

**MEMO# 13165**

February 14, 2001

## **SEC APPROVAL OF NASD'S "TRACE" PROPOSAL**

[13165] February 14, 2001 TO: FIXED-INCOME ADVISORY COMMITTEE No. 2-01 RE: SEC APPROVAL OF NASD'S "TRACE" PROPOSAL The Securities and Exchange Commission has issued an order approving the National Association of Securities Dealers, Inc.'s new rules to establish a corporate bond trade reporting and transaction dissemination facility and to eliminate Nasdaq's Fixed Income Pricing System ("FIPS").<sup>1</sup> As we previously reported to you, the NASD's proposal was originally issued in 19992 and subsequently amended in 20003 in response to concerns raised by numerous commenters, including the Institute.<sup>4</sup> The Commission's order approving the Amended Proposal also approves, on an accelerated basis, certain technical and clarifying amendments that are described in the order.<sup>5</sup> Implementation of the new rules will occur 180 days after the date the NASD provides its members with technical specifications. The Adopting Release is attached, and it is summarized below. Transaction Reporting and Dissemination As adopted, the new rules require NASD members to report all secondary transactions in specified U.S. corporate bonds to the NASD's Trade Reporting and Comparison Entry Service ("TRACE") within one hour of trade execution.<sup>6</sup> The Commission's order adopts 1 SEC Release No. 34-43873 (Jan. 23, 2001); 66 Fed. Reg. 8131 (Jan. 29, 2001) (the "Adopting Release"). 2 See Memorandum to Fixed-Income Advisory Committee No. 9-99, dated December 16, 1999 ("Original Proposal"). 3 See Memorandum to Fixed-Income Advisory Committee No. 13-00, dated December 8, 2000 ("Amended Proposal"). 4 See Memorandum to Fixed-Income Advisory Committee No. 3-00, dated February 11, 2000 (comment letter on the Original Proposal), and Memorandum to Fixed-Income Advisory Committee No. 16-00, dated December 22, 2000 (comment letter on the Amended Proposal). 5 Although the Commission's order grants accelerated approval of the NASD's proposed technical and clarifying amendments, it also solicits comment on them. Comments are due to the SEC on the proposed amendments by February 20, 2001. 6 "TRACE-eligible bonds" consist of: (1) U.S. dollar denominated debt securities issued by U.S. and private foreign corporations that are registered with the Commission and eligible for book-entry services at the Depository Trust Company ("DTC"); (2) Rule 144A U.S. high-yield debt securities designated as "PORTAL Debt Securities" in Nasdaq's PORTAL Market; and (3) Rule 144A investment grade debt securities eligible for book-entry services at DTC. 2several of the Amended Proposal's recommendations in this area, including the requirement that trade reports submitted to TRACE include yield information, as calculated in accordance with Rule 10b-10 under the Securities Exchange Act of 1934.<sup>7</sup> The Commission's order also adopts the Amended Proposal's modified phase-in schedule. Under the Original Proposal, TRACE reporting would have occurred in two phases. In the first phase (six-month period), submission of trade reports would have occurred within one hour after trade execution, with no public dissemination of transaction information; in the second phase, the one-hour reporting

interval would have been reduced to 15 minutes, with immediate dissemination of transaction information for all reported bonds except Rule 144A issues. The Amended Proposal's modified phase-in plan extends the six-month phase-in period to nine months, while retaining the two-phase approach. During Phase I (three-month period), NASD members will report all transactions in TRACE-eligible securities within one hour of trade execution, and immediately thereafter the NASD will disseminate transaction reports in publicly offered, investment grade corporate bonds having an initial issuance size of \$1 billion or more. Transaction reports in high-yield debt securities (i.e., "FIPS 50") will also be disseminated at the time the filing becomes effective. During Phase II (six-month period), NASD members will continue the one-hour reporting time frame, the NASD will disseminate transaction reports of all transactions in the top 50% (by dollar volume) of investment grade bonds, as determined by the NASD Board of Governors, and dissemination of transaction reports in the FIPS 50 will continue. Three months after the start of Phase II (six months after the start of TRACE reporting), the one hour reporting time period will be reduced to 15 minutes, subject to Commission approval. TRACE Ownership and Operation

In the Original Proposal, commenters expressed concerns over Nasdaq's ownership and operation of the TRACE system, particularly that it would have an exclusive franchise over the provision of trade comparison services for corporate bond trades and could profit from the sale and distribution of the data. In response to such concerns, the Amended Proposal made several modifications, which were adopted by the Commission. First, the Adopting Release confirms that the NASD, and not Nasdaq, will own and operate TRACE, including the day-to-day administration and information collection process.<sup>8 7</sup> In addition to yield information, the trade reports must also include information regarding: (1) whether the trade is a buy, sell or cross transaction; (2) CUSIP number or NASD symbol; (3) quantity; (4) price – inclusive of mark-up, mark-down and stated commission; (5) contra-party's NASD symbol (or "C" for customer); (6) date and time of trade execution; and (7) capacity, i.e., principal (with riskless principal reported as principal) or agent. <sup>8</sup> The Institute had expressed concern about the possibility of the NASD's charging excessive fees for the data it will collect and sell back to the market, and thus recommended that the Commission either include market data fees collected by TRACE in any future rulemaking in this area or follow some type of cost-based standard in evaluating and approving the fees for TRACE data. While the Commission's order does not address the issue of fees directly, the Adopting Release clarifies that before the NASD may impose any such fees it must first seek Commission approval pursuant to Section 19(b)(1) of the Exchange Act. Any such approval would be based upon a finding that such fees are reasonable and not unfairly discriminatory under the Act. Moreover, the Adopting Release also points out that Section 15A(b)(5) of the Exchange Act requires the "equitable allocation of reasonable" fees charged to any <sup>3</sup>Second, the Adopting Release confirms the NASD's intention to create a new committee, the Bond Transaction Reporting Committee ("BTRC"). The BTRC will advise the NASD Board of Governors on issues related to the operation of TRACE, including future NASD proposals to phase in dissemination and the setting of fees for dissemination of real-time TRACE data to the public. The Adopting Release also states that under the modified phase-in schedule the BTRC will review the effects on liquidity associated with disseminating fixed income transaction information, and will recommend appropriate time frames for public dissemination of smaller, less-actively traded issues. The BTRC will consist of eight members – four recommended by the staff of the NASD, and four recommended by The Bond Market Association.<sup>9</sup> Finally, the Adopting Release states that the NASD has determined not to register as an exclusive securities information processor under Section 11A of the Exchange Act. Barry E. Simmons Associate Counsel Attachment Attachment (in .pdf format) person using the facilities operated or controlled by the NASD, thus also requiring that any such fees be reasonable and not unfairly discriminatory. <sup>9</sup> The Institute

had recommended that the NASD modify this proposal to include equal “buy-side” representation on the BTRC. The Adopting Release states that the NASD and TBMA will commit to selecting a broad range of bond market participants, including public participants.

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