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

February 17, 2004

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-2003-201; Proposed Expansion of the NASD's Trading Activity Fee to Certain Fixed Income Securities**

Dear Mr. Katz:

The Bond Market Association (the "Association")[1] welcomes the opportunity to submit its comments to the Securities and Exchange Commission (the "Commission") on the proposal by the National Association of Securities Dealers, Inc. (the "NASD") to adopt for the first time a trading activity fee ("TAF") applicable to certain debt securities (the "Debt TAF").[2] The proposed Debt TAF would apply to sales of TRACE-eligible securities and municipal securities subject to Municipal Securities Rulemaking Board ("MSRB") reporting requirements ("Covered Debt Securities"). Each NASD member would pay a fee of $.00075 per bond, with a maximum charge of $0.75 per trade, for each sale of a Covered Debt Security.

I. Summary.

Our comments set forth in greater detail below may be summarized as follows:

- First, we respectfully urge the Commission to postpone approval of the Debt TAF until it has been supported by additional disclosure of relevant financial information and analysis and there has been an opportunity for more informed public comment. Currently, the Proposing Release does not provide adequate

[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 website at http://www.bondmarkets.com. This comment letter was prepared in consultation with Committees of the Association's Corporate Credit Markets and Municipal Securities Divisions.

[2] SEC Release No. 34-49114 (Jan. 22, 2004), 69 Fed. Reg. 4194 (Jan. 28, 2004) (the "Proposing Release").

information to support a determination that the Debt TAF would result in an "equitable allocation of reasonable dues" and otherwise satisfy the requirements of the Securities Exchange Act of 1934 (the "Exchange Act"). Moreover, certain features of the proposed Debt TAF (e.g., its imposition on top of fees already charged to Covered Debt Securities for self-regulatory organization ("SRO") costs, and its disparate impact on certain firms and investors) raise questions about its reasonableness and fairness that are not addressed in the Proposing Release.

- Second, there are a number of practical questions regarding how the Debt TAF will be implemented that should be clarified before the proposal is approved. For example, it is unclear whether and to what extent current NASD guidance regarding the TAF for equity securities would or should apply to Covered Debt Securities. Similarly, it is not clear whether compliance with the Debt TAF will require member firms to track transactions in Covered Debt Securities in a different manner than that used for transaction reporting purposes. These and related issues described below must be resolved prior to approval of the Debt TAF so that the impact and burdens of the proposal can be properly evaluated and members can assess the scope and costs of any necessary systems and operational changes.

The Association wishes to emphasize that its comments on the Debt TAF should not be construed as a criticism of the current system of self-regulation in our securities markets or of the vital supervisory role performed by the NASD and other SROs. We recognize the importance of adequate funding for SRO activities through appropriate dues, assessments and other fees. Before such fees are imposed, however, there must be adequate information available to member firms and other interested parties as to the need for, and reasonableness of, such fees and the manner in which they will be collected.

II. As Proposed, the Debt TAF Falls Short of Satisfying Exchange Act Requirements.

As noted in the Proposing Release, the Debt TAF must comply with Section 15A(b)(5) of the Exchange Act, which requires NASD rules to "provide for the equitable allocation of reasonable dues, fees, and other charges among members and issuers and other persons using any facility or system which [the NASD] operates or controls." In addition, the assessment of the Debt TAF cannot result in "unfair discrimination between customers, issuers, brokers, or dealers"[3] or "impose any burden on competition not necessary or appropriate in furtherance of the purposes of the [Exchange Act]."[4]

Taken as a whole, the Proposing Release fails to provide enough information to permit an appropriate evaluation of whether the Debt TAF satisfies these statutory requirements. Indeed, without further information the proposed Debt TAF could be viewed, in certain respects, as fundamentally inconsistent with these requirements.

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[3] Exchange Act Section 15A(b)(6).
[4] Exchange Act Section 15A(b)(9).

A. The NASD Has Not Provided Sufficient Information Regarding Its Regulatory Costs and Its Overall Fees, Including the Debt TAF.

In order to evaluate whether the Debt TAF provides an "equitable allocation of reasonable dues" that does not unfairly discriminate among market participants or burden competition, it would be necessary to consider, at a minimum, (i) the NASD's costs for providing its regulatory services, and whether those costs themselves are reasonable, (ii) the fees currently derived by the NASD from other sources, including the Gross Income Assessment (the "GIA") and the Personnel Assessment (the "PA"), and projections of the amounts that are expected to be derived from the Debt TAF, and (iii) whether the amount of fees imposed on each fee source reflects some "equitable allocation" of the NASD's overall regulatory costs.

To our knowledge, the NASD has not provided the industry information that would establish a reasonable nexus between the regulatory costs it seeks to fund and the Debt TAF. The NASD has noted that its overall fee structure (including the GIA, the PA and the TAF) is intended to finance its "member regulatory activities, including the regulation of members through examinations, processing of membership applications, financial monitoring, policymaking, rulemaking, and enforcement activities."[5] It has asserted that the overall fee structure is "revenue neutral," and that it "has reviewed the reported volumes for TRACE-eligible and municipal securities in conjunction with the NASD's current regulatory costs associated with the oversight of these securities," and has determined that the proposed fees reflect "NASD's regulatory efforts in the fixed income markets."[6] The industry has not been provided with any disclosure, however, as to the financial analysis that forms the basis for these claims – which is particularly surprising given that the desire for greater transparency arises from the NASD's own members.[7]

These concerns regarding inadequate disclosure echo those that were raised by commenters in connection with the NASD's implementation of the TAF for equity securities – e.g., Is the proposal really "revenue neutral," or does it support an inappropriate level of profit for the NASD? Are transaction fees fairly allocated between debt and equity securities? Do the fees fairly reflect the allocation of supervisory oversight between different SROs? These questions did not prevent the Commission's approval of the equity TAF; yet without adequate information (made available not just to the Commission, but also to the industry) they will inevitably linger.[8] There is some concern, moreover, that the repeated approval of rule filings in which interested parties

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[5] Proposing Release at 4194.

[6] Proposing Release at 4195.

[7] In the past, the NASD has argued that the statutory requirement that fees be reasonable and equitably allocated "does not require a pricing structure so specific and complex as to tie specific self-regulatory programs and related expenses to specific business lines within a firm." Letter from Margaret H. McFarland, Deputy Secretary, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC p. 8 (Mar. 18, 2003). Even assuming it is impractical to link every fee directly and specifically to a regulatory function, however, this cannot justify a complete lack of any disclosure of financial costs and analysis, even on a very general basis, to support the level and allocation of the fees charged.

[8] In the absence of information regarding the relevant costs of NASD's regulatory services, member firms are justifiably concerned about dramatic increases in their NASD fee-related expenses. One member of the Association has estimated that the total fees it expects to pay to the NASD under the proposed fee structure (including the revised PA, GIA and TAF) are 77% higher than the NASD assessments the firm currently pays.

are deprived of information necessary to meaningfully evaluate the merits of a proposal is inconsistent with the objectives of the "notice and comment" process so critical to maintaining a regulatory system that is, and perceived to be, transparent, effective and fair.

B. The Proposed Debt TAF Does Not Address Existing Regulatory Fees Applicable to Covered Debt Securities.

In addition to the general lack of transparency regarding the basis for the Debt TAF, the imposition of the Debt TAF on top of existing transaction-related fees raises further concerns regarding consistency with Exchange Act requirements. The NASD imposes a transaction-related Trade Reporting Fee (that was only recently approved on a permanent basis despite industry concerns) on TRACE-eligible securities.[9] Similarly, MSRB fees are charged on the total par value of municipal securities sales reportable under MSRB rules[10] (in addition to an underwriting assessment charged for municipal securities purchased from an issuer by or through the member as part of certain primary offerings).[11] Prior to approval of the NASD's proposal, the NASD should be required to establish that adding the Debt TAF on top of these existing fees does not result, in effect, in the "double taxation" of Covered Debt Securities.

In the case of TRACE-eligible securities, this issue is particularly troubling because the NASD has used the same category of regulatory expenses to justify both the Debt TAF and TRACE fees. When it adopted the TRACE Trade Reporting Fee, the NASD argued that the proceeds would cover not only "NASD's costs to develop and operate" TRACE but also expenses associated with "*engag[ing] in oversight of the fixed income market*."[12] Absent further explanation by the NASD, based on the current record it is not clear whether member firms are effectively being charged twice for the same regulatory oversight.

Similarly, in the case of municipal securities the NASD does not address the fact that certain of the regulatory functions that it proposes to fund through the Debt TAF for municipal securities – including "rulemaking" and "policymaking" – are delegated by the Exchange Act solely to the MSRB.[13] There is no indication that in proposing the Debt TAF the NASD took into account this allocation of supervisory responsibilities and the fact that member firms already pay fees to support the rulemaking functions of the MSRB.

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[9] See NASD Rule 7010(k).
[10] See MSRB Rule A-13(c).
[11] See MSRB Rule A-13(a).
[12] SEC Release No. 34-49086 (Jan. 15, 2004), 69 Fed. Reg. 3416 at 3417 (Jan. 23, 2004) (emphasis added).
[13] See Exchange Act Section 15B(b). Indeed, the NASD is prohibited from adopting rules that govern trading of municipal securities. Exchange Act Section 15A(f).

C. The Proposed Debt TAF May Have a Disparate Impact on Certain Firms and Investors.

The proposed Debt TAF would appear to have a disparate impact on retail-oriented firms and investors because the cap reduces the effective fee per bond for larger transactions. Such a fee structure obviously imposes a relatively greater burden on firms that help maintain liquidity for the retail markets by engaging in small ticket, large volume transactions. The NASD has not explained why this approach (as opposed to a higher or lower cap, or different fee caps for municipal and corporate debt, etc.) best achieves the Exchange Act requirement that the NASD's rules not impose an unfair burden on competition or discriminate between market participants. The NASD also has not addressed the potential competitive burdens placed by the Debt TAF on member firms that must compete in the municipal securities markets with non-member banks.

We also note that the Debt TAF would not apply equally to similar types of securities. For example, corporate debt securities that at issuance have a maturity of one year or less are not "TRACE-eligible" and therefore would not be subject to the Debt TAF. No comparable exclusion would apply for short-term municipal securities (although municipal securities that have a stated maturity of nine months or less are excluded from MSRB transaction assessments). It is not clear why distinctions should be drawn between these types of securities for purposes of the Debt TAF.

D. SRO Fees for Fixed Income Markets Should be Coordinated and Consistent.

The Association believes that in order to satisfy the "reasonable and equitable" standard under the Exchange Act, and avoid an undue burden on market participants, SRO fees need to be coordinated across all SROs with overlapping jurisdictions. Without such coordination, there can be no reasonable guarantee against over- or under-assessments that result in unreasonable and unfair fee burdens for individual member firms and SROs.

As currently proposed, the Debt TAF does not appear consistent with such a framework. For example, as noted above, there are significant questions about whether the Debt TAF adequately addresses the overlapping jurisdiction and fee schemes of the NASD and the MSRB. In addition, other SROs, such as the New York Stock Exchange, Inc., may claim regulatory oversight of the activities of its members in the fixed income markets. We are particularly concerned that the adoption of the NASD's Debt TAF without further disclosure regarding regulatory costs and allocations may prompt various SROs to impose their own fees, or to increase existing fees, to recoup undisclosed and vaguely defined regulatory costs (or even build a surplus to subsidize other activities) without any assurance that the overall SRO fees charged to member firms are reasonably related to overall regulatory costs.

In our view, a better approach to SRO fees for the fixed income markets can be designed, and we would be pleased to work with the Commission and the SROs to accomplish this goal. Although given the short time frame for addressing the proposed Debt TAF we have not had adequate opportunity to formulate any detailed proposal, we note that among the alternatives to piecemeal and uncoordinated approvals of SRO fees would be a

single TAF that would be allocated among SROs based on their estimated costs of regulating the relevant areas of the fixed income markets. Similarly, the Commission could consider whether excess fees collected by one SRO should be reduced or allocated to other SROs.[14]

III. The NASD Should Clarify Details Regarding the Implementation of the Debt TAF Prior to Any Commission Approval of the Proposal.

The Proposing Release leaves unanswered many practical questions regarding how the Debt TAF will be implemented. Presumably, the NASD intends to address these points through notices to members and other guidance at some point in the future. In the Association's view, however, understanding how the Debt TAF will be implemented is integral to evaluating whether the proposal is fair and reasonable and to assessing the overall burden it will impose on member firms. It is also currently impossible to comment effectively on whether the proposed effective date provides member firms with a reasonable opportunity to make systems or operational changes that may be necessary to ensure they are in compliance with the new fee requirements.

Accordingly, we request that consideration of the Debt TAF be deferred until the NASD provides members with more detail regarding the implementation of the fee and firms have an opportunity to comment on the package as a whole.[15] Key factors to consider in this regard include whether and to what extent the NASD's prior guidance on the TAF – all of which was clearly written solely with a view to the equity markets, and some of which appears inapplicable to or inconsistent with trading practices in the fixed income markets – would apply to transactions in Covered Debt Securities. In addition, it is critical to identify any differences between the manner in which trades of Covered Debt Securities are currently reported (under TRACE and MSRB rules), and the manner in which they will be required to be monitored and reported for purposes of the Debt TAF – since obviously any inconsistencies between these regimes will impose burdens on member firms, increase the risk of error, and require potentially expensive systems and operational changes to implement.

We have identified below examples of issues that require further clarification.

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[14] For example, a large revenue surplus accumulated by one SRO (e.g., the MSRB) could contribute to financing the regulatory functions of other SROs (e.g., the NASD's costs with respect to municipal securities). We recognize that there may be limitations under the Exchange Act on certain approaches to coordinating SRO fees.

[15] The Association notes that when the NASD was developing the TAF for equity securities it afforded members an opportunity to comment on the proposal prior to its filing with the Commission. See Special NASD NTM 02-09 (Jan. 2002) (soliciting comments from members on proposed changes to NASD regulatory fees). The NASD found the comments it received sufficiently compelling that it abandoned its original framework. See NASD NTM 02-41 (July 2002). It is unfortunate that the Debt TAF was not also published for separate comment prior to its filing with the Commission, since doing so may have permitted a number of the questions and concerns identified herein to have been addressed at an earlier stage.

A. Purchases of Covered Debt Securities from Customers.

The proposed Debt TAF would by its terms only be assessed "for the *sale* of covered securities."[16] It is unclear how this requirement will be applied to Covered Debt Securities. In the case of equity securities, the NASD has interpreted this same language to require the payment of the TAF by member firms that are on the *buy-side* of a transaction with a non-broker-dealer (such as a customer).[17] The NASD further elaborated on this interpretation as follows: "simply stated, a fee will be assessed on all sell side transactions. This includes transactions where the sale is *for the account* of a customer and transactions where the sale is for the member itself."[18]

The NASD's approach in the equities context appears to assume that a broker-dealer's purchase from a customer will be accompanied by a contemporaneous sale by the broker-dealer (as agent or riskless principal) made "for the account of" the customer. While this may be consistent with how trading usually occurs in the equity markets, in the fixed income markets broker-dealers more frequently trade as principal, and when they purchase from a customer they often do not have an immediate offsetting sale.[19] Accordingly, applying this interpretation to transactions in Covered Debt Securities may result in a significantly greater number of trades for which a TAF applies than in the case of equity securities – since member firms will be required to pay the fee once when they buy the security from the customer and again when they subsequently sell it to another broker-dealer or customer.[20]

B. Transactions in TRACE-Eligible Securities That Are Not Reported.

As proposed, the Debt TAF would apply to sales of all TRACE-eligible securities apparently without regard to whether those sales are actually subject to reporting through TRACE. The NASD should address how the Debt TAF would apply in such instances. As a practical matter, it is not clear how the fee will be imposed in connection with trades that are not required to be reported, at least without significant operational and systems expense to ensure that these trades are properly identified for fee purposes.

In addition, certain transactions may be exempt from TRACE reporting for reasons that would also support an exemption from the Debt TAF. Repo transactions, for example,

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[16] See Section 1(b) of Schedule A to NASD By-Laws (emphasis added).
[17] See NASD NTM 02-75 (Nov. 2002).
[18] NASD NTM 02-75 (Nov. 2002), Question 1 (emphasis added).
[19] In the context of equity securities, if the member firm is acting as riskless principal and the trade is "correctly reported," the fee is assessed only once. See NASD NTM 02-63 (Sept. 2002). This should apply equally in the debt markets.
[20] The NASD has also stated that where a member purchases securities from a customer "whose account is not carried by the member," a fee is not assessed on the member. See NASD NTM 03-30 (June 2003), Question 1. It would be helpful if the NASD would clarify whether this guidance applies, for example, where the member firm settles on a DVP/RVP basis with a customer that custodies its assets away from the member firm. In addition, the NASD is silent on whether member firms are permitted to pass along the Debt TAF to their customers. Since the NASD has modeled the TAF after the Commission's Section 31 fees (which may be charged to customers), it would be helpful if the NASD would confirm that firms subject to Debt TAF also may pass this fee through to customers.

involve a "purchase" and "sale" of the relevant security but are not subject to TRACE reporting. It would seem no more appropriate to apply the Debt TAF to such financing transactions than to a pledge of securities by a member firm to a bank as collateral for a loan. Moreover, because repos involve a "sale" at both the initiation and the termination of the transaction, and in many cases are entered into on an "overnight" basis and renewed each day, the imposition of the Debt TAF on such transactions would result in excessive fees and might have unintended consequences for the liquidity of broker-dealers and the markets as a whole.

C. Reporting of Transactions.

Under the proposed Debt TAF members must report to the NASD the "aggregate share, bond, contract and/or round turn volume of sales of covered securities in a manner as prescribed by NASD from time to time."[21] The NASD has not provided any further detail as to how such reporting will occur in the context of Covered Debt Securities.

In the context of equity securities, NASD members must self-report to NASD on a monthly basis "the aggregate shares for stocks, aggregate number of contracts for options, and/or aggregate number of round turn transactions for security future products at the clearing firm level."[22] The TAF is assessed directly to clearing firms who must self-report to NASD the required data ten business days following the end of the month.[23]

If the billing and payment mechanisms the NASD envisions differ from current standards for the collection of TRACE and MSRB transaction-related fees, NASD members should be given the opportunity to participate in the process of developing such mechanisms and, if necessary, time to modify existing internal systems and develop and test new ones to ensure compliance.

D. Inter-Dealer Brokers and Brokers' Brokers.

The NASD should clarify how the Rule will apply to inter-dealer brokers and brokers' brokers. In the context of equity securities, the NASD has advised that "[i]f a member firm acts as agent on behalf of another NASD member in the sale of a covered security, the fee will be assessed to the member who is the ultimate seller of the security, not the member acting as agent."[24] Inter-dealer brokers and brokers' brokers who deal only with other member firms effectively provide an agency function facilitating sales of securities by other broker-dealers. It would be helpful if the NASD would confirm, as presumably is the case, that such firms will be exempt from the Debt TAF in accordance with this guidance.

In some cases, inter-dealer brokers may act as "riskless principals" rather than in a pure agency capacity. There would not appear to be any policy rationale, however, for

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[21] Proposed Section 1(b)(4) of Schedule A to NASD By-Laws.
[22] See, e.g., NASD NTM 02-63 (Sept. 2002).
[23] See, e.g., NASD NTM 02-75 (Nov. 2002), NASD NTM 02-63 (Sept. 2002).
[24] NASD NTM 02-75 (Nov. 2002).

distinguishing between firms that provide inter-dealer liquidity solely on the basis of whether they act as agents or riskless principals.[25]

E. Investment Adviser Accounts.

The treatment of transactions with investment advisers that will ultimately allocate the transaction among multiple customers is unclear. The NASD's guidance in respect of the TAF on equity securities indicates that a member may not calculate the fee based on an investment adviser's aggregate order that is allocated to customers on an "average price" basis "because it is comprised of multiple customer accounts."[26] In the case of TRACE-eligible securities, however, the NASD has stated that if a broker-dealer receives an order from a money manager who will break the trade down into sub-accounts, the broker-dealer must report a single sell trade to the money manager; sub-account breakdown is not reportable.[27] As noted above, where the requirements for the TAF are inconsistent with the procedures applicable to the reporting of TRACE-eligible or municipal securities, member firms must assess the operational and programming costs necessary to accommodate the differences.

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The Association appreciates the opportunity to comment on the Proposing Release. Should you have any questions or desire any clarification or additional information regarding any of the matters discussed in this letter, please do not hesitate to contact the undersigned at 646.637.9200.

Sincerely,

/s/ Lynnette K. Hotchkiss

Lynnette K. Hotchkiss
Senior Vice President and
Associate General Counsel

/s/ Michele C. David

Michele C. David
Vice President and
Assistant General Counsel

[25] If the Debt TAF does apply to these firms, the NASD should at a minimum clarify that riskless principal debt transactions would be subject to the fee only once.

[26] NASD NTM 02-75 (Nov. 2002), Question 4.

[27] See TRACE Frequently Asked Questions – Reporting, available at http://www.nasd.com/mkt_sys/trace_faqs_reporting.asp.

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
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Martha Haines, Director, Office of Municipal Securities

National Association of Securities Dealers, Inc.

Mary L. Schapiro, Vice Chairman and President
Steven Joachim, Senior Vice President, Market Operations
Marc Menchel, General Counsel
Elliot Levine, Executive Director and Assistant General Counsel
Justin Tubiolo. Vice President, Fixed Income Department
Sharon K. Zackula, Assistant General Counsel

The Bond Market Association

Corporate Credit Markets Division Executive Committee
Corporate Credit Markets Division Investment Grade Committee
Corporate Credit Markets Division High Yield Committee
Corporate Credit Markets Division Distressed Debt Committee
Corporate Credit Markets Division Legal Advisory Committee
Municipal Securities Division Executive Committee
Municipal Securities Division Legal Advisory Committee
Municipal Securities Division Operations Committee
Municipal Securities Division Syndicate & Trading Committee
Municipal Securities Division Sales & Marketing Committee
Municipal Securities Division Brokers' Brokers Committee