RW SMITH & ASSOCIATES, INC.

February 11, 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") in connection with 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.

The Association fully supports the system of self-regulation for our securities markets, including the funding of self-regulatory organization ("SRO") supervisory activities through appropriate dues and assessments. We also recognize that certain regulatory costs may be highly correlated with trading activity and therefore, at least in principle, a trading activity fee can be included as one component of a reasonable SRO fee structure.

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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").

We have significant concerns, however, with the proposed Debt TAF in its current form. [Summary to follow based on final contents of letter.]

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 Securities Exchange Act of 1934 (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. Moreover, without further information the proposed Debt TAF could be viewed, in certain respects, as fundamentally inconsistent with these requirements.

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.[5]

To our knowledge, the NASD has not provided to the industry any information, even in the most general terms, 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."[6] 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

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3 Exchange Act Section 15A(b)(6).

4 Exchange Act Section 15A(b)(9).

5 **[Discussion Point: Consider consequences of additional disclosure that indicates (i) a higher Debt TAF would be appropriate, or (ii) fees should be charged for other debt, including U.S. Government securities.]**

6 Proposing Release at 4194.

that the proposed fees reflect "NASD's regulatory efforts in the fixed income markets."[7] The industry has not been provided with any disclosure, however, as to the financial analysis that forms the basis for these claims – a circumstance that is particularly surprising given that the request for greater transparency arises from the NASD's own members.[8]

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 some 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 deter 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.[9] There is some concern, moreover, that the repeated approval of rule filings in which interested parties are deprived of information necessary to meaningfully evaluate the merits of a rule proposal risks making a mockery 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's Trade Reporting Fee (only recently approved on a permanent basis despite industry concerns) imposes transaction-related fees on TRACE-eligible securities.[10] Similarly, MSRB fees are charged on the total par value of municipal securities sales reportable under MSRB rules[11] (in addition to an underwriting assessment charged for municipal securities purchased from an issuer by or through

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7 Proposing Release at 4195.

8 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). This argument mischaracterizes the point. Even assuming it is impractical to link every fee directly and specifically to a regulatory function, 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.

9 In the absence of information regarding the relevant costs of NASD's regulatory services, its member firms are justifiably concerned about dramatic increases in their NASD fee-related expenses. One member of the Association has noted that the estimated 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 previously paid. **[Discussion Point: Do other members have relevant anecdotal evidence regarding the expected increase in their fees?]**

10 The TRACE Transaction Reporting Fee is a sliding scale fee based upon the size of the transaction reported. See NASD Rule 7010(k).

11 See MSRB Rule A-13(b).

the member as part of certain primary offerings).[12] 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, the "double taxation" issue is particularly troubling because the NASD has used the same category of regulatory expenses to justify both the TAF and TRACE fees. When it adopted the TRACE fees, 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.*"[13] 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.[14] Indeed, the NASD is prohibited from adopting rules that govern trading of municipal securities.[15] 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. The Debt TAF for municipal securities is no lower than that for corporate debt securities as to which the NASD does have rulemaking and policymaking responsibility.

[The NASD also fails to address the competitive burdens placed by the Debt TAF on municipal securities dealers registered under Section 15 and 15B of the Exchange Act. These firms must compete with bank municipal securities dealers who would not be subject to the Debt TAF because they are not members of the NASD.]

[C. The Proposed Debt TAF May Unfairly Burden Certain Firms and Investors.

The proposed Debt TAF would appear to have a disparate impact on retail-oriented firms and investors because it is calculated based on the number of bonds sold and effectively reduces the marginal costs of larger transactions.[16] 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 such a fee structure is consistent with the Exchange Act requirement that the NASD's rules not impose an unfair burden on competition or discriminate between market participants.[17] Indeed, the per-bond proposal appears somewhat at

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12 See MSRB Rule A-13(a).

13 SEC Release No. 34-49086 (Jan. 15, 2004), 69 Fed. Reg. 3416 at 3417 (Jan. 23, 2004) (emphasis added).

14 See Exchange Act Section 15B(b).

15 Exchange Act Section 15A(f).

16 [Potential cite to statistical data.]

17 We understand that in the case of equity securities the TAF may have been imposed on a per share basis to conform to the fee requirements under Exchange Act Section 31 and thereby reduce programming costs for member firms. Obviously, Section 31 fees do not currently apply to Covered Debt Securities.

odds with the recently adopted trade reporting fees for TRACE-eligible securities, in connection with which both the Commission and the NASD recognized the potential competitive burdens of a per bond fee structure. The NASD argued in that context that a sliding fee based on the size of the transaction reported would distribute the fee "more equitably between retail oriented firms and institutionally oriented firms."[18] Similarly, in approving this approach, the Commission stated that the "sliding scale structure promotes an equitable distribution of the relevant fees while reducing the possibility of discrimination between customers, issuers, brokers, or dealers."[19] It is not clear what rationale drove the NASD to abandon this sliding scale fee approach in the context of the Debt TAF.[20]]

[We also note that the Debt TAF would not apply equally to different types of short-term money market instruments. Corporate debt that at issuance has 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.][21]

D. SRO Fees for Fixed Income Markets Need to 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.

The NASD's Debt TAF is not 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, may claim regulatory oversight of certain fixed income markets. We are particularly concerned that the adoption of the NASD's Debt TAF without further supporting disclosure of 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 fees charged to member firms are reasonably related to 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

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18 SEC Release No. 34-48714 (Oct. 29, 2003), 68 Fed. Reg. 62483 at 62488 (Nov. 4, 2003).

19 SEC Release No. 34-46145 (June 28, 2002), 67 Fed. Reg. 44911, 44913 (July 5, 2002).

20 **[Discussion Point: Should the letter advocate an alternative fee structure, such as a lower cap?]**

21 **[Discussion Point: Should any other disparities in the application of the Debt TAF be identified?]**

sections of the fixed income market. Similarly, the Association would urge the Commission to consider whether excess fees collected by one SRO should be reduced or allocated to other SROs. [For example, the MSRB currently does not share any of the fees it collects from its members with the NASD, but the large revenue surplus it has accumulated during recent years could contribute to financing the regulatory functions of other SROs with respect to municipal securities.[22]]]

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 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 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 members have an opportunity to comment on the package as a whole.[23] 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.[24]

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22 See MSRB Financial Statements and Report of Independent Certified Public Accountants, Sept. 30, 2002 and 2001. **[Discussion Point: Should the proposals in this section be included in the letter? Should any alternative proposals for SRO fees be identified?]**

23 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). Since none of the prior comment process on the TAF contemplated its application to Covered Debt Securities, however, it is disconcerting that the NASD did not offer its members a similar opportunity to comment on the Debt TAF.

24 **[Discussion Point: Should any additional points be raised for clarification (e.g., any other inconsistencies between the reporting and TAF regimes that should be identified)?]**

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" (emphasis added). 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).[25] 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."[26]

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.[27] Accordingly, applying this interpretation to transactions in Covered Debt Securities will 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.[28]

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 review and 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 TAF. Repo transactions, for example, involve a "purchase" and "sale" of the relevant security but are not subject to TRACE reporting because, from an economic perspective, they are financing transactions. It would seem no more appropriate to charge a TAF for such financing transactions than in the case of 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

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25 See NASD NTM 02-75 (Nov. 2002).

26 NASD NTM 02-75 (Nov. 2002), Question 1 (emphasis added).

27 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.

28 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), firms subject to Debt TAF should similarly be permitted to do so.

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." 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."[29] The TAF is assessed directly to clearing firms who must self-report to NASD the required data 10 business days following the end of the month.[30]

If the billing and payment mechanisms the NASD envisions differ from existing 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 granted 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."[31] 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. Presumably, 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 distinguishing between firms that provide inter-dealer liquidity solely on the basis of whether they act as agents or riskless principals.[32]]

[E. Investment Advisory Accounts.

The treatment of transactions with investment advisors that will ultimately allocate the order among multiple customers is unclear. The NASD's guidance in respect of the

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29 See, e.g., NASD NTM 02-63 (Sept. 2002).

30 See, e.g., NASD NTM 03-30 (June 2003). **[Discussion Point: What proposals, if any, should be made as to the reporting of transactions for fee purposes and the payment of those fees?]**

31 NASD NTM 02-75 (Nov. 2002).

32 If the Debt TAF does apply to these firms, the NASD should at a minimum clarify that prior treatment of riskless principal equity transactions would continue to apply to Covered Debt Securities – such that they would be subject to the fee only once.

TAF on equity securities indicates that the member may not calculate the fee based on the overall investment advisory order "because it is comprised of multiple customer accounts."[33] 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.[34] 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 will likely have significant operational and programming costs to accommodate the differences.][35]

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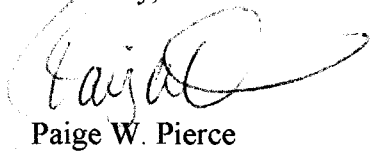
The Association appreciates the opportunity to comment on the Proposing Release. Should you have any questions or desire any clarification or additional information regarding any of the matters discussed in this letter, please do not hesitate to contact the undersigned at (801) 733-9909.

Sincerely,



Paige W. Pierce
Chief Operating Officer

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]

[*National Association of Securities Dealers, Inc.]*

[*The Bond Market Association]*

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33 NASD NTM 02-75 (Nov. 2002), Question 4.

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

35 **[Discussion Point: Should the letter make any specific recommendations in this regard?]**