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June 19, 2006

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1506

Re: NASD Notice to Members 06-22 – Proposed Rule Change to Publicly Disseminate Buy/Sell and Customer/Dealer Information in TRACE

Dear Ms. Sweeney:

The Asset Managers Division ("AMD")[1] of The Bond Market Association appreciates the opportunity to comment on the above-referenced proposal (the "Proposal") submitted by the National Association of Securities Dealers, Inc. (the "NASD") for TRACE to disseminate whether a reporting dealer's counterparty is a customer or a dealer ("Customer/Dealer") and whether a transaction is a buy or a sell ("Buy/Sell"). We commend the NASD for its desire to increase price transparency and disseminate pricing data in the debt securities markets. However, the current Proposal would not facilitate price transparency, but rather would result in trade transparency, which would have detrimental consequences for investors. Further, the dissemination of information requested by the Proposal is unnecessary to achieve the laudable goals of the Proposal.

The AMD therefore urges that the Proposal not be adopted, or, at a minimum, that the Proposal not be submitted to the Securities and Exchange Commission (the "SEC") until more empirical data on TRACE has been released and analyzed and market participants have had the opportunity to work with the NASD to address its concerns in a manner that would not adversely impact investors. The NASD has expressed an intention to distribute a Notice to Members soliciting comments on the distribution of previously undisseminated historical TRACE data. Access to this information will permit market participants and

[1] The AMD is a division of The Bond Market Association, a trade association that represents approximately 200 securities firms, banks and asset managers that underwrite, trade and invest in fixed-income securities in the United States and in international markets. The AMD represents more than 20 firms with $8 trillion under management. Fixed income securities include U.S. government and federal agency securities, municipal bonds, corporate bonds, mortgage-backed and asset-backed securities, money market instruments and funding instruments such as repurchase agreements. More information about the AMD, and other divisions and activities of The Bond Market Association is available on its website www.bondmarkets.com.

others to more closely analyze the impact of TRACE on the marketplace and to better address any NASD concerns.

The Proposal, if adopted, would negatively affect the ability of investors to obtain optimal prices on their securities transactions. Dissemination of Customer/Dealer and Buy/Sell information would make it more difficult for investors to accumulate or dispose of positions without moving the market. It would permit market participants to discern the trading intent of others and consequently trade in a manner that is harmful to the interests of the investor whose trade was reported. Thus, it would increase costs to investors and would potentially reduce liquidity. In this regard, the dissemination of additional information as proposed would be an intrusion into the trading strategies of investors, rather than a disclosure that will facilitate price discovery.

In addition to negatively impacting market participants, the Proposal provides unnecessary information. The information currently disseminated through TRACE is sufficient for investors to assess whether they are receiving fair prices from dealers, without resulting in adverse trade transparency. Further, dealers do not require such information to meet their obligations under the NASD's fair pricing rules—namely, Rule 2320 (best execution) and Rule 2440 (mark-ups/mark-downs)—or related federal securities laws.

Moreover, trade reporting protocols for municipal bonds should not be applied to corporate bonds; the corporate bond market is sufficiently distinct from the municipal bond market that such protocols hinder rather than help corporate bond dealers and their customers. We also note that dealers active in the equities markets are not subject to the kind of disclosure requirements that would be mandated by the Proposal.

I. Dissemination of Buy/Sell and Customer/Dealer Information Would Reveal Investor Trading Strategies and Result in Increased Costs to Investors

The NASD does not need to implement the Proposal to further its audit and surveillance functions; the NASD already receives this information from TRACE. To the extent that the NASD believes Buy/Sell and Customer/Dealer information is helpful in determining whether dealers have complied with their fair pricing and best execution obligations, the NASD has access to such information. As such, the Proposal should be effected only to the extent that investors and dealers determine there is a need for it. The NASD contends that dealers and investors need Buy/Sell and Customer/Dealer information to compare prices, and that investors need it to request better prices. However, disseminating such information would increase the costs of trading for investors, decrease liquidity and result in worse prices for investors.

A. Description of Trading Activity

The trading activity of institutional customers, such as banks, insurance companies, hedge funds and institutional investment advisers, constitutes a significant portion of the trading volume in TRACE-eligible securities.[2] Institutional investors often seek to buy or sell large blocks of bonds and rely on dealers to facilitate trading in these blocks. At times, a dealer may facilitate an investor's trading by finding the other side of the trade and acting as a riskless principal. At other times, a dealer may facilitate the customer's trade by taking the other side itself, *i.e.*, taking a risk position. The dealer may choose to hold the position, or seek to lay it off over some period of time, ranging from minutes to weeks. In addition to taking long positions to facilitate customer sales, dealers will often take short positions by selling bonds to facilitate customers' purchases. In this situation, dealers take on considerable risk because they are then required to buy the bonds to cover the short position.

The ability of investors to execute trades without signaling their activities to the market is essential to induce dealers to commit capital to facilitate trades and integral in enabling customers to obtain optimal prices. As the market is driven by supply and demand, sellers (who introduce supply into the market) and buyers (who introduce demand into the market) risk affecting the price of securities against their own positions while seeking to trade blocks of bonds. Therefore, a buyer seeks to avoid moving the market up when purchasing bonds and a seller seeks to avoid moving the market down when selling bonds. An important technique that we and other investors use to mitigate the risk that their trading activity itself may move the market against them is to trade portions of a large position over time and to allocate the sale of bonds amongst a number of different dealers. Thus, we and other investors typically request quotes from each dealer only for a portion of their total trading interest, and dealers often seek to discreetly implement these trading decisions.[3]

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[2] Retail trade volume, or trades of 100 bonds or less, is a small percentage of total corporate trade volume. The NASD has stated publicly that a significant percentage of the number of trades reported to TRACE is retail size trades. Robert Glauber, Chairman and CEO, NASD, Speech at the NASAA Enforcement Conference (Jan. 9, 2005). However, the NASD has not to our knowledge disclosed the percentage of the dollar volume of securities traded which is in round-lots of 1,000 bonds or more or the proportion of the volume that is in large blocks (10,000 bonds or more). The Association estimates that institutional size trades comprise 98 percent of the overall dollar volume in corporate bonds.

[3] The effect of supply and demand on the trading of a particular bond is more pronounced for bonds with relatively lower credit ratings. Investment grade bonds tend to trade on a spread to treasury securities, are more sensitive to macro-economic factors such as changes to prevailing interest rates, and are less sensitive, on a relative basis, to supply-demand imbalances related to the particular bond, than are high yield or distressed bonds. High yield or distressed bonds tend to trade at a dollar price rather than spread to treasuries, are less sensitive than investment grade bonds to macro-economic factors, and are more sensitive to supply-demand imbalances related to the particular issuer.

B. Costs to Investors of Disseminating Buy/Sell, Customer/Dealer Information

The NASD's current Proposal to disseminate Buy/Sell and Customer/Dealer information would, in effect, further undermine investors' ability to trade discreetly in order to prevent the market from moving against their trading interests. Disseminating the proposed information would permit other market participants to discern the near-term future trading interest of the market participant whose trade is being reported and to take advantage of this information to the detriment of that market participant. Thus, dissemination of this information would create the opportunity for prices to be artificially ratcheted up or down as it would convey material information about market activity to participants who could then buy or sell in advance of such activity. As market participants trade on the information, prices would fall ahead of sellers and rise ahead of buyers.[4] Thus, investors would pay more for the bonds they purchase and receive less for the bonds they sell.

The adverse market movements precipitated by additional trade transparency would negatively impact both institutional and retail investors. By revealing institutional investors' trading strategies and thereby increasing the costs of conducting corporate bond transactions, the Proposal would hurt customers, including retail customers, of members of the AMD and other institutional investors. In addition, the Proposal would undermine such institutional investors' fiduciary responsibilities to their customers to maintain policies and procedures to prevent misuse of their trading strategies.

In addition, liquidity would further decrease; dealers would be more reluctant to position bonds to facilitate customer trades because of the heightened risk that the market would move against them once the trade is reported. As a result, investors would find it more difficult to reduce or increase their positions at acceptable prices. Once the dealer reports that it has purchased securities from the customer, the market would perceive an increase in supply and the market would drop, leaving the dealer's position compromised and jeopardizing the capital invested by the dealer in performing its market making role. Conversely, once the dealer reports that it has sold securities to a customer, the market would perceive a rise in demand, driving up prices. In particular, this would result in dealers being reluctant to take short positions because they would anticipate that the market would rise were they to report the sale of a bond, causing the trader's position to be compromised. To the extent dealers are willing to position bonds to facilitate investor purchases in the face of these risks, the dealers would seek to protect their capital by quoting markets at wider bid-offer spreads, leading to worse customer pricing relative to a market without such disclosure. Thus, customers would find it more difficult to have their trades executed at acceptable prices. The problem of sales at lower prices is especially acute in situations where investors are required to sell, such as in liquidation or dissolution proceedings. The decrease in liquidity and the resulting inferior pricing would further adversely impact market participants.

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[4] Other investors, recognizing the trading strategy, can seek to rapidly purchase bonds and drive up prices, or quickly sell bonds and push down prices.

Moreover, before a market participant who has identified an opportunity can fully consummate it, other participants, who would be able to discern that market participant's trading intent, would be able to effectively capitalize on that information without paying for it. In essence, this provides free access by the public to the research and investment strategies of investors. Since the technique of trading large blocks in pieces and through various dealers is well-known to market participants, information that a customer is selling or buying would signal to other market participants that more bonds are about to be sold or bought. This classic "free rider" dilemma would create disincentives among market participants to invest their resources in developing and locating opportunities, resulting in reduced trading volumes and liquidity and diminishing market efficiency.

II. Any Supposed Benefits of Dissemination of Buy/Sell and Customer/Dealer Information Do Not Outweigh the Expected Harm to Customers

The NASD points to two reasons dealers need Buy/Sell and Customer/Dealer information: to aid them in providing fair and reasonable mark-ups, and to facilitate their compliance with best execution obligations. However, dealers already have sufficient information and tools to comply with their fair pricing obligations without dissemination of information that would ultimately be harmful to investors.

NASD Rule 2440 requires dealers to trade securities with customers at fair prices. Dealers are first required to determine the prevailing market price, and are then required to compute any mark-ups (in the case of customer purchases) or mark-downs (in the case of customer sales) from that price. The institutional bond market, which includes dealers, broker's brokers, and institutional customers, is a highly negotiated market. When dealers and institutional customers negotiate trades, they each take into account information from various sources. Customers have access to quotation information from multiple dealers, and dealers may have access to information on the trading intent of multiple customers, as well as quotes from broker's brokers (which may represent the trading interests of other dealers or other dealers' customers). Market participants also have access to TRACE-disseminated information, which, while undoubtedly significant, is only one among many pieces of information available to dealers, customers, and broker's brokers when exchanging quotes and conducting price negotiations. Given that TRACE information represents only one of several information sources, it is not necessary for dealers to know Buy/Sell and Customer/Dealer information in order to accurately determine prevailing market price. In light of these other information sources, dealers and customers are adequately equipped to determine prevailing market prices from existing disseminated TRACE data without the attendant risks of harming investors and decreasing liquidity that would result from the dissemination of Buy/Sell and Customer/Dealer information.

The NASD also states that the dissemination of this additional information would permit customers to "knowledgeably assess and compare the disseminated all in price of their purchases and sales with other customer transactions." However, the TRACE information currently disseminated is sufficient for investors to achieve this goal without suffering the negative implications from the Proposal.

Although we have in the past noted that it is difficult to identify inter-dealer trades because the TRACE system does not currently differentiate between inter-dealer trades and customer trades in its disseminated reports,[5] we were not advocating the dissemination of such information; rather, we were urging the NASD to recognize that a bond dealer performing market-making functions should be able to use contemporaneous sales to institutional customers to establish a basis for determining a bond's prevailing market price. Clearly, if dealers could look to trades with customers to establish prevailing market prices on par with inter-dealer trades, there would be no need for the NASD to disseminate information distinguishing customer trades from dealer trades.

Further, in the Proposal, the NASD also posits that dealers require Buy/Sell and Customer/Dealer information to aid them in complying with their best execution obligations under Rule 2320. However, dealers do not need information about trades by other dealers to determine the prices at which securities are currently being offered. When viewed in light of the harm to customers from this Proposal, the NASD's mark-up policy and best execution rule do not provide a convincing basis for its adoption.

III. Comparison to MSRB Rule G-14 Trade Reporting Protocols Should Not Drive Trade Reporting for the Corporate Bond Markets

As the NASD points out, the Municipal Securities Rulemaking Board (the "MSRB") currently disseminates both Buy/Sell and Customer/Dealer information in real time, together with other price, quantity and yield information for transactions in municipal bonds. However, different trade reporting regimes are appropriate for different markets. The NASD needs to assess what trade information should be disseminated in the corporate debt markets based on the characteristics of that market, without reference to other markets with different characteristics. Different markets have different trade reporting and dissemination protocols, each of which may make sense for the particular market.[6] Moreover, material differences exist between the municipal bond market and the corporate bond market. First, the municipal bond market has larger retail participation than the corporate bond market[7] and municipal bonds trade less frequently than corporate bonds. With fewer large block trades, the overall risk of a particular trade moving the price against an investor's trading

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5 *See* Letter from The Bond Market Association (regarding File No. SR-NASD-2003-141), to Jonathan G. Katz, Secretary, SEC (April 5, 2005), p. 13.

6 For example, disseminated trade reports in equity markets do not contain the type of information the NASD is proposing to disseminate in the corporate bond markets.

7 For the fourth quarter of 2005, the overall average size of a municipal bond trade was approximately $225,000 whereas the average size of a corporate bond trade was $690,000, indicating that trading in the corporate bond market was dominated more by institutional size trades. Moreover, data from the Board of Governors of the Federal Reserve indicate that as of December 31, 2005 approximately 39 percent of municipal securities outstanding were held by "households"—a proxy for retail investors—compared to approximately six percent of corporate bonds outstanding held by households. See "Flow of Funds Accounts of the United States," Federal Reserve Statistical Release Z.1, March 9, 2006.

interest is significantly lower. Moreover, municipal bond dealers generally do not take short positions to facilitate customer trades, while corporate bond dealers customarily short securities.[8] Thus, the significant risk present in the corporate bond market that a dealer will sell short into a rising market simply does not exist in the municipal bond markets.

In addition, we note that such information is not disseminated in other markets, such as the equity securities market. Given the difference in trading of municipal bonds and the fact that the equity securities market has not adopted such rules, we question the reliance on the MSRB model.

IV. Conclusion

For the reasons described above, the Proposal should not be adopted, or, at a minimum should not be submitted to the SEC for comment until further information regarding TRACE has been released and analyzed and market participants have had the opportunity to work with the NASD to address its concerns in a manner that would not adversely impact investors. The additional dissemination of TRACE information as contemplated by the Proposal would impair our and other investors' ability to execute block trades without moving the market against positions. In addition, disseminating Buy/Sell and Customer/Dealer information would harm investors because dealers would be less willing to facilitate trades unless they widened bid-offer spreads to protect themselves from a market that could move against them once the trade is reported. Lastly, in addition to the Proposal's detrimental impact, the dissemination of information requested by the Proposal is unnecessary to achieve the laudable goals of the Proposal.

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We appreciate this opportunity to address the issues raised by the NASD's Proposal. If you have any questions concerning these comments, or would like to discuss these

[8] Municipal bonds are typically not sold short for several reasons. First, most municipal bonds trade infrequently. According to the TRACE, MSRB and CUSIP Service Bureau data, approximately 99,000 municipal bond CUSIPs traded during May 2005, representing only 6.2 percent of total municipal bond CUSIPs outstanding. In contrast, during the same month, about 98,000 corporate bond CUSIPs traded, which represented nearly 24% of total corporate bond CUSIPs outstanding. Thus, dealers in municipal bonds face significant risks by shorting, as they may not be able to purchase the security needed to cover the short. In addition, tax law applicable to tax-exempt securities strongly disfavors shorting. As tax benefits are a key benefit to purchasers of municipal bonds, shorting makes little economic sense. In contrast, corporate bonds are taxable and trade more frequently than municipal bonds. For instance, in 2005, approximately 97 percent of TRACE-eligible investment grade corporate bonds and approximately 98 percent of TRACE-eligible non-investment grade corporate bonds traded more than one time per year, based on information from MarketAxess for bonds with information disseminated by TRACE.

comments further, please feel free to contact Joseph Sack at 646.637.9265 or via email at jsack@bondmarkets.com.

Sincerely,

John R. Gidman
Chairman, AMD
Loomis, Sayles & Company