360 Madison Avenue
New York, NY 10017-7111
Telephone 646.637.9200
Fax 646.637.9126
www.bondmarkets.com

1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456

St. Michael's House
1 George Yard
London EC3V 9DH England
Telephone 44.20.77 43 93 00
Fax 44.20.77 43 93 01

THE BOND MARKET ASSOCIATION

May 9, 2003

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: SR-NASD-2003-13: Proposed Interpretive Material Regarding the Use of Investment Analysis Tools

Dear Mr. Katz:

The Bond Market Association[1] (the "Association") is pleased to comment on the proposed interpretive material ("Proposed Interpretation") referenced above filed with the Commission by the NASD. The Association shares the concerns expressed by other commenters about the potential breadth of the language of the Proposed Interpretation, as well as the short time period provided for comment.[2] We write solely to express particular concern about the potential application of the Proposed Interpretation to established tools that are provided to and relied upon by investors in managing their fixed income portfolios.

Relevance to Fixed Income Tools

Bond Calculators

Securities firms and other providers have long offered tools generally denoted as "bond calculators," which essentially allow investors to calculate the yield on a given bond based on the input of other known facts about the bond. For example, at the most basic level, the yield to maturity of a bond is a function of the stated principal, the purchase price, the coupon rate, and time to maturity. In the case of callable bonds, the yield to call can be calculated the same way, but substituting the time to the first call for the time to maturity. Calculations of yield to maturity and yield to call allow investors to

[1] The Association represents securities firms and banks that underwrite, distribute, and trade in fixed income securities, both domestically and internationally. More information about the Association is available on its web site, http://www.bondmarkets.com. The Association's On-Line Legal/Regulatory Committee has been consulted in the drafting of this comment letter.
[2] *See*, *e.g.*, Letter from Christopher P. Gilkerson, Charles Schwab & Co., Inc. to Jonathan G. Katz, SEC, dated April 29, 2003; Letter from John Polanin, Eliot Wagner, and Hardy Calcott, SIA, to Jonathan G. Katz, dated May 7, 2003.

more readily compare different bonds based on the same valuation measure. Bond calculators are regularly used by both institutional and retail investors.

Other similar tools may allow comparison between different investments based on mathematical calculations. For example, the Association, through its www.investinginbonds.com web site, provides a calculator that allows investors to determine what they would need to earn on a taxable security in order to equal the tax-free return they would receive on a municipal bond, based on each investor's state of residence, net taxable income, and filing status.

We believe it is reasonably clear that bond calculators and similar tools are excluded from the prohibition of Rule 2210(d)(N), and therefore from the Proposed Interpretation, based on the exclusion for illustrations of mathematical principles.[3] We also think it is clear that regulatory policy should promote the use of such tools, since they are objective, empower investors to better understand the differences among investments, and are not used to sell specific securities. Nonetheless, because of the concerns described further below regarding the breadth of the language of the Proposed Interpretation, we ask that the NASD clarify that the Proposed Interpretation does not apply to or affect the provision or use of such tools.

Risk Management Tools

A different category of tools from those described above includes various risk management tools that NASD members and other providers have made available to money managers and other institutional investors to help them in managing their portfolios ("Risk Management Tools"). A prime example is the use of tools to calculate return on mortgage-backed securities ("MBS"). The return on MBS depends, among other things, on the average life of the underlying mortgages in the particular mortgage pool. In general, the average life is the average time that each principal dollar in the pool is expected to be outstanding, based on assumptions about prepayment speeds, or how quickly mortgage obligors will prepay individual loans.

For purposes of calculating prepayment speeds, various standard and proprietary prepayment models exist. One of the most common methods is the Standard Prepayment Model, first developed by the Association in 1985. Projections and historical prepayment rates are often expressed as "percentage of PSA," or prepayment speed assumptions, and this terminology is widely used by both sell-side and buy-side

[3] The paragraph states that "hypothetical illustrations of mathematical principles are not considered projections of performance: e.g., illustrations designed to show the effects of dollar cost averaging, tax-free compounding, or the mechanics of variable annuity contracts or variable life policies." It is not clear whether well-established and widely accepted financial models, such as the Black Scholes Option Pricing Model, are similarly excluded. Like most financial models, even widely used and accepted ones, Black Scholes makes certain assumptions that could be characterized as subjective.

firms in the MBS market. Tools of this type are designed for and used by sophisticated participants in the MBS market to help them estimate the return that may be expected with regard to a particular investment and to help manage the risk associated with an MBS portfolio when making purchase and sale decisions and entering into hedging transactions.

Another class of tools is designed to help institutions quantify and manage the risk associated with investment portfolios. These tools are also well-established and generally involve software utilizing a value-at-risk ("VAR") methodology that estimates the market risk exposure to movements in interest rates, security or index prices, or other market changes through the use of Monte-Carlo, historical, or other analytic simulation methods. In some cases, these tools are proprietary products of a particular securities firm, which provides them directly to its institutional clients, or to its representatives for use when advising such clients. In other cases, securities firms may make available to clients Risk Management Tools purchased or licensed from third party vendors, which the firms themselves may use for their own proprietary risk management purposes. Because of the pace of technological change in this area, and the competition in the development of such products, these tools are subject to updating and improvement on an ongoing basis.

<u>Analysis of the Proposed Interpretation</u>

By its terms, the Proposed Interpretation would apply to any "technological tool that produces simulations and statistical analyses that present a range of probabilities that various investment outcomes might occur, thereby serving as an additional resource to investors in the evaluation of the potential risks of and returns on particular investments."[4] It is described in the proposing release ("Proposing Release") as intended to "allow NASD member firms to use certain investment analysis tools that show the probability that investing in specific securities or mutual funds may produce a desired result."[5] It is our understanding that the initial impetus for the Proposed Interpretation was the desire of some firms to provide to their retail customers tools devised by third-party service providers that would project the performance of different mutual funds, based on information input by the customer relating to his or her personal circumstances.

Notwithstanding the nature of the regulatory impetus for the Proposed Interpretation, there is nothing in it or the Proposing Release that would appear clearly to exclude Risk Management Tools provided to institutional investors. Tools that produce calculations of a bond's effective yield and average life based on different prepayment

---

[4] The application of this language is somewhat confusing, since the definition captures the concept that the tool presents a range of probable outcomes, while at the same time one of the *conditions* (paragraph (c)(1)) to the use of the tool is that it present such a range of probabilities.
[5] 68 FR 16325, 16326 (April 3, 2003).

speed assumptions, or calculate a VAR for a portfolio of securities based on certain assumed time horizons and based on historical price movements of certain securities, for example, could arguably be considered to describe a range of possible investment outcomes (although arguably not a "range of probabilities" of outcome), at least to the extent of the parameters that a user inputs into the tools. Although Risk Management Tools are not generally used to estimate the likelihood of a "desired result" so much as to estimate the most likely result in terms of a return, or maximum exposure to loss, from a particular security or portfolio, the Proposed Interpretation is at least ambiguous as to how such tools should be characterized, and should be either amended or clarified.

We strongly believe that there are many reasons why Risk Management Tools should not be included within the types of tools that should be subject to the Proposed Interpretation. First, such tools are generally made available exclusively, or nearly exclusively, to institutional investors, who are fully capable of understanding their limitations and who do not require the intervention and review of NASD staff prior to deciding whether to use them.

Second, there is no history of abuse or investor confusion that warrants additional regulation to protect investors. To the contrary, imposing a review period could be deleterious to the interests of money managers and other institutional investors, who require access to the latest technology in managing their portfolios.

Third, the conditions to use of the tools set out in the Proposed Interpretation cannot by their terms be easily or appropriately applied. Prior review by the NASD staff will be extremely difficult for several reasons and, even if possible, would not appear to provide any material benefit to investors. Many of these tools are based on a client/server or Internet-based architecture that precludes "delivery" of the entire tool to a stand-alone PC or server. Specifically, many of these tools are combinations of different components, frequently from various parties, combining proprietary and/or third party historical databases, real-time market data feeds, complex software programs and high-powered computer servers. In addition, to the extent that some of these components belong to third parties, an NASD member firm may be contractually precluded from providing a third party with access.[6]

Further, tools that produce calculations based on assumptions of prepayment speed, for example, have gained validity through market use and acceptance over the experience of many years. Risk management tools that calculate a VAR or other similar risk measures are extremely complex and constantly evolving as risk management models and theories become more refined. Even if the staff were to undertake to pre-review and approve the use of such a tool, it could be effectively subject to multiple reviews as

[6] License agreements typically prohibit the licensee from disclosing the licensed material to third parties.

it is modified. Moreover, these tools, many of which rely on complex and integrated mathematical models, are not easily susceptible of being changed in response to NASD requests.

Fourth, the specific required disclosures called for by the Proposed Interpretation are not well-suited to these types of tools. The requirement, for example, that each report of a tool's results must include at a minimum "upside," "downside," and "median" projections of estimated outcomes may be impossible to determine and, in any event, would not be appropriate or helpful when the purpose of the tool is to derive a number or series of numbers representing return or risk of loss on a security or portfolio based on its unique characteristics. Specifically, it is impossible to determine "upside", "downside", and "median" projections of estimated outcomes when the inputs of variables are selected by the user of the tool (i.e. the user inputs its portfolio for analysis, or inputs its own assumptions regarding interest rates and other market factors).[7] Disclosures designed to alert investors to the fact that results may vary with use and over time are already well-understood by such investors. Disclosures meant to inform users as to how such tools are designed are highly individual, depending on the nature and complexity of the tool, are not generally capable of standardization, and are perhaps best left to the judgment of the firms that provide them.

Fifth, the Proposed Interpretation, to the extent it erects hurdles for NASD members in the nature of a required pre-review process that delays immediate use of newly developed tools, would be anti-competitive and could be harmful to both the risk management and investor education process generally. Because it would not apply to third party vendors who are not NASD members, the Proposed Interpretation and the regulatory burdens it imposes could inhibit the incentive of firms to develop proprietary products that are designed to meet their own risk management needs or those of their customers, and limit the range of potential tools available to institutional investors.[8]

---

[7] Some fixed income portfolio analysis tools can analyze well over one million securities. In addition, many such tools allow users to create custom securities for analysis. Given this vast universe of potential fixed income securities and the infinite variety of combinations in a portfolio, determining a minimum "upside", "downside", and "median" projections of estimated outcomes is practically impossible.

[8] There is a thriving industry of unregulated technology vendors that provide products "to make investment performance analysis based on daily data" (Barra, Inc.; see http://barra.com/news/pr/030422-pr.asp); "which combine information from …RiskMetrics Group with proprietary CMS BondEdge data" (CMS BondEdge; see http://www.bondedge.com/us/); and "[to m]anage an impressive range of investment instruments including mutual funds, equities, fixed income, mortgage-backed securities, derivatives, variable rate securities and many more" (Advent Software Inc.; see http://www.advent.com/news/pr_detail.asp?id=426).

Finally, as a matter of process, the Proposed Interpretation is framed as a "safe harbor" from the more general prohibition against investment prediction or projections. We believe that firms may have reasonably concluded that the general prohibition does not prevent them from providing access to certain types of bond calculators and Risk Management Tools, the use of which has been well-established and integrally connected to fixed income investment decisions for years. If the NASD in fact intended to reach such tools (and we do not assume that this is the case), we believe the NASD would need to fully indicate why it believes that this Proposed Interpretation is necessary or appropriate in the context of the overall customer protection purposes of Rule 2210. Moreover, we believe it should be clarified that the "safe harbor" offered by the Proposed Interpretation is not the exclusive means pursuant to which investment analysis tools can be offered to customers.

<u>Request</u>

Accordingly, we request that the Proposed Interpretation be amended, or the Commission's approval order be written, to clearly provide that Rule 2210 and the Proposed Interpretation do not limit the ability of NASD member firms to provide access to (i) bond calculators and similar mathematical tools, or (ii) risk management tools that are provided to institutional investors.

We would be pleased to meet with the staffs of the Commission and/or the NASD to more fully explore the issues raised in this letter, or to demonstrate the use of tools of the type described above. Please feel free to contact me at 646.637.9230 with any questions.

Sincerely,

John Ramsay

John M. Ramsay
Senior Vice President and Regulatory Counsel

cc: ***Securities and Exchange Commission***
William H. Donaldson, Chairman
Cynthia A. Glassman, Commissioner
Harvey J. Goldschmid, Commissioner
Paul S. Atkins, Commissioner
Roel C. Campos, Commissioner
Annette L. Nazareth, Director, Division of Market Regulation
Kathy England, Assistant Director, Division of Market Regulations
Joseph Morra, Division of Market Regulation
Paul F. Roye, Director, Division of Investment Management

NASD
Elisse Walter, Executive Vice President, Regulatory Policy and Programs
Marc Menchel, General Counsel
Nancy C. Libin, Assistant General Counsel
James S. Wrona, Assistant General Counsel