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April 14, 2005

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

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

Ladies and Gentlemen:

Banc of America Securities LLC ("BAS") welcomes the opportunity to comment on the interpretation proposed by NASD, Inc. concerning the application of its Mark-Up Policy to transactions in certain debt securities (the "Proposed Interpretation"). BAS is a subsidiary of Bank of America Corporation (the "Corporation"), a Delaware corporation, a bank holding company and a financial holding company under the Gramm-Leach-Bliley Act. Through its banking subsidiaries and various nonbanking subsidiaries, including BAS, the Corporation provides a diversified range of banking and nonbanking financial services and products. BAS is a full-service investment banking and brokerage firm that is registered as a broker/dealer with the Securities and Exchange Commission (the "SEC" or the "Commission"). BAS also is a member of the New York Stock Exchange, Inc. and the NASD. BAS is a top-tier dealer in securities, with a business that spans nearly all types of equity and debt securities, including many types of illiquid debt securities.

The Proposed Interpretation was recently published for comment by the Commission with an approximately one-month comment period that expired on April 5, 2005.[1] BAS requests that the Commission exercise its discretion under 17 C.F.R. § 202.6(b) to consider these comments and include them in the public record. BAS believes that the Proposed Interpretation will, if adopted, have a significant adverse impact on the debt securities markets.

BAS believes that the Proposed Interpretation threatens to diminish market liquidity for many types of debt securities, in particular asset backed securities ("ABS") as defined in Regulation

[1] 70 Fed. Reg. 12,764 (Mar. 15, 2005).

AB,[2] structured debt securities,[3] and collateralized debt securities ("CDOs"), as well as high-yield, distressed and emerging market debt securities. Moreover, BAS believes the Proposed Interpretation's application of concepts and trading practices observed in the equity markets to the debt markets — intended or not — risks unsettling the well-established expectations of dealers, issuers, and investors, with consequences to the financing and capital raising needs of issuers that cannot be clearly foreseen or understood but are likely to be unintended and negative. BAS urges the SEC to reject the Proposed Interpretation and direct the NASD to model its approach instead on the fair pricing rules adopted by the Municipal Securities Rulemaking Board in Rule G-30. At the very least, the SEC should require the NASD (1) to recognize that dealers risking capital to facilitate customer trading in debt securities should be treated as "market makers" and (2) to modify or eliminate its proposed "Hierarchy" of permissible pricing considerations and propose instead an approach that better addresses the practical realities of the markets for many types of illiquid debt securities.

BAS fully supports the comments of The Bond Market Association in its letter[4] to the Commission (the "BMA Letter") and, accordingly, without limiting the degree of BAS' concurrence with the BMA Letter, BAS wishes to address and/or emphasize several matters that are of particular importance to its business.

I. Interest of BAS in the Proposed Interpretation.

BAS has a substantial interest in the regulation of the domestic debt markets, including the manner in which the NASD interprets and administers Rule 2440 and the Mark-Up Policy as they relate to trading in debt securities. As part of its Global Capital Markets and Investment Banking operations, BAS underwrites and makes markets in government and agency securities, investment grade and high-yield corporate debt securities, equity-linked securities, distressed corporate debt securities, commercial paper, structured debt securities, ABS and CDOs. BAS is a recognized market leader in execution services for debt securities. For example, BAS is an active trader in ABS and CDOs with a combined primary and secondary market trading volume of over $4.4 trillion for 2004, and BAS is one of the most active high-yield and distressed debt dealers, regularly providing liquidity with respect to approximately 700 issues (with an average daily trading volume of roughly $400 million) for 2004. BAS is a top tier participant in the domestic ABS market with expertise in origination, structuring and execution, analytics, and

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[2] Regulation AB defines "asset backed security" as a security that is "primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders . . . ." 17 C.F.R. § 229.1101(c)(1).

[3] Structured debt securities may be issued by an agency or non-agency issuer. Frequently, although not always, they are rated investment grade. The interest payable on these securities will depend on a formula related to measurements external to the issuer.

[4] Letter from Micah S. Green, President, and Michele C. David, Vice President and Assistant General Counsel, The Bond Market Association, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Apr. 5, 2005).

distribution that spans the auto loan, student loan, credit card, home equity loan, residential mortgage loan and commercial mortgage loan asset classes. The Corporation's affiliates serve as sponsors, issuers and servicers in a similarly wide array of ABS transactions.

II. The Proposed Interpretation Risks Unintended, Negative Consequences in the Markets for Illiquid Debt Securities.

The Proposed Interpretation provides a disincentive for dealers to risk capital to facilitate customer trading, risking an exodus of dealer capital from those sectors of the bond markets that need it the most — the illiquid markets for ABS, structured debt securities and CDOs, as well as high-yield, distressed and emerging market debt securities. Read together with prior informal NASD guidance suggesting that bond dealers must publish quotes in an *inter-dealer* market to be considered "market makers," the Proposed Interpretation would deny a "spread" to most bond dealers that hold themselves out as willing to commit capital or act as block positioners to execute customer transactions.[5] Dealers in illiquid debt securities set the prices at which they are willing to buy or sell based in part on an assessment of the risk of loss associated with committing capital at those prices. Subject to only very limited (and generally unavailable) exceptions, the Proposed Interpretation would prohibit the consideration of that risk as a pricing factor and require dealers acquiring at-risk positions in illiquid bonds to re-offer them at a price tied exclusively to their "contemporaneous cost." If dealers may not receive compensation for risks accompanying capital commitment, they will be deterred "from taking the risk of maintaining a market or a position in a security which would consequently impair market liquidity."[6]

Further reduction in the amount of dealer capital available in the secondary market for illiquid debt securities would likely reduce the number and types of investors willing to participate in the primary offerings of certain fixed income issuers. For example, the primary market for ABS or CDOs depends on the willingness of dealers to provide aftermarket liquidity support for each and every tranche in the capital structure, including the unregistered, non-investment grade or unrated tranches representing the most subordinated or "equity component" of an ABS or CDO offering. These tranches are usually sold to qualified institutional buyers pursuant to Rule 144A. If dealers become unwilling to commit capital to support a secondary market in the most illiquid (and typically unregistered, non-investment grade or unrated) tranches of ABS or CDO offerings, the market for the other registered investment grade tranches will likewise become impaired as investors insist on a premium for the added illiquidity, increasing the cost of capital (or, in the case of certain types of debt obligations, the cost of financing). Similarly, as issuers of convertible and high-yield debt would be forced to pay an additional premium to compensate investors for the risks associated with illiquidity, their access to the debt capital markets would become even more expensive. In the case of structured notes, the additional premium necessary

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5 Proposed Interpretation, 70 Fed. Reg. at 12,766 & n.12; BMA Letter at 7-17.

6 In re Peter J. Kisch, Exchange Act Rel. No. 19005, 1982 WL 529109, at *5 (Aug. 24, 1982).

to compensate investors for the increased illiquidity risks may result in issuers foregoing their use as a capital raising tool.

III. The Proposed Interpretation Incorrectly Assumes the Existence of Developed Inter-Dealer Markets that Do Not Exist for Many Types of Illiquid Debt Securities.

In a number of different circumstances, the Proposed Interpretation proceeds from the incorrect premise that a well-developed inter-dealer market exists for most debt securities. For example, the Proposed Interpretation seeks to make inter-dealer trades or quotations a meaningful or necessary part of the "Specified Institutional Trade" provision,[7] the "Hierarchy" of permissible pricing factors,[8] and the list of "additional factors" that may be considered if the Hierarchy factors are not present.[9] For many types of debt securities, there is no developed inter-dealer market. Dealers in high-yield, distressed and emerging market debt securities generally have access to brokers' brokers, but not the automated dealer quotation systems of the sort that typify the equity inter-dealer markets. Moreover, for many types of illiquid debt securities, such as ABS, structured debt securities and CDOs, the security may be traded irregularly and only by a single dealer (typically the firm that underwrote the original distribution).

IV. The Proposed Interpretation Should Be Modified To Make Clear That Dealers That Commit Capital To Facilitate Customer Trades Are "Market Makers" under Section 3(a)(38) of the Securities Exchange Act of 1934 ("Exchange Act").

The NASD should adopt a safe harbor to ensure that dealers that devote substantial capital to providing market liquidity are treated as "market makers" within the meaning of the NASD's debt mark-up interpretation.

When Congress amended the Exchange Act in 1975 to include a statutory definition of "market maker," it did so with the expressed desire to "foster the risk-taking function of market makers" and warned that regulation should not "make them all do business in the same way."[10] Over the years, the SEC, too, has recognized that a dealer performing market making functions is generally entitled to a "dealer's turn" and that a regulatory scheme that did not permit compensation for this service would threaten market liquidity,[11] the exact point made in Section II above.

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7 Proposed Interpretation, 70 Fed. Reg. at 12,764.

8 Id. at 12,767.

9 Id.

10 Securities Acts Amendments of 1975, Report of the Comm. on Banking, Housing and Urban Affairs of the U.S. Senate To Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess. 14-16 (Apr. 14, 1975).

11 In re Adams Securities, Inc., Exchange Act Rel. No. 31971 (Mar. 9, 1993) ("The difference between the market maker's bid and offer, or the 'dealer's turn,' is appropriate compensation for market makers because, by acting as market makers, they provide a liquidity service to the marketplace.").

Dealers act as market makers in different ways, depending upon the structure of the particular market. The fixed income market consists of thousands upon thousands of individual nonfungible securities. In the case of many ABS and CDO offerings, the securities are issued in the context of a complex structure of tiered or tranched securities, where it is possible, for example, for an entire tranche of the more subordinated or riskier securities to be sold to a single investor. In addition, for certain types of offerings there may be only one or two underwriters, with secondary market liquidity for the non-investment grade or unrated securities typically being provided only by the dealers who participated in the original distribution. The greater the complexity of the structure of a security and the smaller the size of the offering, the more likely that a dealer who commits capital to buy and sell such securities will be the main (or even the only) source of liquidity. Although that dealer is unlikely to publish quotations in an inter-dealer communications system, it is nevertheless in every sense a "market maker" — it holds itself out as such to customers, commits capital to facilitate customer transactions at the prices at which it iswilling to buy or sell, and may also act as a block positioner. That is why the SEC and federal courts have held that certain dealers in high-yield corporate debt securities and in direct participation program securities that performed these core market making functions were "market makers" under Section 3(a)(38) of the Exchange Act, notwithstanding their failure to publish quotations in an inter-dealer communications system.[12]

Ifdealers are not entitled to be compensated based on the spread between the prices at which they are prepared to buy or sell, it will not merely tighten spreads — liquidity will lost. Accordingly, BAS favors the adoption of a safe harbor that would codify the principles set forth above and provide certainty to both dealers and the investors that rely on dealer-provided liquidity. The safe harbor should deem dealers in debt securities to be market makers for the purposes of the NASD debt mark-up interpretation provided that (1) they hold themselves out to customers as willing to buy or sell for their own account and meet certain net capital requirements or (2) for dealers acting as block positioners, they execute at-risk trades in excess of $1 million face amount without an offsetting order at the time capital is initially committed.

V. The Proposed Interpretation's "Hierarchy" of Permissible Pricing Considerations Ignores the Realities of the Markets for Many Types of Illiquid Debt Securities, Including Customized Structured Debt Securities.

The centerpiece of the Proposed Interpretation is its "Hierarchy" of permissible pricing factors. Yet the Hierarchy imports concepts and structures from the vastly different markets for equity securities and applies them to the debt markets. The Proposed Interpretation — including the Hierarchy — provide little if any pricing guidance for a dealer in illiquid debt securities. For example, a dealer attempting to determine the "prevailing market price" of an equity tranche of a CDO held in inventory would face the following obstacles:

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[12] C.R.A. Realty Corp. v. Tri-South Investments, 738 F.2d 73, 74, 78-79 (2d Cir. 1984); In re Raymond James & Assocs., Inc., Exchange Act Rel. No. 38893 n.14 (Aug. 1, 1997).

- a presumption that its contemporaneous cost was the "prevailing market price," notwithstanding that it had acquired the securities days or weeks prior to the contemplated transaction;
- provided it had no "contemporaneous" trade, an instruction to look first to inter-dealer trades in the same security, notwithstanding the complete absence of an inter-dealer market;
- an instruction to look next to (a) "contemporaneous" trades with (b) institutional customers with which the dealer regularly effects trades in the same security, notwithstanding that no contemporaneous trades would exist and, even if they did, the dealer would have no way of knowing the identity of the institution whose trade was reported;
- an instruction to look next to bid or offer quotations, but only if the security is "actively traded," which would be wholly inapplicable;
- an instruction to look next to a variety of equally inapposite factors relating to (a) "similar" securities (defined to exclude most ABS, CDO and structured securities), (b) contemporaneous transactions, and (c) "validated" inter-dealer quotations.

In such a circumstance, the one and only potentially applicable course of action sanctioned by the Proposed Interpretation would be for the dealer to "consider as a factor . . . the prices or yields derived from economic models." The Proposed Interpretation, however, provides very little guidance to dealers on the permissible use of such models, beyond noting that models should take into account the security's features and imposing a new recordkeeping provision relating to their use, which would be extraordinarily burdensome to observe given the nature of many models utilized for securities such as ABS, CDOs and structured securities.

BAS urges the Commission to modify or eliminate the proposed Hierarchy of permissible pricing considerations and propose instead an approach that better addresses the practical realities of the markets for many types of illiquid debt securities.

VI. The Proposed Interpretation Should Expand the Circumstances in which Dealers May Rely on the Use of Economic Models.

BAS commends the NASD's recognition that economic models are an important tool used to price many types of debt securities. Models are particularly important to the trading and pricing of many types of ABS, CDOs, and structured securities. BAS is concerned, first, that there is not a full understanding of the nature of models used in the context of many highly structured debt securities in the fixed income market. For example, in an ABS offering with multiple tranches, a dealer typically will create its own model to reflect certain assumptions regarding the performance of the underlying asset pool and other market events in the context of the particular subordination structure reflected in the offering's different tranches. As those models are used subsequent to initial issuance, there are a number of "inputs" reflecting the model user's subjective beliefs about interest rate, prepayment, delinquency, and reinvestment risks, such that two institutions using an identical model could reach two very different assessments of the price

for the same tranche even though the subordination and the underlying pool of assets are identical.

Furthermore, there are no universally accepted models — investors create their own independent models reflecting their own views regarding the valuation of a particular security. Such models also may not be static. Investors and dealers are constantly readjusting models to reflect changes in market dynamics and assumptions relative to the performance of the underlying pool of assets. Therefore, it is not unusual for two investors, based on their own independently created models to have very different views regarding the value of the same illiquid structured security. Apart from the model output with respect to the value of a security, dealers and investors may also factor in their general view of overall market liquidity in setting a price at which they are willing to purchase or sell that security.

Second, the Proposed Interpretation overly restricts the use of economic models. For example, the Proposed Interpretation permits the use of economic models only if a dealer has no contemporaneous trades, there are no inter-dealer trades or quotations, and there are no similar securities. Such a restriction would create confusion in the sectors of the fixed income markets that currently rely on modeling as a key, and in some instances the primary, indicator of a debt security's value and, hence, its prevailing market price. BAS fails to see the justification for a regulatory requirement that requires dealers to ignore valuation information generated by a state-of-the-art modeling program unless it happens to generate a price within 5% of the dealer's last trade.

If the Hierarchy set forth in the Proposed Interpretation is adopted, BAS would urge further careful review of the nature and use of models in the fixed income markets, particularly in respect of ABS, CDOs and structured securities and their fundamental and necessary use in establishing the prevailing market price of certain securities.

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BAS appreciates the opportunity to comment on the NASD's Proposed Interpretation. Please do not hesitate to contact the undersigned at (212) 847-5109 or Peggy Grieve at (646) 313-8144 if it would be helpful to the Commission or its staff to discuss the issues addressed in this letter in greater detail.

Very truly yours,

William C. Caccamise
General Counsel

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

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