NASD

September 7, 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: New York Stock Exchange Automated Bond System Proposal
File No. S7-06-05 (Release No. 34-51998)
File No. SR-NYSE-2004-69 (Release No. 34-51999)

Dear Mr. Katz:

NASD appreciates the opportunity to comment on the application[1] of the New York Stock Exchange ("NYSE") for exemptive relief ("Exemption Application"), pursuant to Section 36[2] of the Securities Exchange Act of 1934 ("Exchange Act"),[3] and the related proposed rule change notice ("Notice")[4] of the NYSE (collectively, the "NYSE Proposal"). While debt securities traded in the over-the-counter ("OTC") market are not subject to the registration requirements of Section 12 of the Exchange Act[5] and need not be issued by companies that file periodic reports with the Securities and Exchange Commission ("Commission") pursuant to Section 13 of the Exchange Act,[6] debt securities traded on national securities exchanges are required to be so registered. If approved by the Commission, the NYSE Proposal would eliminate this distinction with respect to the NYSE, by permitting the NYSE to trade unlisted debt securities on the NYSE.

As neither a market operator nor a trading center, NASD does not compete with the NYSE or its Automated Bond System ("ABS") for order flow in corporate bonds. However,

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1 Exchange Act Release No. 51998 (July 8, 2005), 70 FR 40748 (July 14, 2005). The comments provided in this letter are solely those of the NASD staff; the Board of Governors has not considered or endorsed them. For ease of reference, this letter uses the term "NASD," but this term refers only to NASD staff.

2 15 U.S.C. 78mm.

3 15 U.S.C. 78a *et seq*.

4 Exchange Act Release No. 51999 (July 8, 2005), 70 FR 41067 (July 15, 2005).

5 15 U.S.C. 78*l*.

6 15 U.S.C. 78m.

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as a registered national securities association under Section 15A of the Exchange Act,[7] NASD is charged with regulating the OTC market, including the OTC market for fixed-income securities. In furtherance of that role and NASD's fundamental goal of protecting investors and ensuring market integrity, NASD has established (pursuant to Commission mandate) the Transaction Reporting and Compliance Engine ("TRACE"), a corporate bond trade reporting system that facilitates regulation of and transparency in the OTC corporate bond market.[8] In calling upon NASD to implement TRACE and generally to increase transparency in the corporate bond market, the Commission challenged NASD to: (1) adopt rules requiring dealers to report all transactions in U.S. corporate bonds and preferred stocks to the NASD and to develop systems to receive and redistribute transaction prices; (2) create a database of transactions in corporate bonds and preferred stocks to enable regulators to take a proactive role in supervising the corporate debt market; and (3) create a surveillance program to better detect fraud in order to foster investor confidence in the fairness of these markets.[9]

As a registered national securities association and the operator of TRACE, NASD fully supports increased transparency in the corporate bond market and the development of platforms to make trading of corporate bonds more efficient. NASD is concerned, however, about certain issues that arise under the federal securities laws and prudential regulatory policy in connection with the NYSE Proposal. First and foremost, by providing for the trading of unlisted bonds, the NYSE Proposal would result in the establishment of an OTC facility and, as such, it must be subject to full NASD regulation. Beyond the fact that the NYSE's ABS, as proposed, is an OTC facility under the federal securities laws, broad public policy concerns are raised by the NYSE Proposal. Specifically, the public policy considerations of investor protection argue for implementation of the NYSE Proposal in a manner that neither results in the fragmentation of transaction information nor hampers the ability of NASD to conduct comprehensive surveillance of the U.S. corporate debt market, in accordance with the third prong of the Commission's directive, irrespective of the OTC platform on which such transactions occur.

I. ***<u>OTC Bond Market Overview</u>***

As discussed in the NYSE Proposal, debt securities traded OTC are not subject to the registration requirements of Section 12 of the Exchange Act[10] and need not be issued by

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7 15 U.S.C. 78*o*-3.

8 *See generally* Exchange Act Release No. 49854 (June 14, 2004), 69 FR 35088 (June 23, 2004).

9 *See* Exchange Act Release No. 42201 (December 3, 1999), 64 FR 69305 (December 10, 1999).

companies that file periodic reports with the Commission pursuant to Section 13 of the Exchange Act.[11] Approximately 99% of corporate bond market transactions are effected in the OTC market[12] and TRACE transaction data captures 100% of OTC secondary market activity in TRACE-eligible securities (including restricted debt permitted to be resold pursuant to Rule 144A of the Securities Act of 1993).[13] TRACE disseminates transaction information for 100% of publicly traded TRACE-eligible securities.[14]

Consistent with the third prong of the Commission's TRACE mandate, NASD created a surveillance program to better detect fraud and foster investor confidence in the fairness of the corporate debt market. Since TRACE's inception, NASD has committed significant financial and human resources to building a robust regulatory infrastructure for the OTC corporate bond market. NASD currently actively surveils trading activity in TRACE-eligible bonds for NASD rule and federal securities law violations (*e.g.*, excessive mark-ups, trading ahead of customer orders, and excessive commissions).[15] As a result, NASD has been using the new found transparency to aggressively implement significant surveillance programs and pursue an unprecedented number of enforcement actions with respect to corporate bond trading violations.

II. NYSE Proposal's ABS is an OTC Facility

A defining hallmark of a registered national securities exchange is that its members may only trade on it those securities that are Exchange Act registered.[16] By seeking an exemption from this fundamental Exchange Act requirement, the NYSE Proposal is seeking to establish an NYSE execution facility in the OTC market. Consequently, the operation and position of ABS in the market would be similar to other OTC corporate bond trading platforms, such as BondDesk*ATS, MarketAxess, and TradeWeb. As such, transactions in

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10 15 U.S.C. 78*l*

11 15 U.S.C. 78m.

12 Exchange Act Release No. 50317 (September 3, 2004), 69 FR 55202 (September 13, 2004).

13 *Id.*

14 *Id.*

15 In conjunction with TRACE, NASD designed and implemented the Bond Oversight and Surveillance System ("BOSS") to monitor corporate bond transactions reported to TRACE for possible illicit trading activity and to assist in the enforcement of investor protection rules.

16 15 U.S.C. 78*l*.

unlisted bonds that are effected through ABS must be subject to NASD's statutorily mandated oversight as the OTC market regulator under Section 15A of the Exchange Act.[17]

NASD fully supports the addition of new and innovative execution platforms for corporate bonds in the OTC market. To the extent exchanges establish such OTC facilities, however, the regulatory playing field must be level. Specifically, there must be regulatory parity between how exchange OTC facilities are regulated and how other entities that choose to operate in the OTC market are regulated. Therefore, the NYSE must either register ABS as an OTC bond Alternative Trading System ("ATS")[18] or position it as an OTC bond trading platform.[19]

III. <u>NASD Must Oversee ABS to Avoid Harmful Regulatory Fragmentation</u>

The NYSE argues that its proposal will enhance competition in the corporate bond market for the ultimate benefit of investors. NASD stresses, however, that competitive execution venues for the OTC bond market must not arise at the expense of sound regulatory policy. The Commission has traditionally sought to foster ever greater competition for the purposes of greater market efficiency and investor protection. Such competition has generally benefited investors by increasing execution venue selection, reducing transaction costs, and spurring innovation in trading technology and customer service. Notwithstanding these benefits, the Commission has also acknowledged the significant concerns associated with inter-market competition.[20] For instance, as order flow fragments across markets, the ability of regulators to "see the full picture" and, thus, detect illicit trading activity is diminished.

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[17] 15 U.S.C. 78*o*-3.

[18] *E.g.*, BondDesk*ATS.

[19] *E.g.*, MarketAxess and TradeWeb.

[20] *See generally e.g.*, the SRO Structure Concept Release, Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004); the SRO governance and transparency proposed rulemaking, Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004); Nasdaq's regulatory arbitrage whitepaper, Securities Exchange Act Release No. 47849 (May 14, 2003), 68 FR 27722 (May 20, 2003); and the Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions on Certain Options Exchanges, Exchange Act Release No. 43268 (September 11, 2000) (Administrative Proceeding File No. 3-10282).

While the NYSE Proposal notes that the volume of corporate bond transactions currently effected on national securities exchanges is quite low,[21] it also suggests the potential for the proposal to draw significant bond order flow to the NYSE.[22] Moreover, while the NYSE Proposal repeatedly references the NYSE's competitive position relative to the OTC bond market,[23] noticeably absent is a discussion of how best to maintain a robust consolidated inter-market audit trail and to ensure that the broader corporate bond market is effectively regulated without fragmentation. However, appropriately recognizing ABS as an OTC facility, would ensure that the regulatory fragmentation concerns, typically associated with inter-market competition, would be forestalled since transactions occurring on the ABS would be part of the comprehensive OTC corporate bond market subject to the NASD reporting requirements and market regulation program.[24] In turn, the efficacy and efficiency of OTC corporate bond market regulation would be enhanced because NASD would have sight of the full picture of a market that is not artificially truncated along execution platforms. To conclude that ABS, as an OTC platform, resides outside the sphere of NASD regulation is not only inconsistent with the requirements of the federal securities laws, it would also undermine one of the Commission's original goals for the TRACE system. Specifically, NASD was tasked with establishing an effective surveillance regime to bolster investor confidence in the corporate bond market.

The ability of NASD to conduct surveillance with respect to ABS transaction information is particularly important in that bond dealers may use ABS to transact the first leg of what is ultimately an OTC riskless principal transaction between a firm and its customer. Without being able to conduct surveillance with respect to both legs of such a transaction, NASD's surveillance would be greatly hindered. Relatedly, as the NYSE Proposal itself notes, ABS currently serves primarily the "small-lot" corporate bond market (*e.g.*, individuals, bank trust accounts, and small institutions).[25] Upon approval of the NYSE Proposal, NYSE

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21 Exemption Application at 21-23.

22 *Id.*

23 *Id.* at 4, 21, 22, and 28.

24 The current regulatory fragmentation in the equities and options markets has required regulators to struggle with methods of consolidating sufficient regulatory information across markets. *See generally* SRO Structure Concept Release at Section III, Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004). Without sufficient consolidated data, regulators are unable to monitor markets effectively. Indeed, the Commission has commented recently on the importance of a consolidated order audit trail in the options market and the lack of agreement on the efficacy of current systems in place for regulating inter-market order flow in the equity markets. *Id.* As noted above, if the Commission interprets the NYSE Proposal to result in an OTC facility that is subject to robust NASD regulation, regulatory fragmentation concerns would be addressed.

envisions ABS being used more by large bond dealers to offset "tail-end" bond positions acquired in the course of large lot trading.[26] Thus, the potential exists for the development of a two tiered bond market in which retail investor trades are executed at one set of prices on ABS, while dealers buy and sell in block sizes at different prices in the OTC market. NASD asserts that these prices should be deemed to be components of a single OTC market and that transactions underlying these prices should be regulated on a consolidated basis by NASD. To the extent NYSE's ABS proved to be an effective platform for the execution of small bond orders and even for large dealers to dispose of "tail-end" bond positions, dealers could potentially benefit from having an additional execution venue alternative. However, to regulate the OTC bond market effectively, NASD must have access to consolidated data.[27]

IV. NASD Must Oversee ABS to Prevent the Development of Harmful Information Fragmentation

While NASD supports the development of platforms to make trading of corporate bonds more efficient, the NYSE Proposal also presents potential information fragmentation concerns that could undermine the progress made by NASD with respect to corporate bond market transparency. By promulgating Section 11A of the Exchange Act,[28] Congress signaled its belief in the importance of consolidated market data and its being made available to brokers, dealers, and investors. In support of this principle, the Commission directed NASD to, among other things, develop TRACE as a system for the collection and dissemination of corporate bond transaction data.[29] As described above, NASD, through TRACE, has made significant strides in enhancing corporate bond market transparency by developing a consolidated system for uniform trade reporting and dissemination of corporate bond transaction information and increasing investor awareness of the bond market generally.[30]

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25 Exemption Application at 23.

26 *Id.*

27 While the concept of consolidated data typically involves the dissemination of market data by multiple competing markets, in this case, NASD emphasizes the true nature of the proposed ABS as an OTC facility (and not a separate competing market). Thus, NASD's need for consolidated data is even more pronounced in that its ability to "see the full picture" of the OTC market alone (and not even including other markets) would be compromised, if ABS is not regulated as an OTC facility.

28 15 U.S.C. 78*o*-3.

29 *See* Exchange Act Release No. 42201 (December 3, 1999), 64 FR 69305 (December 10, 1999).

30 NASD has published bond market educational material that is publicly available on the NASD's website at www.nasd.com and makes TRACE transaction data publicly available at no cost to non-professionals and professionals for non-commercial purposes at www.nasdbondinfo.com. In addition,

If significant corporate bond transaction data is disseminated by the NYSE, investors will be confronted with two unconsolidated corporate bond "tapes." Because of these separate "tapes," investors, particularly retail investors, may make corporate bond investment decisions based upon incomplete or inconsistent corporate bond pricing information. While larger market participants would likely purchase a montage of TRACE and ABS data feeds from market data vendors (or create their own montages), smaller firms and retail investors may not have access to consolidated data. Ultimately, this could undermine the Commission's original goal of increasing transparency in the corporate bond market. Thus, in response to the Commission's question in the Exemption Application as to whether the NYSE Proposal would increase transparency, NASD believes that it could diminish transparency in that investors would find themselves having to make investment decisions with incomplete pricing information. NASD regulatory oversight of ABS and the inclusion of ABS transaction data in the TRACE data stream would address this important investor protection concern.

NASD concurs with NYSE's assertion that "price transparency in the U.S. capital markets is fundamental to promoting the fairness and efficiency of our markets."[31] However, NASD believes that investors can only fully benefit from price transparency if they can consider consolidated data - a sentiment that the Commission signaled its support for in the 1970s by adopting equity data consolidation rules pursuant to Section 11A of the Exchange Act.[32] Without effective information consolidation, the separate TRACE and ABS corporate bond "tapes" could be the foundation for separate retail and institutional corporate bond markets. As with regulatory fragmentation, NASD believes that potential inter-market information fragmentation concerns need not arise with respect to the NYSE Proposal provided there is the appropriate recognition of ABS as an OTC facility for corporate bond trading that is essentially the same as other established OTC bond ATS and inter-dealer trading platforms.[33]

NASD produces TRACE aggregate market information, including market breadth and most actives, which is published on the NASD website, NYT.com, WSJ.com, Barrons.com and in the New York Times.

31 Exemption Application at 3.

32 15 U.S.C. 78k-1.

33 It is also worth noting that, in not accounting for the existence of TRACE and the NASD's corporate bond regulatory program, certain operational aspects of the NYSE Proposal further highlight information fragmentation issues. For example, the NYSE Proposal would only permit the trading of unlisted bonds on the ABS with an outstanding market value or principal amount of $10 million and trading would be suspended in those bonds that have a market value or principal amount outstanding of less than $1 million. *See* proposed NYSE Rule 1401. It is not clear from the NYSE Proposal whether

V. ***Conclusion***

NASD appreciates the opportunity to express these concerns and looks forward to working with the Commission to address the issues discussed. If you have any questions regarding the NASD's concerns, please feel free to contact Elliot Levine, Chief Counsel, Senior Advisor, Transparency Services, at 202-728-8405.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President and
Corporate Secretary

cc: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Annette L. Nazareth
Allen L. Beller, Director, Division of Corporation Finance
Robert L.D. Colby, Deputy Director, Division of Market Regulation

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market value in this case would be based on last sale trade reports generated by TRACE or only based upon trades effected through ABS. Such data inconsistencies may confuse investors and market participants and ultimately undercut the Commission's goal of enhancing bond market transparency.