



REGIONAL
BOND DEALERS
ASSOCIATION

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May 7, 2009

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F St., NE
Washington, DC 20549

Subject: File Number SR-FINRA-2009-010

Dear Ms. Murphy,

The Regional Bond Dealers Association (“RBDA”) is pleased to offer comments on SEC Release Number 34-59733 (File Number SR-FINRA-2009-010), “Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto To Expand TRACE To Include Agency Debt Securities and Primary Market Transactions,” published in the *Federal Register* on April 16, 2009 (“the release”). The RBDA is the organization of regional, middle-market securities firms active in the U.S. bond markets.

The RBDA supports more transparent bond markets. We believe transparency can help ensure that retail bond investors get the best pricing on their trades with dealers. However, we also believe that market liquidity is equally as important to an efficient market as transparency, and systems to promote transparency should not do so at the expense of liquidity. Real-time trade reporting systems like TRACE, combined with regulatory limitations on dealer markups and markdowns, have the effect of discouraging bond dealers from bidding aggressively for investors’ trades because those systems create a circumstance where dealers have little to gain but much to lose by taking risk positions. Because dealers’ purchases from customers are disclosed to the market in real time, dealers lose the ability to bargain effectively when trying to sell positions they have taken on. Dealers face potentially large losses if market prices move against their positions while their potential profitability is limited by the markup rules.

The RBDA questions the need for expanding TRACE into the market for agency debt and into the primary market for corporate bonds. With respect to our experience with TRACE in the corporate bond market since 2002, while TRACE has had a positive effect of providing retail investors with market pricing data they never before had access to, the system has had a negative effect on liquidity in the institutional market for corporate bonds. As a result of TRACE, corporate bond dealers are less willing and less likely to commit capital to support customer trading. The result is that institutional investors receive less aggressive quotes and poorer execution on their trades. Many institutional corporate bond investors have expressed their

dissatisfaction with TRACE,¹ and the system, while well-intentioned, has done more harm than good in the institutional corporate bond market.

TRACE is less needed and potentially more harmful in the institutional market for agency debt than for corporate bonds. The institutional market for agency debt is already more transparent than most sectors of the bond markets. The Agency market has fewer total issues outstanding and is more homogenous than the corporate bond market, and agency bond prices are available to institutional investors through the Bloomberg Information Service and other widely used market information systems. There is an active interdealer broker market for agency debt, which provides another source of pricing through products such as ICAP's AgencyPx, which offers "real-time interdealer bid and offer data (spread to Treasury and yield) on more than 150 active and off-the-run US government agency and GSE issues."²

In its press release announcing the proposed TRACE expansion, FINRA emphasized the potential benefits for retail investors. "Based on our experience with corporate bonds, this expansion should help all investors—especially retail investors—get better prices," the release said.³ However, relatively few agency bonds are held by retail investors, the sector of the market where more transparency is arguably needed. According to the Federal Reserve, only 11 percent of outstanding agency debt and mortgage-backed securities are held by the "household sector."⁴ This figure overstates the amount of agency debt held by retail investors, since the Fed uses "household sector" as a residual category in its tabulations, meaning that in addition to retail, the sector also includes the holdings of some important categories of institutional investors who are not otherwise specified, such as certain hedge funds. In addition, based on anecdotal evidence, it is clear that the vast majority of trading volume in agency securities involves institutional, not retail, investors.

With that said, we recognize that TRACE is here to stay, and we appreciate the opportunity to comment on issues related to expanding the system to cover transactions in agency debt and primary market corporate bonds.

Reverse inquiries

Our most significant concern regarding the proposed TRACE expansion relates to "reverse inquiries." Reverse inquiries are a method of issuance common in the market for agency debt securities. In a typical bond issuance, an issuer determines an amount and type of bonds to sell in order to meet its funding needs. In a reverse inquiry, investors or dealers determine an amount and type of bonds they wish to buy and approach the issuer with a request to buy debt securities with particular features at a particular price. If the issuer agrees, the bonds can be issued often within a few minutes, but in all cases on the same day. Reverse inquiries are very common in the agency debt market.

¹ See, for example, the presentation of Michael Decker, Senior Managing Director, Securities Industry and Financial Markets Association before the European Commission Internal Market and Services Directorate General, "Public Hearing on Non-Equity Market Transparency," September 11, 2007.

² ICAP, "GovPX," 2008.

³ Financial Industry Regulatory Authority, "FINRA Seeks Major Expansion of TRACE Reporting," press release, March 9, 2009.

⁴ Board of Governors of the Federal Reserve, *Flow of Funds*, March 12, 2009, page 88.

FINRA's release proposes to amend FINRA Rule 6760 related to notification requirements for underwriters of corporate bonds and agency debt securities. Currently, Rule 6760 specifies that broker-dealers who are underwriting new corporate bonds must notify FINRA Operations in general by 5:00 p.m. on the day before a new offering begins. The release would change this requirement by proposing that broker-dealers would be required to notify FINRA about new issues "prior to the commencement of primary market transactions."

Complying with this requirement would be effectively impossible the case of a reverse inquiry since the new issue materializes and the primary market transaction takes place precisely upon the agreement of the issuer to sell bonds at the terms proposed by the investor. Until that time, the underwriting broker-dealer is not certain that a primary market transaction will take place and cannot comply with the proposed notification requirement.

We would recommend changing the proposed amendments to Rule 6760 such that underwriting broker-dealers be required to notify FINRA Operations of a new issue before the commencement of primary market transactions or, if that is not possible because the issue is a reverse inquiry or for other similar reasons, that the notification requirement be within 15 minutes after the commencement of primary market trading, after the underwriting of the new issue.

The proposed rule is also problematic with regard to distinguishing between primary market and secondary market transactions in the context of reverse inquiries. It is often the case that secondary market trading can begin very quickly with reverse inquiry issuances, sometimes almost simultaneously with the distribution itself. This can happen, for example, if an issuer sells separate but substantially identical issues at nearly the same time but at different prices or yields, causing one issue to trade at the price of the other or for both issues to trade at an average price between them. FINRA proposes to "require indicators in transaction reports to distinguish secondary market transactions from primary market transactions and to further distinguish primary market transactions that are List or fixed offering price transactions and Takedown transactions from those that are not." In the case of reverse inquiries, each individual dealer determines the length of the primary market distribution period, which can be from minutes to days. Each dealer determines when to begin secondary market trading.

The terms "primary market transaction" and "secondary market transaction" are undefined in the context of TRACE reporting rules. If the rules will require dealers to distinguish between primary market and secondary market transactions, these terms should be clearly defined. Also, those definitions should be flexible enough to account for the subjective transition from primary market to secondary market in the context of reverse inquiry transactions. Alternatively, the rules should simply not distinguish between primary market and secondary market trades. Another possible solution would be to maintain the proposed definitional and reporting scheme for list or fixed offering price transactions and takedown transactions and define those transactions as primary market. Any other transaction would be secondary market.

Issues related to reverse inquiries raise some unique challenges regarding trade classification and reporting. We would welcome the opportunity to discuss these issues in detail with FINRA or SEC staff.

Market data and reporting fees

FINRA proposes pricing and selling the agency debt securities transaction data collected from dealers under the proposed expansion of TRACE separately from the data collected on corporate bond transactions. Charging a separate fee for the use of the agency debt securities data is unfair and unwarranted. This extra market data fee would require dealers to pay three times for transaction data: once when the data is reported to FINRA and once each for the use of corporate bond and agency debt securities trade data.

We strongly urge the SEC to require that FINRA offer corporate bond and agency debt securities price data under TRACE as a single data set priced no higher than the current rate for corporate bond data, and with the same methods of connectivity that are currently utilized for corporate bond transactions. In general, we believe that aggregate TRACE-related fees—trade reporting fees and market data fees—should track closely the actual expenses of developing and maintaining the system. Expanding the system to cover transactions in primary market corporate bonds and agency debt securities will not double FINRA’s development and maintenance expenses, and FINRA should not charge separate market data fees for the agency debt securities data. At the very least, we urge the SEC to mandate a detailed and public accounting of FINRA’s expenses associated with developing and maintaining the TRACE system in the context of the revenue the system generates.

Moreover, FINRA proposes to charge reporting fees for agency debt securities that would be “equivalent to the fees charged for corporate bonds.”⁵ However, the market for agency debt securities is much more liquid and homogenous than the corporate bond market. Bid-ask spreads and dealer markups in the agency market are lower than in the corporate market, and dealers earn less compensation on each trade. The reporting fees proposed by FINRA for agency debt securities trade reporting would comprise a significantly higher portion of the revenue earned by dealers on agency securities trading than the same fees in the corporate bond market. We urge the SEC to reduce the fees associated with reporting agency debt securities trades in proportion to the levels of bid-ask spreads and dealer markups for agency debt securities relative to corporate bonds.

Additional recommendations

The proposed major expansion of TRACE reporting rules creates an opportunity for FINRA to re-visit and improve other elements of the TRACE system. One area that deserves attention is the treatment of errors in reporting.

In general, when a FINRA member must amend a TRACE trade report due to clerical error or some other factor and the amended report is submitted more than 15 minutes past the time of the trade, the amended report is treated by FINRA as a late report, and the member is subject to sanction. We urge the SEC to support a rule change by FINRA that would treat good-faith

⁵ Under current FINRA rule 7730, these fees are \$0.475/trade for transactions of \$200,000 and below, \$0.002375 per bond per trade for trades above \$200,000 and below \$1,000,000, and \$2.375/trade for transactions above \$1,000,000. *FINRA Manual*, Rule 7730, “Trade Reporting and Compliance Engine (TRACE).”

amendments to trade reports as exceptions rather than violations.

In addition, we urge FINRA to specify that the same technological interface will be used for both transactions that are currently TRACE-eligible and those that are proposed to be TRACE-eligible under the FINRA release. Dealers have made substantial investments in technology necessary to comply with TRACE reporting rules, and it would be unfair and inefficient to maintain two reporting systems and require dealers to develop and maintain separate systems for compliance.

Finally, we urge FINRA to revise its proposed schedule for implementing the proposed changes to TRACE rules. The FINRA release states “FINRA will announce the effective date of the proposed rule change in a *Regulatory Notice* to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the *Regulatory Notice* announcing Commission approval.” We feel strongly that six months will provide sufficient time for dealers to implement the requirements of the proposal. This is especially true given that, as the FINRA release recognizes, “extending TRACE reporting to Agency debt securities may result in certain trading desks having to report transactions to TRACE for the first time.” We urge FINRA and the SEC to consider an implementation period of up to one year for the proposed rule changes.

Summary

We do not accept the arguments made by FINRA that expanding TRACE into the markets for agency debt securities and primary market corporate bond transactions is justifiable—and, indeed, we believe such an expansion could have the effect of harming market liquidity. However, to the extent that the SEC looks favorably on FINRA’s proposal, we urge the SEC to direct FINRA to adopt the recommended changes to the proposal outlined above to bring the TRACE system in line with issuance and trading practices common in the agency market such as reverse inquiries. Moreover, we urge the SEC to direct FINRA to amend the proposed TRACE fee structure for both reporting and market data fees associated with agency debt securities.

FINRA staff has indicated publicly that they have undertaken significant outreach with the deal community in crafting the proposed amendments to TRACE. While we applaud the dialog FINRA has initiated with the industry, we urge FINRA and the SEC to actively seek out input from regional dealers in crafting rule changes. Regional fixed-income firms play a vital role in keeping the bond markets efficient, and have some unique perspectives to bring to the rulemaking process.

We again appreciate the opportunity to present our views. Please do not hesitate to contact us if you have any questions.

Sincerely,

/s/

Michael Decker
Co-Chief Executive Officer

/s/

Mike Nicholas
Co-Chief Executive Officer

