SIFMA™
Securities Industry and
Financial Markets Association

January 4, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Dear Ms. Morris:

On behalf of the MBS and Securitized Products Division of the Securities Industry and Financial Markets Association ("SIFMA"),[1] SIFMA is pleased to submit this additional comment letter to the Securities and Exchange Commission ("SEC" or "Commission") in connection with the National Association of Securities Dealers, Inc.'s ("NASD") proposed interpretation concerning the application of its mark-up policy to transactions in debt securities (the "Proposed Interpretation" or "Proposal"). The Proposal recently was amended and published for comment by the SEC.[2]

In a companion letter submitted in response to the Proposal, SIFMA provided comments on the Proposed Interpretation as it applies to the debt markets generally, with particular application to the market for corporate debt.[3] The ABS/MBS Division fully supports the

[1] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] Notice of Filing Amendments Nos. 3, 4, and 5 to a Proposed Rule Change Relating to Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities, Exchange Act Rel. No. 54799 (Nov. 21, 2006), 71 Fed. Reg. 68856 (Nov. 28, 2006) (the "Proposing Release").

[3] In that letter SIFMA requested that the NASD expand the exemption from NASD Rule 2440 and IM-2440 (the "Mark-Up Policy") to (1) include private bond transactions by dealers with QIBs in all debt securities; (2) provide dealers with more guidance regarding the definition of "contemporaneous cost", including restoring the "size" proposal; (3) allow for a more flexible and nuanced approach in determining prevailing market price where the dealer establishes that contemporaneous cost is not the best evidence of the prevailing market price; and (4) expand the discussion of the situations in which a bond dealer may consider itself a market maker.

positions described in that letter. SIFMA submits this additional letter to comment on provisions of the Proposed Interpretation as they apply to securitized products.[4]

As the SEC has historically recognized in no-action letters, in Regulation AB and in other contexts, securitized products have characteristics that make them fundamentally different from corporate debt and Treasuries.[5] These differences in the products have necessitated differences in regulatory treatment. It is equally the case that securitized products are different for purposes of the Proposed Interpretation, as the way securitized products are valued and traded differs materially from the valuation and trading of other debt securities. We therefore summarize some of the most relevant differences in order to establish the foundation for the discussion that follows:

- Rather than providing a determinate payment schedule and fixed maturity, securitized products pay principal and interest at a rate that is linked to the performance of an underlying asset pool and depends on one or more of (i) pre-payment rates, (ii) default rates, (iii) recovery rates on defaults, (iv) default correlations and (v) structural characteristics of the relevant tranche. Thus, the use of mathematical analysis to model these variables is almost always necessary to price securitized products. Differences in modeling techniques among firms can result in very different price estimates for all but the most commoditized products (certain plain-vanilla liquid AAA tranches of MBS and ABS).

- Structuring technologies provide originators of securitized products with tremendous flexibility to customize capital structures to satisfy the particular risk/return demands of investors. Such technologies permit originators to create "single tranche" securitized products which reflect only a portion of the risk and return associated with a pool of reference assets. Due to the ability to customize securitized products, they are highly varied, and any individual securitized product will most commonly be sold to a limited number of sophisticated institutional investors.

- In securitized products, the credit rating assigned to an issuer or its assets is only one indicator of a security's level of risk, price volatility or liquidity. The way a

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[4] For purposes of this letter, the term "securitized products" includes asset-backed securities (ABS), residential mortgage-backed securities (MBS), commercial mortgage-backed securities (CMBS), collateralized debt obligations (CDOs), synthetic CDOs and risk-linked bonds such as catastrophe bonds. We emphasize that the securitized products market is characterized by rapid innovation and development in the application of securitization techniques to new assets classes and that the list of products noted above is not intended to be exhaustive.

[5] *See, e.g., Greenwood Trust Co., Discover Master Card Trust I,* SEC No-Act. (Apr. 5, 1996) (use of written materials outside a statutory prospectus); *Public Securities Association,* SEC No-Act. (Feb. 7, 1997) (publication of research reports by broker-dealers proximate to an offering registered on Form S-3); Exchange Act Rules 13a-15 and 15d-15 (special form of certification under Section 302 of the Sarbanes-Oxley Act); SEC Rel. IC-19105 (Nov. 19, 1992) and Investment Company Act Rule 3a-7 (exclusion from the definition of "investment company"); SEC Rel. 33-8238 (Jun 5, 2003) (exemption from reporting and attestation requirements relating to internal controls under Section 404 of the Sarbanes-Oxley Act); SEC Rel. 34-50905, (Jan 7, 2005) (adopting Regulation AB); SEC Rel. 33-8591 (Jul 19, 2005) (adopting securities offering reform).

security has been structured and offered will often have a greater impact on characteristics such as liquidity and price behavior. For example, securities can be structured so that what benefits one class will operate to the detriment of another class. Consequently, as interest rates change, underlying assets default, reserve accounts are funded or depleted, or other events affecting a pool or structural protections occur, the values of securities that are backed by the same class of assets and that bear the same credit rating may be affected in different ways and may in fact move in opposite directions. Highly rated but complex or exotic securities are generally sold to one or a small number of sophisticated institutional investors and tend to be illiquid.

- In trading equity securities, it is possible to trade successfully without knowledge of the underlying security or issuer, because the "market" sets the price for such securities based on supply and demand. Further, investors may trade based on the "momentum," upward or downward, of a stock or other "technical" trading characteristics. In fact, SEC Rule 15c2-11 recognizes that, even as to relatively illiquid securities, dealers may have little fundamental knowledge of the security, but may trade based only on the state of the market. Trading in this manner is not possible as to most securitized products. As the individual securities tend to be unique and to trade infrequently, momentum and other technical factors are of little relevance. In the market for illiquid securitized products, most trades are based to a significant extent on results from models.

I. The NASD should Expand the Proposed Carve Out for QIBs to Include Additional Transactions in Securitized Products Where Restrictive Price Regulation is Unnecessary.

In the Proposing Release, the NASD recognizes that large institutional investors frequently have sufficient knowledge of the market to negotiate at arms-length, and proposes to exempt QIBs who meet certain additional tests from the definition of "customer" for purposes of the Proposed Interpretation. However, the NASD proposes to limit the exemption to transactions in non-investment grade securities. The NASD does not directly explain the rationale for limiting the QIB exception, but suggests that the absence of an investment grade rating is a proxy for illiquidity and notes that in the case of generally illiquid market sectors (including securitized products sold pursuant to an exemption from registration under the Securities Act), the application of the so-called "Hierarchy" and attempts to compare "similar" securities would not yield useful pricing information.

SIFMA appreciates the NASD's responsiveness to prior industry comments on the application of the Proposed Interpretation to transactions with sophisticated investors and its addition of an exemption for certain transactions with QIBs. The proposed exemption would provide regulatory relief with respect to a substantial number of transactions in debt securities for which the significant costs of price regulation are not justified. However, SIFMA submits that the scope of the proposed QIB exemption is better tailored for the market for corporate debt securities than for securitized products. For securitized products, credit rating is a poor indicator of liquidity or the likelihood that the Proposed Interpretation will provide useful pricing information. Moreover, due to the particular characteristics of securitized products, expansive

application of the Proposed Interpretation to those products that are investment grade will have significant adverse effects on the market for such products that are not present to the same degree for corporate debt.

For these reasons, SIFMA urges the NASD to expand the QIB exemption to include all transactions in securitized products (including investment grade securitized products). Alternatively, the NASD should at least exempt all QIB transactions in debt securities that are initially offered and sold pursuant to the exemption provided by Section 4(2) of the Securities Act and continue to be offered and sold pursuant to Rule 144A or the so-called Section "4(1)1/2" exemption from registration under the Securities Act (collectively, "private bond transactions") as the NASD's own rationale for the exception applies to these securities.

A. The QIB Exception Should Cover Securitized Products Regardless of Rating.

SIFMA believes that the exception should be available for all transactions in securitized products with QIBs. As a starting matter, sophisticated institutional investors are certainly as capable of negotiating fair prices with respect to investment grade and/or liquid securitized products as they are with respect to such products that are illiquid. Indeed, where there is a liquid market and robust market information is available to institutional investors, the policy rationale for restrictive price regulation disappears and therefore we do not believe that its cost can be justified.[6]

More significantly, in the case of securitized products particularly, SIFMA believes that application of the Proposed Interpretation to investment grade transactions with QIBs will have a material adverse effect on liquidity and market efficiency in situations where dealer willingness to risk capital is most critical. For example, news of deteriorating payment rates in asset pools, such as a particular vintage of sub-prime mortgage pools, can cause rapid price movements and disorderly markets in MBS, CMBS and ABS.[7] In such cases, the provision of buy-side liquidity in the face of strong selling depends on dealers willing to commit capital in the midst of high volatility. If dealers are required to apply "contemporaneous" cost and the "Hierarchy" to large transactions with QIBs in such a volatile marketplace, they are likely to be deterred from providing the liquidity necessary for the marketplace to function most efficiently.

In addition, there will almost certainly be numerous other circumstances in which the rigid set of proxies for market price required by the Proposed Interpretation will create unanticipated market inefficiencies for securitized products. Thus, SIFMA believes that application of the Proposed Interpretation to QIBs who do not need such protection is likely to result in unjustified costs.

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[6] Consistent with the requirements for the QIB exemption generally, members would still be required to establish that a QIB has the capacity to evaluate investment risk independently and is in fact using independent judgment in deciding to enter into the relevant trade.

[7] It is not atypical in today's market for spreads to widen by 30 basis points or more over a series of a few trades and for the prices for such securities to be highly discontinuous.

B. If the NASD Does not Include all Securitized Products Transactions with QIBs, the QIB Exception Should at Least Include all Private Bond Transactions.

If the NASD nevertheless decides not to generalize the QIB exemption, it should at least exempt any private bond transaction in a securitized product, whether the security is investment grade, non-investment grade or unrated. As described in the introduction to this letter, an investment grade credit rating is not a good indicator of liquidity for securitized products nor is it an indicator of retail participation. Structured bonds that carry investment grade ratings can be highly illiquid because of the manner in which the transaction is structured or the complexity of underlying assets. For example, it is typical for securitized products such as cash CDOs to include one or more investment grade tranches that are sold to no more than a handful of institutional investors. Such sales are conducted without registration under the Securities Act, and the private nature of the transaction combined with the limited initial placement and the complexity of the instrument make such bonds quite illiquid.

In fact, most highly customized securitized products, most subordinate but investment grade tranches of CDOs, and securitized products based on "exotic" assets such as litigation settlement securitizations in private transactions, are sold only to a small number of highly sophisticated institutional investors, including in investment grade tranches. Due to the highly innovative and dynamic nature of the securitized products markets, there are in fact a wide variety of products sold exclusively to sophisticated institutional investors that are generally illiquid even though they have an investment grade rating.

SIFMA suggests that the manner of offering provides a better guide in many cases than credit rating to situations in which securitized products should be exempted from the Proposed Interpretation. Securitized products sold to QIBs in private placements or through 144A transactions are often comparatively illiquid whether or not they are given an investment grade rating, and in all cases the institutional parties to the transaction are well informed and able to understand the risks. Thus, the NASD's rationale for excluding trades by QIBs in non-investment grade debt securities applies equally to private bond transactions by QIBs involving securitized products, regardless of rating.

C. In the Event that the QIB Exception Continues to be Tied to Credit Rating, the NASD Should Clarify That a Separate Credit Evaluation is Not Required for Unrated Debt in Appropriate Circumstances.

Finally, to the extent that the NASD does limit the QIB exemption to non-investment grade debt, it should clarify the requirements of the exemption with respect to unrated debt. Specifically, the NASD should provide guidance clarifying that it is not necessary to document a separate credit evaluation of such debt in order to demonstrate that the credit quality is equivalent to non-investment grade when the appropriateness of treating unrated debt as non-investment grade can be demonstrated. Such circumstances would include where a dealer can demonstrate that it treats the relevant security as non-investment grade debt for other business purposes, or can establish that the security in question is affirmatively determined to be equivalent to non-investment grade.

II. When Securitized Products are Not Otherwise Exempt From the Application of the Mark-up Rule, the NASD Should Permit Dealers to Immediately Move From Contemporaneous Cost to Consideration of Economic Models.

As described in SIFMA's other comment letter to the Proposed Interpretation, SIFMA believes that the rigidity of the Hierarchy would unrealistically require dealers to ignore relevant price information and consequently increase risk. This is particularly true for securitized products, because both the structured nature of such securities and their general illiquidity necessitate the use of models. Given the need to model securitized products in order to value them, SIFMA believes that dealers should be permitted to move more directly from contemporaneous cost to a models-based assessment of prevailing market price. The superiority of this approach to forcing dealers to prioritize other information at the expense of their own model-based view of proper pricing can be seen in several ways:

- Because all dealers necessarily model securitized products, the "prevailing market prices" for such securities, is, as a practical matter, the calculated result of such models. A dealer's own models-based view of the proper price of a debt security is a critical input into the price formation process and is probative of market price regardless of whether the so-called "Hierarchy" information is available.

- At least for the bulk of securitized products that are inactively traded, pricing information obtained from economic models is superior to prices derived by applying the so-called "Hierarchy." As currently drafted, the Proposed Interpretation would appear to preclude a dealer from considering other factors once any relevant pricing information (i.e., a single transaction by another dealer) within the "Hierarchy" is available.[8] Yet, for many securitized products, such pricing information, when available at all, would be nothing more than the application of the other dealer's model. Requiring one dealer to price based on another's model rather than its own can hardly be justified by a requirement for fair pricing, would reduce the efficiency of price formation and indeed would frequently result in worse prices for customers.

- For most securitized products, there are no "similar" securities. Moreover, comparisons to the prices of "similar" securities would generally be nothing more than comparisons of model results, as a prior transaction in a similar security was

[8] While the Proposed Interpretation provides that "[i]n reviewing the pricing information available within each category, the relative weight, for purposes of identifying prevailing market price, of such information....depends on the facts and circumstances of the comparison transaction or quotation," it only permits a dealer to move from one category to the next "in the absence of transactions" described in the preceding category. We note that, the direction that "a member may consider a succeeding category of pricing information only when the prior category does not generate relevant pricing information", appears to conflict with the subsequent statement in the Proposed Interpretation that "isolated transactions or isolated quotations generally will have little or no weight or relevance in establishing prevailing market price." Given this conflict, the Proposed Interpretation creates some uncertainty as to when members must adhere to pricing information obtained through the application of the Hierarchy and when, as a result of the isolated nature of the transactions that gave rise to that information, such information should be disregarded.

almost certainly the result of pricing based on another dealer's models. In other words, for securitized products, a dealer's determination of "similarity" itself would be the product of the use of models.[9]

- It is inevitable that application of the NASD's approach to mark-ups would prevent dealers from entering into transactions. That is, if one dealer's model shows a value that is materially at variance with a trade for the same or a similar security affected by another dealer, the second dealer will be effectively precluded from trading unless it is willing to conform its prices to those produced by the models of the other dealer.

In addition, rigid gating through the series of comparisons required by the Proposed Interpretation would be unduly burdensome for dealers of securitized products. Each of the steps in the progression that would be required under the Proposed Interpretation poses significant difficulties. While "similar" securities will not be available for securitized products other than very high-grade MBS and certain ABS, the Proposed Interpretation would place the burden on dealers to show the absence of such similar securities before going to models. Even where "similar" securities did exist, a dealer would be faced with a potential conflict of models, and would have to determine whether transactions in such (likely illiquid) securities were sufficiently timely and similar in terms of size, side of market, and spread to serve as a proper benchmark. Similarly, in applying the "Hierarchy," a dealer would be required at each step to determine whether any transactions were "contemporaneous," notwithstanding that the prices of such transactions could differ significantly from what the dealer's own models tell it is the proper price. For these reasons SIFMA believes that requiring dealers to treat models as price indicators of last resort would result in decreased liquidity, wider spreads and worse prices for customers.

III. In The Event that the Use of Models Remains a Last Resort, the NASD should Clarify the Burden of Proof for Determining that Use of Models is Acceptable.

In the event that the NASD nevertheless requires dealers in securitized products to apply the full process required by the Proposed Interpretation before using models, it should at a minimum provide guidance specifying that they would not be required to have burdensome documentation procedures to demonstrate that they have done so. While the NASD has provided general and informal assurances in this regard, the Proposed Interpretation is silent on what a dealer would be required to do in any particular case to demonstrate to the satisfaction of the NASD's examiners that the NASD's preferred sources of prevailing market price were either not available, not "contemporaneous" or (in the case of "similar" securities) insufficient as a guide to price.

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[9] For example, a dealer's models could tell it that a security could serve as a reasonable benchmark for a securitized product for small changes in expected interest rates, but a poor benchmark for larger changes.

IV. The NASD Should Clarify that "News" Deemed to Affect the Prevailing Market Price Includes any Publicly Available Information Reasonably Expected to Have a Material Effect on the Value of Securitized Product.

SIFMA welcomes the NASD's inclusion of language recognizing that a dealer's (near) contemporaneous cost may not be indicative of the prevailing market price of a security when news that has an effect on the perceived value of the security has subsequently been disseminated to the market. As the NASD states, such a provision is necessary, since certain significant news would not be captured by previously proposed language which was limited to a recognition that interest rate changes and credit quality changes may affect the price of a debt security.

However, SIFMA is concerned that the accompanying explanatory language in the Proposing Release could be read to limit the Proposed Interpretation to news affecting issuers specifically, rather than applying to any news that affects the price of a security.[10] In the context of securitized products, price changes generally reflect news relating to the value of the pool of assets underlying the relevant security rather than the issuer as such. For example, hurricanes, floods or other natural disasters in a particular region will obviously affect the price of MBS based on assets originating in that region. Since such price-relevant information is also not captured by the concepts of interest rate changes or credit-quality changes, the NASD should clarify that "news" includes news relating to the collateral underlying, or other factors affecting, a securitized product.

In addition, given the models-based approach to valuing securitized products, the NASD should also clarify that news affecting expectations about the value of a collateral pool are included. Such "news" could include, for example, publicly available information concerning observed payment rates, delinquencies, losses and recoveries on assets in the trustee reports for a securitization, views on the relationship between interest rates or other variables and mortgage prepayments, new evidence on correlations of underlying assets in a CDO, or advances in modeling techniques. While the NASD has previously rejected "changes in valuation assumptions" used by a dealer as a basis for considering factors other than contemporaneous cost,[11] changes in the state of knowledge about the expected behavior of a collateral pool is a fundamental form of market information that can not be appropriately ignored, and all investors are benefited when such information can be priced into the marketplace as quickly and efficiently as possible.

Finally, as discussed more generally above, the NASD should clarify how a dealer may consider news to rebut the contemporaneous cost presumption in the context of illiquid

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[10] In the Amended Proposing Release, NASD states that "'News' referred to in paragraph b(4)(ii) of the Proposed Interpretation . . . may affect specific issuers, a group of issuers or an industry sector and includes news such as pending or contemplated legislative developments (e.g., relating to asbestos claims); the announcement of a judicial decision; the announcement of new pension regulation or a new interpretation; and the announcement of a natural disaster, an attack or a war."

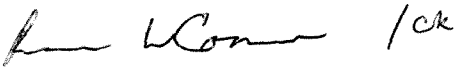
[11] Sharon K. Zackula, NASD Response to Comments on Additional MarkUp Policy for Transactions in Debt Securities, (Oct. 4, 2005)

securities. Since transaction data and contemporaneous quotes will frequently not be available in the post-news period for such securities, a change in market perception about value of the relevant securities would frequently be difficult to document. In effect, the relevant dealer's transaction could be the first transaction to "price-in" such news. Rather than requiring dealers to demonstrate that the "perceived value" of a security has changed, the NASD should make clear that dealers are permitted to use alternatives to contemporaneous cost whenever intervening news would reasonably be expected to have a material effect on the value of a security or the perceived value has otherwise been affected.

CONCLUSION

SIFMA appreciates this opportunity to comment on the Proposal and the markets for securitized products. We would welcome the opportunity to provide any additional information that could be of assistance in considering the issues discussed in this letter. If you have any questions concerning these comments, or would like to discuss the issues raised herein, please feel free to contact me at (646) 637-9228 or via email at rconner@sifma.org.

Sincerely,



Robbin Conner
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cc: Marc Menchel, General Counsel, NASD
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