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Chairman and Chief Executive Officer

December 16, 2002



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

Dear Congressman Dingell:

In this, the fourth annual status report called for by your committee on the progress of the corporate bond transparency initiative mandated by the Securities and Exchange Commission ("SEC"), NASD is pleased to report that the Trade Reporting and Compliance Engine, referred to as TRACE, was implemented on July 1, 2002. At 8:00 a.m. on July 1, 2002, TRACE began capturing and disseminating corporate bond transaction information.

BACKGROUND

In September 1998, former U. S. Securities and Exchange Commission ("SEC") Chairman Arthur Levitt requested NASD to provide increased price transparency in and better surveillance of the corporate debt market by (i) requiring that NASD members report corporate bond transactions to NASD; (ii) developing a system or systems to surveil the corporate debt market, including an audit trail of reported transactions; and (iii) delivering price and other transaction information to large and small investors and other debt market participants.

As noted in the NASD 2001 Report to the Committee, the SEC approved the TRACE Rules on January 23, 2001, and NASD planned to start receiving and disseminating information on February 4, 2002. When NASD assessed industry readiness for TRACE after September 11, 2001, NASD delayed implementation until July 1, 2002. This delay allowed firms to recover from September 11 and return to more normal business operations before TRACE started. During the course of the year, additional modifications and refinements were made to the TRACE Rules. The final SEC approval of such amended TRACE Rules occurred on June 28, 2002.¹ Upon approval, NASD immediately published the final TRACE Rules on the TRACE Web page on the same day for the benefit of members. Less than 72 hours later, on July 1, 2002, TRACE was implemented as planned.

DISCUSSION

In order for TRACE to begin successfully, NASD and the industry were engaged in completing a number of operational and developmental steps from November 2001 to July 2002. Some of the more important regulatory and operational issues addressed during this period are described below.

¹ Securities Exchange Act Rel. No. 46144 (June 28, 2002), 67 Fed. Reg. 44907 (July 5, 2002) (File No. SR-NASD-2002-46).

Development of Several Alternatives for Reporting. Initially, NASD resolved to provide members a variety of choices for accessing TRACE. During the final months preceding implementation, NASD worked to finalize the requirements and specifications for each of the reporting options being offered. Members had substantial flexibility in accessing TRACE, and could choose from among the several reporting mechanisms listed below, allowing members to report either directly to NASD or indirectly, through a third party provider. The reporting options are: (1) a computer-to-computer interface (CTCI), which some members previously had installed for purposes of accessing various NASDAQ systems and which may be used for multiple functions or a single function; (2) a secure NASD web browser, a manual reporting method; (3) a vendor or a service bureau; or, (4) the National Securities Clearing Corporation (“NSCC”).² NASD’s development of the range of reporting options allowed members substantial flexibility in identifying the best method of reporting for the firm, based upon the member’s size, current systems capabilities, and volume of trading in corporate debt securities.

Verification of Readiness by Testing. The industry-wide testing initially scheduled for the fall of 2001 was deferred after September 11, 2001. However, beginning in December 2001, NASD was able to begin beta testing for a defined user group that was ready to access the test site. Generally, members were provided flexibility to test their operations and systems at any time from February 2002 through June of 2002. Members were scheduled for testing as soon as they executed participation agreements. At member request, NASD sponsored additional weekend test sessions as July 1, 2002 approached. All members that submitted the appropriate documentation were able to engage in testing prior to July 1, 2002.

Member Education. With the advent of the new regulatory reporting system, NASD undertook an extensive education campaign to make the industry aware of TRACE reporting. NASD issued press releases, a Notice To Members, industry mailings, and made extensive use of the NASD web site. NASD conducted two road shows in New York, one in Chicago, and one in San Francisco. Industry phone-in workshops were held in each of the four weeks preceding startup. TRACEfeedback@nasd.com was set up as a feedback hotline, which has received and responded to well over 1,000 e-mails over the last year. A toll-free hot line was set up to help firms complete required documentation and assist them with reporting and eligibility questions. This toll-free number is still available to anyone with questions about TRACE. Whenever possible, TRACE information is made available online, directly at www.nasd.com/trace and also under the “Market Systems” section of the NASD web site. This is an open site where the TRACE User Guide, relevant agreements, technical specifications, Frequently Asked Questions, and updates on the rules and latest developments can be found.

Initial Phase. As of this writing, 1,881 NASD member firms have signed up for TRACE reporting. Although NASD has 5,448 members, many members neither underwrite nor engage in the trading of corporate debt securities and therefore have no regulatory obligations under TRACE.

The TRACE-reportable universe currently consists of over 24,600 corporate debt issues. Reporting is required when a transaction occurs in any of these 24,600 securities. Dissemination occurs for 536 of these corporate debt issues. 469 of the bonds disseminated are the largest, very

² Efforts to develop NSCC as a method of reporting to TRACE began relatively late in the development of TRACE. However, NASD and NSCC worked cooperatively to develop this option, which provided reduced industry costs and additional efficiencies. Members could begin developing or modifying their systems to use this method as of June 1, 2001.

liquid Investment Grade bonds, and 50 are Non-Investment Grade bonds transferred from the former high yield trade reporting and quotation system, the Fixed Income Pricing System (FIPS), that has now been dismantled. Although limited in number, the bonds currently subject to dissemination represent, for TRACE-eligible Investment Grade debt, approximately 51% of daily Investment Grade volume and 40% of the daily transactions and, for TRACE-eligible Non-Investment Grade debt, 10% of daily volume and 11% of daily transactions being disseminated to the public and market participants.³

NASD charges fees for real-time receipt of the disseminated data to professionals, and provides the data, on a delayed basis, to the public free of charge.⁴ It is expected that the NASD Board of Governors and the SEC will approve additional securities for dissemination, on an incremental basis. More transaction data is expected to be made public during the first quarter of 2003 and periodically after that, as more is known about the relationship between increased price disclosure and impact upon liquidity.

TRACE Regulatory Structure. NASD member firms are currently reporting to TRACE under the rules described below.

TRACE-Eligible Securities. Under the Rules, if a fixed income security is a TRACE-eligible security, generally, over-the-counter, secondary market transactions in such securities to which a member is a party must be reported to 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; 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 and purchased or sold pursuant to Rule 144A under the Securities Act⁵. Specifically excluded from the term "TRACE-eligible security" are debt instruments of government-sponsored entities (including sovereign, provincial, and development bank debt); mortgage- or asset-backed securities; collateralized mortgage obligations, money market instruments (defined as corporate debt that at issuance has an original maturity of one year or less), and debt securities that are not DTCC-eligible or are in physical form. The TRACE Rules do apply to those Non-Investment Grade securities that were formerly designated as FIPS securities.

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.

³ Dissemination statistics are based upon a sample of issues reported to TRACE that have traded at least once between July 8, 2002 and August 23, 2002. Under the TRACE Rules, "Investment Grade" means "any TRACE-eligible security rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories." Rule 6210 (h). "Non-Investment Grade" means "any TRACE-eligible security that is unrated, nonrated, split-rated (where one rating falls below Investment Grade), or otherwise does not meet the definition of Investment Grade in paragraph (h)." Rule 6210(i).

⁴ All TRACE-related fees, including reporting fees and market data fees were approved June 28, 2002, by the SEC on a pilot basis (Securities Exchange Act Rel. No. 46145 (June 28, 2002); 67 Fed. Reg. 44911 (July 5, 2002) (File No. SR-NASD-2002-63) pending availability of hard revenue figures; the pilot program is scheduled to expire December 28, 2002.

⁵ 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, may also qualify as a TRACE-eligible security.

Reporting Requirements. All member firms are required to report secondary market transactions in eligible securities, executed over-the-counter, to the TRACE system within one hour and fifteen minutes (75 minutes) of the time of execution, during TRACE hours of operation, which are 8:00 a.m. Eastern Time through 6:29:59 p.m. Eastern Time.⁶ Specific trade reporting obligations are defined in order to take into account global trading and can accommodate transactions occurring 24-hour/7-days a week, including holidays.

In TRACE, all members have equal obligations to report to TRACE, whether they are introducing broker-dealers, clearing broker-dealers, or acting as inter-dealer brokers (brokers' brokers). In transactions between two members, both members submit a trade report. In transactions involving a member and a non-member, including a customer, the member must submit a trade report. Dual-side reporting creates an end-to-end audit trail for use by surveillance personnel.

Each transaction report must include (1) the CUSIP number or NASD symbol; (2) the number of bonds; (3) the price, inclusive of mark-up (or the elements necessary to calculate price, which are contract amount and accrued interest); (4) a symbol indicating whether the transaction is a buy or a sell; (5) the date of execution (if an as/of trade); (6) the contra-party's participant identifier; (7) the capacity, either Principal or Agent; (8) the time of execution; (9) the reporting side executing broker as "give-up" (if any); (10) the contra side introducing broker in case of a "give-up" trade; (11) the commission (if an agency trade); (12) such trade modifiers as required either by the TRACE Rules or the TRACE users guide; and (13) the lower of yield to call or maturity, unless yield cannot be calculated due to unknown variables or if the determination is made that reporting yield would provide inaccurate or misleading information.

Dissemination. In this, the initial phase of TRACE, TRACE Rule 6250 provides that NASD will disseminate transaction information for 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 (excluding those securities that are purchased and sold pursuant to Rule 144A of the Securities Act); and (2) 50 actively traded Non-Investment Grade TRACE-eligible securities designated by NASD staff based upon volume, price, name recognition, research following, minimum number of bonds outstanding, minimum number of dealers trading the issue, and industry diversity. As noted above, under these two categories, dissemination occurs for 519 bonds at the time of this writing.

For each transaction, NASD disseminates, or supplies 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, the actual quantity of the transaction (the total par value of the bonds purchased or sold) is 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+" is disseminated instead of the actual quantity. For a Non-Investment Grade TRACE-eligible security, the actual quantity of the transaction is disseminated if the total par

⁶ NASD proposed to extend the original reporting time from one hour to one hour and fifteen minutes in order to allow member firms to both report and clear transactions with a single submission to NSCC, which currently runs in batch cycles rather than in real time. In response to industry concerns and until the technology can support a shorter trade reporting time frame, the SEC granted the request to extend the reporting window by 15 minutes. (File No. SR-NASD-2002-46). It is expected that the time frame to reporting will be significantly compressed when technology can uniformly support the change.

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+" is disseminated instead of the actual quantity. The highest and lowest price of the day and the last sale price are also disseminated. NASD disseminates the information immediately upon receipt.

Public Web Site Dissemination. The public TRACE site, www.nasdbondinfo.com became operational on Friday, July 5, 2002. Disseminated data is delayed by four hours and is available to anyone at no charge. Users can see 90 days of transaction history, 90 days' daily high/low price, and by next July will be able to see a full 52 weeks of weekly high/low prices. The public site also has a feedback mailbox, BONDINFOfeedback@nasd.com, so that private investors may ask questions about the system and about bonds in general. The public site is a work in progress, and NASD plans to provide a general education piece on corporate bonds, as just one feature.

Future Dissemination. The Bond Transaction Reporting Committee ("BTRC") was formed in 2001 for the purpose of making recommendations to the NASD Board on how to increase dissemination and transparency in the bond markets. NASD has been working with the BTRC to develop parameters and timeframes for expanding the universe of bonds subject to dissemination. The BTRC is tasked with analyzing the effect that the dissemination of price and other information in certain TRACE-eligible securities transactions has upon the liquidity of those markets. The BTRC is comprised of ten members, all industry experts, five recommended by NASD staff and five by The Bond Market Association to the NASD Board for participation in this advisory committee. The BTRC met in January, April, August, and three times during the month of September, once in October, and twice in November in order to formulate a proposal for submission to the NASD Board of Governors on parameters and timetables for dissemination of additional groups of bonds. Further, the Committee is identifying liquidity studies it would like NASD to commission involving independent economists.

NASD's Board of Governors approved the BTRC recommendations at its November meeting, and will, accordingly, submit rules for the next phase of dissemination to the SEC very shortly. This group is expected to include transactions in all investment grade bonds of \$100 million or more original issue size that are rated at least A3/A-. In addition, NASD will also disseminate transaction information on 90 bonds rated "triple-B" that will serve as test bonds for this debt quality in the liquidity studies. The 90 bonds will represent the spectrum of "triple-B"-rated bonds, with 30 securities rated Baa1/BBB+, the highest "triple-B" rating; a second group of 30 securities rated Baa2/BBB, representing the mid-range in quality; and a third group of 30 securities rated Baa3/BBB-, representing the lowest "triple-B" rating. If approved by the SEC, it is expected that price disclosure for the next group of bonds will occur during the first quarter of 2003 and that the number of bonds subject to transparency will then total over 4,000 issues.

CONCLUSION

NASD is pleased to have met its goal of delivering the TRACE initiative on July 1, especially given the challenges facing the industry at this point in history. Further, the transparency initiative has been implemented during a period of internal restructuring at NASD, which has refocused on and rededicated itself to the mission of becoming the world's leading private-sector regulatory services organization. It is in the spirit of this mission that the TRACE initiative will continue to become an increasingly important tool to monitor the corporate debt market, to protect all investors, and to ensure market integrity.

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 Glauert". The signature is fluid and cursive, with a long horizontal stroke at the end.

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