April 14, 2005

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

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

Dear Mr. Katz:

Citigroup Global Markets Inc. ("CGMI") is pleased to submit this comment in response to the Commission's notice of the NASD's proposed IM-2440-2 entitled "Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities" (the "Interpretation").

Introduction

CGMI has participated in the preparation of the comment letter dated April 5, 2005, filed by the Bond Market Association on the same topic (the "BMA Letter"), and we endorse the views contained in that letter. CGMI takes seriously its obligation to provide its customers with fair prices. We are writing separately to highlight our particular concerns with the Interpretation.

First, during the more than 10 years that the NASD has been considering various versions of the Interpretation, it has evolved from a proposal that recognized for mark-up purposes the significant differences between equities and fixed income markets and allowed consideration of any relevant evidence in determining the "prevailing market price" of a debt security, to its current form, which would severely limit the ability of dealers to point to evidence, other than the dealer's cost, of the prevailing market price. We believe that this approach is at odds with the basic premise contained in the current text of Rule 2440 that fair pricing questions should "[take] into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction…." Further, the regulators have failed to explain the reasons for the fundamental changes in approach reflected in the various versions of the Interpretation

during this period, or to address the concerns that have been raised in comment letters over the implications of the Interpretation.

Second, we want to emphasize our special concerns with the application of the Interpretation to transactions in relatively illiquid bonds that are typically traded at a substantial discount from par value because of concerns related to the issuer's credit. For purposes of this letter, we refer to these securities as "credit sensitive bonds." We agree with the BMA that the effect of the Interpretation would be to limit further the willingness of dealers to commit capital to trading in credit sensitive bonds, with detrimental effects on the market for those securities.

The Interpretation proposes a general presumption that the prevailing market price for debt securities should be measured by the dealer's contemporaneous cost.[1] For these purposes, "contemporaneous" could refer to a purchase by the dealer some number of days prior to the trade in question. A dealer can try to overcome this presumption only in two limited circumstances. The first involves a change in interest rates or credit standing of the issuer after the time of the dealer's contemporaneous trade. If, but only if, either of those events has occurred, the dealer can look to the hierarchy of factors identified in the Interpretation as a better indication of the prevailing market.

The second circumstance in which a dealer can try to avoid the application of the contemporaneous cost standard involves trades with certain institutional accounts (those with which the dealer "regularly" effects transactions in the same or a similar security) at a price that is away from the prevailing market because of the size and risk of the transaction (dubbed a "Specified Institutional Trade"). The relief provided for these institutional trades, however, is available only if the dealer can establish the prevailing market by reference to inter-dealer trades in the same security executed contemporaneously with the trade that is effected with the institutional account.

With respect to credit sensitive bonds, assuming that the dealer cannot use the Specified Institutional Trade provision because of a lack of contemporaneous inter-dealer transactions, the Interpretation permits the dealer to consider the use of economic models to try to establish the prevailing market price. This tool, however, would be available in very limited circumstances because, as described above, a dealer could try to overcome the presumption only when there has been an intervening change in interest rates or credit standing of the issuer.

Background and History

The long, somewhat tortured history of the Interpretation began with the passage of the Government Securities Act Amendments of 1993, which, among other things, provided authority to the NASD for the first time to apply its sales practice rules to transactions in government securities. Following the grant of that authority, the NASD proposed in

[1] The principles described in the Interpretation also apply, in a reverse fashion, to mark-downs (for example, contemporaneous cost would be translated to contemporaneous sale proceeds). For convenience, this letter refers to the application of the principles in terms of mark-ups.

1994 to adopt an interpretation on the application of its Mark-Up Policy (NASD Rule IM-2440) to transactions in government and other debt securities (other than municipal securities, which are governed by the rules of the Municipal Securities Rulemaking Board).[2] The summary that follows identifies only some of the more significant changes to the Interpretation since its original publication.

The original version of the Interpretation, in Notice to Members 94-62, expressed the view that it was not appropriate to impose a general contemporaneous cost presumption without first considering other factors. That version was never filed with the Commission. The next version, which was filed in August of 1997 (the "1997 Version"),[3] states that inter-dealer transaction prices are ordinarily the best measure of prevailing market price but may be "rare or non-existent" for certain securities. Therefore, "if evidence does not exist of inter-dealer transaction prices," contemporaneous cost generally should be used. "However, there may exist evidence that demonstrates more accurately the prevailing market price." The filing goes on to provide that, in the absence of inter-dealer transactions, a dealer that determines the mark-up on a basis other than its contemporaneous cost must be prepared to demonstrate that the other basis is a better measure.

The 1997 Version contains a list of factors, all related to transactions by dealers in "similar" securities, that dealers could look to in seeking to find a better measure of the prevailing market price. At the same time, the filing recognized the difficulty of applying this analysis to credit sensitive bonds: "The Interpretation states that it is not intended to apply to all debt securities. It clarifies that the use of similar securities of unrelated companies will generally not be relevant for pricing purposes in the case of those debt securities that trade with significant equity-like characteristics (that is, where the value of the security is highly dependent on the particular circumstances of the issuer, rather than responding to changes in interest rates in a manner typical of most other debt securities)."

The form of the Interpretation that was subsequently published for comment by the Commission, in September of 1998 (the "1998 Version"),[4] made a number of significant changes from the 1997 Version. First, the presumption in favor of contemporaneous cost was strengthened: "Countervailing evidence of the prevailing market price may be considered only where the dealer made no contemporaneous transactions or can show that in the particular circumstances the dealer's contemporaneous cost is not indicative of the prevailing market price."[5] The filing clearly applied the presumption to "inactively traded" debt. While noting that the determination of the prevailing market in such circumstances is "difficult," the document clearly states that "[i]n such circumstances, absent countervailing evidence, the contemporaneous cost…should be used as the basis for determining the appropriate mark-up."[6]

[2] NASD Solicits Member Comments on the Application of the NASD Mark-Up Policy to Transactions in Government and Other Debt Securities, NASD Notice to Members 94-62 (Aug. 1994).
[3] File No. SR-NASD-97-61 (Aug. 20, 1997)
[4] Securities Exchange Act Release No. 40511, 63 Fed. Reg. 64169 (Oct. 8, 1998).
[5] 63 Fed. Reg. at 54170.
[6] *Id.*

At the same time, the 1998 Version noted that market makers are able to calculate mark-ups from their contemporaneous sales prices to other dealers, and said that "[i]n the debt securities markets, a market maker is a dealer who, with respect to a particular security, furnishes *bona fide* competitive bid and offer quotations on request and is ready, willing, and able to effect transactions in reasonable quantities at his or her quoted prices with other brokers or dealers."[7]

The 1998 Version attracted substantial negative comment on a variety of points, including that the Interpretation inappropriately imported to the debt markets mark-up concepts principally developed in the equities markets.[8] This version was later withdrawn, and so the comments were never addressed.

The next version was filed by the NASD in September of 2003 (the "2003 Version").[9] That version begins with a flat statement that the prevailing market price for a debt security is established by referring to the dealer's contemporaneous cost. The 2003 Version retains the language noting that where bonds trade inactively, inter-dealer transactions may be rare or non-existent, and establishing the prevailing market price may be difficult. The 2003 Version continues to say that dealers seeking to use a measure other than contemporaneous cost must provide evidence sufficient to overcome the presumption, and points as non-exclusive factors to price information relevant to "similar" securities.

The 2003 Version was amended twice. In the amended version published by the Commission on March 15 of this year (the "2005 Version"),[10] as described above, the Interpretation would limit the ability of dealers to argue for any measure of prevailing market other than its contemporaneous cost to cases involving an intervening change in interest rates or credit standing (assuming there were no contemporaneous inter-dealer trades). Prior versions of the Interpretation that had included the contemporaneous cost presumption had always permitted dealers to try to overcome the presumption by pointing to any relevant evidence, including the specific factors that were listed. The second amendment to the 2003 Version changed this approach, without explanation, deleting the following language in brackets: "A dealer may be able to show that its contemporaneous cost or proceeds are not indicative of prevailing market, and thus overcome the presumption, in instances [such as] where (i) interest rates or the credit quality of the security changed…."[11]

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[7] *Id.*

[8] *See* in particular Letter from Lee B. Spencer, Jr. and R. Gerald Baker, Securities Industry Association, to Margaret H. McFarland, Deputy Secretary, SEC (December 14, 1998); Letter from Paul Saltzman and George P. Miller, The Bond Market Association, to Jonathan G. Katz, Secretary, SEC (December 16, 1998).

[9] File No. SR-NASD-2003-141 (Sept. 16, 2003), avail. at www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_000053.pdf.

[10] Securities Exchange Act Release No. 51338, 70 Fed. Reg. 12764 (March 15, 2005).

[11] 70 Fed. Reg. at 12764, compared to Amendment No. 1 to File No. SR-NASD-2003-141, avail. at www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_010730.pdf.

The current version of the Interpretation also eliminates any reference to market makers, again without explanation, other than to make a footnote reference to the market maker definition in Section 3(a)(38) of the Exchange Act.[12]

Impact of the Interpretation

In summary, the Interpretation over time has progressively become more and more restrictive so that dealers would have little ability in practice to attempt to rebut the presumption in favor of contemporaneous cost. This is true for all bonds to the extent that dealers are unable to point to an intervening change in interest rates or credit standing or, alternatively, are unable to use the Specified Institutional Trade provision because contemporaneous inter-dealer trades do not exist.

The impact on credit sensitive bonds is particularly severe. The Interpretation does virtually nothing to recognize the additional risks that are incurred when dealers take positions in volatile securities. Interest rate changes by definition will have less impact on credit sensitive bonds. Credit standing, of course, is a relevant factor for such securities, but it is relevant because of the volatility and risk that are implied when dealers buy or sell them. It should not be necessary to show a contemporaneous change in credit standing for the impact of this factor on pricing to be recognized.

The reference to Specified Institutional Trade exemption superficially recognizes risk taking by referencing trades done away from the prevailing market "because of the size and risk of the transaction," but that provision is expressly unavailable unless the dealer can show that there are contemporaneous inter-dealer trades in the same security. As noted by the BMA Letter, inter-dealer transactions occur less frequently in the fixed income, as compared to the equity, markets, and this is especially true for credit sensitive bonds (which by their nature are infrequently traded by any means). That point in fact was made in previous versions of the Interpretation by the statement that for inactively traded securities, inter-dealer trades may be rare or non-existent, and establishing the prevailing market price in such cases may be difficult. This statement also was dropped in the 2005 Version.

The elimination of any reference to market makers in the text of the Interpretation also casts doubt on whether this concept would be given any practical application to fixed income transactions. In fact, even the indirect reference to the relevance of risk taking from the statement in earlier versions that the dealer's cost should always be used in the case of *riskless* transactions has been eliminated in the current proposal.[13]

The reference to the use of economic models might be helpful if not for the pre-condition of interest rate/credit quality changes. Just as important however, the real relevance of economic models in this context is in the extent to which they can help measure the

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[12] 70 Fed. Reg. at 12766.

[13] From the 1998 Version: "The Commission has held that when a dealer that is not a market maker effects a riskless principal transaction, the dealer's cost must always be used as the base on which to calculate mark-ups." 63 Fed. Reg. at 54170.

amount of risk and volatility that are inherent in trading in particular bonds. It is not clear that they could provide clarity in establishing a specific "prevailing market price" at a defined point in time, particularly in the face of a strong presumption in favor of the dealer's cost.

Summary

We believe that the approach embodied in the current version of the Interpretation is fundamentally at odds with the basic premise in Rule 2440 that questions about whether dealers are charging fair prices should take into account "all relevant circumstances, including market conditions with respect to such security at the time of the transaction…." As a practical matter, the Interpretation eliminates consideration of all but a few relevant circumstances, and it practically forecloses consideration of all circumstances, other than the dealer's cost, that are likely to be relevant to the pricing of credit sensitive bonds. As noted by the BMA Letter, the likely effect will be to discourage the willingness of dealers to take on risk in buying and selling such bonds. Concerns by institutional investors over the willingness of dealers to take risk in facilitating customer transactions were cited by the NASD's own Corporate Debt Market Panel in its 2004 report.[14]

Accordingly, prior to any further action on the proposed Interpretation, we believe that the NASD and the Commission should address, in a transparent and straightforward way, the questions identified in the BMA Letter and particularly those relating to the potential impact of the Interpretation on the market for credit sensitive bonds and on capital formation.

Please feel free to contact the undersigned at 212.816.8894 with any questions you may have.

Sincerely,

Edward F. Greene
General Counsel
Corporate and Investment Banking

cc: ***U.S. Securities and Exchange Commission***
The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Roel C. Campos, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
Giovanni P. Prezioso, General Counsel

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[14] Report of the Corporate Debt Market Panel 6 (Sept. 2004).

cc: ***U.S. Securities and Exchange Commission (cont'd.)***
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Robert L.D. Colby, Deputy Director, Division of Market Regulation
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