility to avoid adversely affecting the market in CDSs and similar instruments. Further, NASD believes that not disseminating information on TRACE-eligible securities transactions executed in connection with the exercise or settlement of an option or similar instrument or the settlement or termination of a CDS, any other type of swap, or similar instrument is in the public interest and protects investors, particularly retail investors, because the dissemination of such information may cause significant investor confusion, particularly for retail investors, and such information does not appear to contribute to price discovery by market participants.

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

NASD does not believe that proposed rule change would impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

Written comments were neither solicited nor received.

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

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

- (A) by order approve such proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2006-103 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-NASD-2006-103. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also

will be available for inspection and copying at the principal office of NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2006-103 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹¹

Nancy M. Morris
Secretary

¹¹ 17 CFR 200.30-3(a)(12).