



Robert R. Glauber
Chairman & Chief Executive Officer

December 31, 2001

The Honorable John D. Dingell
Ranking Member
U.S. House of Representatives
The House Committee on Commerce
2328 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Dingell:

Since the last status report submitted to you last year, the National Association of Securities Dealers, Inc. ("NASD" or "Association") has continued to move forward in its effort to implement the initiative for increased transparency in the corporate bond market, as mandated by the Securities and Exchange Commission ("SEC").

OVERVIEW

In September of 1998, former SEC Chairman Levitt charged the NASD with providing increased price transparency and better surveillance of the corporate debt market through the creation of a regulatory database of corporate bonds, the development of systems necessary to surveil the corporate market, and providing a mechanism for delivering increased price discovery to the investing public. The Trade Reporting and Compliance Engine ("TRACESM") is the NASD-developed vehicle that facilitates mandatory regulatory reporting of eligible transactions to the NASD. The rules, referred to as the "TRACE Rules," will be contained in the new Rule 6200 Series. The TRACE Rules provide the following:

1) fixed income transactions that must be reported under the new TRACE Rules are those over-the-counter ("OTC") secondary market transactions involving a "TRACE-eligible security";

2) the term "TRACE-eligible security" means all United States dollar denominated debt securities that are depository-eligible securities; Investment Grade and Non-Investment Grade (as defined in the TRACE Rules); issued by United States and/or foreign private corporations; and: (1) registered with the SEC; or (2) issued pursuant to Section 4(2) of the Securities Act of 1933 (Securities Act) and purchased or sold pursuant to Rule 144A under the Securities Act;

- 3) the term “TRACE-eligible security” specifically excludes debt securities that are not depository-eligible or are in physical form; sovereign debt; development bank debt; mortgage- or asset-backed securities, collateralized mortgage obligations, and money market instruments;
- 4) exempt from reporting are transactions that are part of a primary distribution; transactions in listed debt securities that are both executed on, and reported to, a national securities exchange; and transactions in which the buyer and seller have agreed to trade at a price substantially unrelated to the current market for the debt security (e.g., to allow the seller to make a gift);
- 5) a member that is a party to a transaction involving a member and a non-member, including a customer, in a fixed income security that is a TRACE-eligible security must report the transaction to the NASD within one hour and fifteen minutes of the time of execution;
- 6) when the party on the sell side and the party on the buy side of a transaction in a TRACE-eligible security are both members, both members must report the transaction to the NASD within one hour and fifteen minutes of the time of execution;¹
- 7) the NASD will disseminate transaction information relating to transactions in the following two types of securities:
 - a) a TRACE-eligible security having an initial issuance size of \$1 billion or greater that is Investment Grade at the time of receipt of the transaction report (except those securities that are issued pursuant to Section 4(2) of the Securities Act and purchased or sold pursuant to Rule 144A under the Securities Act); and
 - b) a TRACE-eligible security that is designated as a Fixed Income Pricing SystemSM (FIPS[®]) Mandatory Bond (“FIPS 50 security”) immediately prior to the time that the FIPS rules (the current Rule 6200 Series) are rescinded; and
- 8) dissemination in the securities transactions referenced in 7 above will occur immediately after the transaction information is received by the NASD.

¹ In the NASD's status report to Congress last year, it was stated that, in the absence of mandatory comparison, firms would be asked to submit duplicate clearing information to NASD in order to assist surveillance personnel in following a complete audit trail; however, the industry overcame its initial reticence and maintained that dual-sided reporting would in fact be a less cumbersome solution to the problem of creating a complete audit trail for surveillance purposes. The Association was urged by the industry to reconsider the rules in favor of the dual reporting option and, subsequently, the rules were amended to require both sides of a transaction to be reported.

On January 23, 2001, the SEC approved the proposed NASD rules. At the time of the approval, NASD had announced that the effective date of TRACE reporting would be 180 days following the publication of the technical specifications. Since January, NASD staff has worked with the industry to design adaptations to the National Securities Clearing Corporation (“NSCC”) trade comparison processes so that firms can use these processes to also satisfy the NASD’s trade reporting requirements. The specifications for this interface were published on June 1, 2001. Based on the time necessary for firms and vendors to implement these specifications and for the NASD to finish its own development efforts, the NASD determined that, although system testing might realistically begin 180 days later, in December, actual TRACE implementation would not begin until February 4, 2002. The schedule was impacted once again on September 11, 2001. In the aftermath of the September 11, 2001 attacks upon the World Trade Center, NASD gathered information on the status of firms based in the area and on the impact of the attacks on business continuity. Responding to requests from the industry and in order to allow the industry to recover and to return to business normalcy, NASD elected to postpone the implementation date for regulatory reporting and dissemination of eligible corporate bond transactions until Monday, July 1, 2002.

BACKGROUND

The SEC approved SR-NASD-99-65, the TRACE Rules, after more than two years of industry and NASD discussion and review. The NASD received and considered many comments, and, in response to comments, made significant changes to the original proposal. With the implementation of the TRACE Rules, secondary market transactions in broad categories of registered and unregistered debt instruments will become subject to reporting for the first time. In addition, price and other transaction information for two types of debt instruments will be publicly disseminated. The scope of the regulatory changes and the schedule for implementation are described below.

Effective Date

In order for the industry to prepare for such changes, and in particular for technological changes to be made throughout the industry, the NASD has delayed the effective date and implementation of the TRACE Rules. The Association published the technical specifications on June 1, 2001. The Association is preparing to file with the Commission a schedule of proposed NASD member and non-member fees to cover the cost of regulation, connectivity to the system, ongoing maintenance of the system, and the wholesaling of the raw market data. As is customary, there will be a public comment period, with the SEC giving final approval of the proposed fees. Prior to the events of September 11, the expected effective date of the TRACE system and the TRACE Rules was to have been February 4, 2002. In the aftermath, however, NASD assessed the damage and made a determination that relief in terms of a delay was necessary. NASD based this decision upon information gathered directly from member firms and other industry sources about operations and impediments to business continuity.

Currently, many firms are faced with reorganizing personnel, second moves from multiple locations into new quarters, and reestablishing normal connectivity. As part of NASD's responsiveness to its membership, the Association determined to delay the effectiveness of the TRACE rules and the implementation date of the system until July 1, thereby allowing members to reestablish, to the extent possible, normal business operations prior to the implementation of regulatory reporting.

Testing Schedule

NASD member firms had been requested to contact the NASD by November 1, 2001, to arrange for system testing, with the testing window opening officially on December 3, 2001. In light of the events of September 11, as firms become ready to begin testing, they will be able to schedule testing slots with NASD from February through June of next year. NASD will attempt to facilitate earlier testing during for those firms that are ready at a sooner date.

DISCUSSION

The TRACE Rules have three main components that: (1) identify those fixed income securities transactions that are required to be reported; (2) detail the reporting requirements; and (3) identify those fixed income securities transactions that are subject to dissemination.

TRACE-Eligible Securities

If a fixed income security is a TRACE-eligible security, generally transactions in such securities to which a member is a party must be reported to the NASD. Most corporate debt securities fall within the definition of a TRACE-eligible security. Specifically, "TRACE-eligible security" means all United States dollar denominated debt securities that are depository-eligible securities under Rule 11310(d); Investment Grade and Non-Investment Grade (as defined in TRACE Rule 6210(h) and (i), respectively); issued by United States and/or foreign private corporations; and: (1) registered with the SEC; or (2) issued pursuant to Section 4(2) of the Securities Act and purchased or sold pursuant to Rule 144A under the Securities Act. Specifically excluded from the term TRACE-eligible security are sovereign debt; development bank debt; mortgage- or asset-backed securities; collateralized mortgage obligations, money market instruments, and debt securities that are not depository-eligible or are in physical form. The term TRACE-eligible security also does not include municipal securities. Rather, municipal securities are subject to reporting under the rules of the Municipal Securities Rulemaking Board. The TRACE Rules do apply to those Non-Investment Grade (as defined in the TRACE Rules) securities that are currently designated as FIPS securities or FIPS 50 securities. A security that is designated as a "PORTAL security" under the Rule 5300 Series that is a fixed income security, is sold in a private placement under Section 4(2) of the Securities Act, and is eligible for resale under Rule 144A, is a TRACE-eligible security.

Exempt Transactions

Exempt from reporting are transactions that are part of a primary distribution; transactions in listed debt securities that are both executed on, and reported to, a national securities exchange; and transactions in which the buyer and seller have agreed to trade at a price substantially unrelated to the current market for the debt security (e.g., to allow the seller to make a gift).

Reporting Requirements

A transaction in a TRACE-eligible security must be reported to the NASD by an NASD member within one hour and fifteen minutes of the time of execution. The NASD will be requesting that the SEC grant an additional fifteen minutes to the original one-hour time frame already approved, in order to accommodate firms that may choose to report through a newly developed interface between NSCC and NASD. Due to the multi-batch nature of NSCC's current processing system, lag is introduced between the time firms submit their trades into NSCC and the receipt of those trades by the NASD. It was determined that an additional 15 minutes should be added to the one hour reporting requirement to allow for this issue. Once DTCC implements their real-time trade matching system (RTTM), this lag will be eliminated.

When two members are the parties to the transaction, both the member representing the sell side and the member representing the buy side must report the transaction. When a member is a party to a transaction involving a non-member, including a customer, the member must submit the transaction report. Each transaction report must include: (1) the security's CUSIP number or NASD symbol; (2) the number of bonds; (3) the price or the elements necessary to calculate the price, which are contract amount and accrued interest; (4) a symbol indicating whether the transaction is a buy or sell; (5) the date of trade execution ("as of" trades only); (6) the contra-party identifier; (7) the capacity—principal or agent; (8) the time of trade execution; (9) reporting side executing broker as "give-up" (if any); (10) contra side Introducing Broker in case of "give-up" (if any); (11) stated commission; (12) such trade modifiers as required by the TRACE Rules or the TRACE users guide; and (13) the lower of yield to call or yield to maturity, unless yield cannot be calculated because of variables.

Reporting Mechanisms

Members will be able to choose from among several different mechanisms in order to meet their reporting obligations. First, members may report directly through a computer-to-computer interface (CTCI). This method requires a dedicated line using the TCP/IP network protocol. It will be possible to send TRACE CTCI messages over an existing line that a member firm may use at this time to communicate with various Nasdaq reporting systems.

Second, members may report manually through a secure Web-based application that the NASD will provide. The Web application will be supported under Windows

95/98/NT/2000, and Sun Solaris 2.61. Web browsers that will be supported include Microsoft Internet Explorer 4.01SP1 for Windows and Sun, and Netscape Navigator Windows version 4.6 and above, or Sun version 4.0 or higher.

Third, vendors and service bureaus will be able to provide a reporting service for their clients by developing a CTCI interface and reporting on behalf of their clients.

Finally, as previously mentioned, the NASD and the National Securities Clearing Corp. ("NSCC") have agreed that members may forward transaction reports to the NSCC, which will forward them to the NASD. NSCC and NASD have developed a set of transaction layouts that build upon the layouts used by NSCC for Street-side transactions and upon the customer layouts used by the MSRB for municipal customer transaction reporting. The NSCC interface will allow members to transmit initial transaction reports for T-date and "as of" transactions; however, cancellations and corrections must be reported through the NASD Web browser. The NSCC interface will also support regulatory reporting for those transactions not clearing/settling through NSCC (e.g., cash trades).

Dissemination

The TRACE Rules provide that the Association will disseminate transaction information relating to transactions in two types of securities: (1) a TRACE-eligible security having an initial issuance size of \$1 billion or greater that is Investment Grade at the time of receipt of the transaction report (except those securities that are issued pursuant to Section 4(2) of the Securities Act and purchased or sold pursuant to Rule 144A under the Securities Act); and (2) a TRACE-eligible security that is designated a FIPS Mandatory Bond immediately prior to the rescission of the FIPS rules.

Not all of the information that is reported will be disseminated. For each transaction, the NASD will disseminate, or supply to vendors to disseminate, the following information: (a) the NASD symbol for the fixed income security; (b) the CUSIP; (c) the date and time of trade execution; (d) price; (e) yield; and (f) quantity of bonds, subject to the following limitations. For a TRACE-eligible security having an initial issuance size of \$1 billion or greater that is Investment Grade as referenced above, the actual quantity of the transaction (the total par value of the bonds purchased or sold) will be disseminated if the total par value of the reported transaction is \$5 million or less; if the reported amount is greater than \$5 million, a large volume trade dissemination cap identifier of "5MM+" will be disseminated instead of the actual quantity. For a TRACE-eligible security that is designated as a FIPS Mandatory Bond as referenced above, the actual quantity of the transaction will be disseminated if the total par value of the reported transaction is \$1 million or less; if the reported amount is greater than \$1 million, a large volume trade dissemination cap identifier of "1MM+" will be disseminated instead of the actual quantity.

For each security, the highest price of the day, the lowest price of the day, and the “last sale” price of the day will be flagged with indicators for dissemination, when applicable. Certain modifiers may also be part of the information disseminated.

Immediately upon receipt of transaction reports between 8:00 a.m. and 6:30 p.m., Eastern Time, the Association will disseminate the transaction information. (Reports received earlier or later than the times set forth above are also subject to dissemination as set forth in greater detail in TRACE Rule 6250(c) and (d)).

The Association expects that more fixed income securities transactions will become subject to dissemination in the future. In order to expand the classes and types of fixed income securities that would become subject to dissemination, the Association will work with the Bond Transaction Reporting Committee (BTRC), a special committee of the NASD that will be formed to analyze the effect that the dissemination of price and other information in certain TRACE-eligible securities transactions has upon the liquidity of those markets. An eight member panel of industry experts, four recommended by the NASD and four by The Bond Market Association, was approved by the NASD Board of Governors at the end of July. Since that time, TBMA has requested adding one additional person; consequently, NASD will also submit for approval one additional person to the Board, so that the final number of panel members will be ten instead of eight. Based in part on the BTRC’s recommendations, the Association will determine a schedule for the dissemination of additional TRACE-eligible debt securities.

Announcement Of Technical Specifications

The NASD has published on the NASDR web site, www.nasdr.com/trace.htm, the technical specifications that members will need in order to make the technical changes required for members to comply with the TRACE Rules. In addition, the technical specifications may be made available through other media.

FIPS Rules Rescission

When the TRACE Rules take effect, the FIPS rules, which are currently set forth in the Rule 6200 Series, will be rescinded. There are 50 securities, called the FIPS Mandatory Bonds or FIPS 50 securities, for which aggregate price information is available currently. When the FIPS rules are rescinded, as noted above, transaction information in those 50 securities will be subject to dissemination under the new TRACE Rules. As a result, pricing information for the FIPS Mandatory Bonds will continue to be available following the implementation of TRACE. However, under TRACE the information disseminated will be transaction specific and will be updated continuously. In order to continue dissemination of transaction information in Non-Investment Grade debt securities, the Association expects to propose amendments to the TRACE Rules, which will allow the Association to continue designating up to 50 Non-Investment Grade debt securities for dissemination, using standards that parallel the standards now set forth in the FIPS Rules for the designation of the FIPS Mandatory Bonds (also known as the FIPS 50 securities).

CONCLUSION

The NASD's principal goal in developing TRACE is to meet the mandate of the SEC to provide greater transparency to investors and to enhance the NASD's regulatory oversight of corporate bond trading. The NASD believes it has continued to respond in a flexible and proactive manner to various industry concerns regarding TRACE.

I would again personally like to thank you, your staff, and the other members of the Committee for the continued effort to better inform and protect the investing public and all market participants. If I can be of further assistance, please do not hesitate to call.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert R. Glauber". The signature is fluid and cursive, with a large initial "R" and "G".

Robert R. Glauber

cc: The Honorable W. J. "Billy" Tauzin, Chairman
Committee on Energy and Commerce

The Honorable Michael G. Oxley, Chairman
Committee on Financial Services

The Honorable John J. LaFalce, Ranking Member
Committee on Financial Services

The Honorable Harvey L. Pitt, Chairman
Securities and Exchange Commission