



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 30, 2003

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
2322 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515-6115


Dear Congressman Dingell:

In September 1998, you asked the Commission to provide you with annual progress reports, through the year 2003, on SEC and industry initiatives to improve corporate bond transparency. Today, I am pleased to provide this sixth and final annual report, prepared by the Division of Market Regulation.

The report notes that, during the past year, the NASD's TRACE initiative for reporting and disseminating last sale information on corporate bonds was significantly enhanced and expanded. Specifically, the NASD increased the number of bonds subject to dissemination and reduced required time frames for reporting bond transactions. I believe the enhancement and expansion of TRACE will greatly improve the transparency of the corporate bond market and improve the ability of the NASD to conduct surveillance of this important market. In addition, the report notes that the number of alternative trading systems that trade debt securities has decreased during the past year, reflecting substantial industry consolidation in this market.

Please do not hesitate to call me at (202) 942-0100 or Annette Nazareth, Director of the Division of Market Regulation, at (202) 942-0090 if we can be of further assistance.

Sincerely,


William H. Donaldson

MEMORANDUM

TO Chairman Donaldson

FROM Annette L. Nazareth, Director
Division of Market Regulation

RE: Corporate Bond Transparency

DATE: December 29, 2003

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In September 1998, Congressman John D. Dingell asked the Commission to submit annual progress reports to the House Committee on Energy and Commerce regarding corporate bond transparency. These reports, to be provided through this year, are to contain a discussion of regulatory and industry initiatives in this area to permit the Committee to determine how much progress has been made. This memorandum summarizes developments during the past year regarding the National Association of Securities Dealers, Inc.'s ("NASD") TRACE proposal and the operation of alternative trading systems under Regulation ATS under the Securities Exchange Act of 1934 ("Act").

NASD's TRACE Initiative

As we previously reported, on January 23, 2001, the Commission approved the NASD's proposal to establish the TRACE system for reporting and dissemination of last sale information on corporate bonds.¹ On July 1, 2002 TRACE commenced operations. TRACE is being implemented in phases, and has not yet been fully implemented. Currently, dealers must report trades on all eligible U.S. corporate bonds to the NASD within 45 minutes (this was reduced from 75 minutes on October 1, 2003).² Although almost all corporate bond trades are reported to the NASD, not all of that data is disseminated to market users at this time because of concerns about the effects that dissemination might have on market liquidity.

The NASD currently disseminates transaction information on (i) investment grade corporate bonds with initial issuance size of \$1 billion or greater, (ii) investment grade corporate bonds rated "A3" or higher by Moody's Investors Service, Inc., and "A-" or

Securities Exchange Act Release No. 43873 (January 23, 2001), 66 FR 8131 (January 29, 2001 ("Approval Order")).

² The majority of trades are reported automatically within a few seconds after execution. NASD allows up to 45 minutes to accommodate some dealers (mostly small) that wish to report for both regulatory and clearing purposes through a facility operated by the National Securities Clearing Corporation.

higher by Standard & Poor's, a division of McGraw Hill Co., Inc., with initial issuance size of \$100 million or greater, (iii) 120 bonds designated by the NASD that are rated "Baa/BBB" at the time of designation (this was expanded from 90 securities on March 25, 2003), and (iv) approximately 50 high-yield debt securities.

The data currently disseminated through TRACE includes transaction information on more than 4,200 securities representing about 75 percent of the dollar value of trading activity in investment grade bonds. The NASD makes this information available at no cost to investors (on a delayed basis with a minimum four-hour time lag) on its website at www.nasdbondinfo.com. Real-time price data is available from several third-party data vendors at additional cost.

TRACE is expected to further improve price transparency in the corporate bond market in a subsequent phase. The NASD, after consulting with an advisory committee of industry representatives, is required to consider expanding the universe of bonds that are subject to dissemination through TRACE. The NASD and its advisory committee are currently studying the impact of real-time price reporting on trading activity in the 120 bonds designated by the NASD for dissemination that are rated "Baa/BBB". In addition, the NASD expects to reduce the reporting period to 15 minutes after the industry acquires greater experience with reporting.

We believe that dissemination of last sale data on corporate bonds through TRACE has significantly improved the transparency of the corporate bond market. In addition, because transactions data in all eligible bonds is reported to TRACE and available to the NASD for surveillance purposes, TRACE has enhanced the NASD's ability to conduct surveillance of this important market.

Finally, the National Securities Clearing Corporation ("NSCC") and the Fixed Income Clearing Corporation ("FICC") recently announced plans to support an interface to TRACE as it develops its Real Time Trade Matching ("RTTM") system for matching for municipal and corporate bonds. An interface between RTTM and TRACE will be used to pass trade data directly to the NASD for price reporting purposes in real time and will permit NASD to reduce the required reporting time from 45 minutes to 15 minutes or less.

2. Alternative Trading Systems

The number of alternative trading systems that trade debt securities has decreased from last year. Today, out of an estimated 49 alternative trading systems that operate pursuant to Regulation ATS, the staff estimates that 15 systems trade debt securities. That number represents an decrease of 22 percent relative to the 24 debt systems that the staff estimates were in operation at this time last year. The decrease in number of alternative trading systems for debt securities reflects a significant consolidation in the industry as trading firms have merged to form new entities or ceased operations entirely. In addition, the relative trading volume of these systems continues to remain low. The most successful electronic system for trading corporate bonds is a multi-dealer system

that facilitates trading in corporate bonds and makes TRACE transaction data available to its users. This system does not report on Form ATS because it does not meet the definition of “alternative trading system.”