



**Testimony**

**of**

**Doug Shulman**

**President**

**Markets, Services and Information**

**Before the**

**United States Senate**

**Committee on**

**Banking, Housing, and Urban Affairs**

**“An Overview of the Regulation of the Bond Markets”**

**June 17, 2004**

Mr. Chairman and Members of the Committee: NASD would like to thank the committee for the invitation to submit this written statement for the record.

## **NASD**

NASD is the world's preeminent private sector securities regulator, established in 1939 under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. We regulate every broker-dealer in the United States that conducts a securities business with the public – nearly 5,400 securities firms that operate more than 92,000 branch offices and employ more than 665,000 registered representatives.

Our rules comprehensively address every aspect of the brokerage business. NASD examines broker-dealers for compliance with NASD rules, MSRB rules, and the federal securities laws – and we discipline those who fail to comply. Our market integrity and investor protection responsibilities include examination, rule writing, professional training, licensing and registration, dispute resolution, and investor education. NASD runs market transparency facilities, such as its TRACE system for corporate bonds, which provide investors with information to help them make more informed decisions. NASD monitors all of the over-the-counter markets in equity and debt securities, including trading on the NASDAQ Stock Market – which is more than 100 million orders, quotes, and trades per day. NASD has a nationwide staff of more than 2,000 and is governed by a Board of Governors comprising a majority of non-industry and public members.

### **Increased Retail Participation in the Bond Markets**

Corporate bonds have become an important retail investment vehicle as the activity level of individual investors purchasing bonds or bond funds has increased dramatically in recent years. According to data from the Federal Reserve, the percentage of household assets in corporate and foreign bonds grew 70 percent between 1995 and 1999. During this time frame, household holdings of corporate and foreign bonds eclipsed municipal bond holdings. And contrary to popular belief, newly available NASD trading statistics reveal that the bond market has substantial retail participation. In fact, approximately 65 percent of the transactions in the corporate bond market are in quantities of fewer than 100 bonds or amounts less than \$100,000 in par value. We believe this trend of increasing retail participation in corporate bonds will continue as the 'baby boomer' generation reaches retirement age and shifts portfolios into fixed income investments.

While bonds and bond funds can play an important role in portfolio diversification, neither product is entirely risk-free. Bonds and bond funds may be viewed incorrectly as – and in some cases, marketed as – risk-free alternatives to equity securities. Purchasers of bonds and bond funds often believe that their principal is safe and that they are guaranteed a particular yield on their investment. Investors may also

believe that bonds are inexpensive to purchase or sell because they may not realize that they pay a commission or other form of broker-dealer compensation – mark-ups or mark-downs – on the transaction. Moreover, the terms, conditions, risks, and rewards of bonds vary widely, and in some cases, such as high-yield bonds, the risks may be substantial.

As the activity level of individuals investing in bonds and bond funds grows, NASD is concerned that many individual investors may not fully appreciate the risks and costs associated with these products. A recent NASD survey showed that 60 percent of retail investors do not understand that, as interest rates rise, bond prices fall. Therefore, when interest rates rise, investors who decide to sell their bond fund may not recoup their full investment. In the same environment, investors who decide to sell bonds prior to a call or the maturity date also may not receive the full amount of their principal invested.

## **TRACE**

Even educated investors cannot make wise investment decisions if they cannot access important transaction information such as comparable prices for investment products, including bonds. While investors are accustomed to having access to current last sale information in the equities markets, bond information, historically, has not been similarly available.

On July 1, 2002, NASD launched the first intraday ‘consolidated tape’ in the U.S. over-the-counter corporate bond markets. The Trade Reporting and Compliance Engine, commonly referred to as TRACE, enables investors to access current price information for U.S. corporate bonds. All broker-dealers regulated by NASD have an obligation to report transactions in TRACE-eligible corporate bonds under rules approved by the SEC.

As with the dissemination of the selling prices of equities, this capability provides a new level of information to bond investors who now have access to independent bond transaction data that can be used to help determine that they are getting a fair market price when they are buying or selling bonds. While information on all bond transactions that are reported to TRACE is not disseminated under provisions currently in place, the program will be expanded in the next phase so that prices of all reported transactions will be made available to the public. Because TRACE makes a great deal of important price information public and accessible, it helps to increase market fairness and integrity.

With this improved availability of market information, NASD now has a better view into the U.S. corporate bond market. For example, since the launch of TRACE, we have learned that the corporate bond marketplace is far more active than originally anticipated. On a typical day approximately \$20 billion par value of corporate bonds “turn over” in approximately 25,000 transactions. Of the close to 5,400 broker-dealer firms regulated by NASD, more than 1,900 report transactions to TRACE. And of that number, approximately 500 broker-dealers report at least one trade every day. The top 10 firms account for approximately 60percent of the volume and the top 25 firms trade approximately 85percent of the volume. In addition, of the 23,000 publicly traded

corporate bond issues, 20 percent trade at least one time per day with 5 percent trading more than 5 times per day. As a result of TRACE, NASD now possesses the information to identify trading patterns, trading volume, and market participation.

Both individual investors and investment professionals can access TRACE information. Most investment professionals access the trade data through market data vendors or their firm's proprietary applications. Retail investors typically access TRACE data through web sites such as NASD's [nasdbondinfo.com](http://nasdbondinfo.com) or [Investinginbonds.com](http://Investinginbonds.com), a part of The Bond Markets Association's web site. And in an effort to increase distribution of the data on a more widespread basis, NASD is actively finding additional ways to distribute the information.

### ***TRACE Reporting and Dissemination***

Currently, more than 29,000 corporate debt securities are subject to TRACE reporting requirements. Each firm regulated by NASD that is a party to a secondary "over-the-counter" market transaction in a TRACE eligible security has a reporting obligation under TRACE. As a general rule, the vast majority of dollar denominated corporate debt instruments must be reported to TRACE. Not included under TRACE are government debt securities such as U.S. Treasury bonds, municipal securities (which are subject to a separate reporting and dissemination regime managed by the MSRB), GSE securities, mortgage or asset backed securities, and money market instruments.

More specifically, the list of TRACE eligible securities include the following classes:

- Investment grade debt
- High-yield and un-rated debt of U.S. companies and foreign private issuers
- Medium term notes
- Convertible debt not otherwise reported to an exchange
- Capital trust securities
- Equipment trust securities
- Floating rate notes
- Global bonds issued by U.S. and foreign private issuers

### ***TRACE Reporting Time***

During the past two years, NASD has worked with the bond trading community to expedite public reporting of TRACE data. Upon the inception of TRACE in July 2002, bond dealers had 75 minutes to report trades into TRACE. Since that time, NASD has moved aggressively to reduce the time frame for reporting to TRACE. Currently, broker-dealers must report trades to TRACE within 45 minutes. This requirement will be reduced to 30 minutes later this year and the reporting time will be reduced again to 15 minutes by mid-2005. Notwithstanding this requirement, in the first 5 months of 2004, 74 percent of trades were submitted within 15 minutes of execution and 85 percent within 30 minutes of execution.

NASD has worked hard to ensure that market participants have had the time to prepare their processes and systems for this new reporting regime, while moving aggressively to reduce reporting times.

### ***Trace Dissemination***

TRACE has gathered every secondary transaction conducted in the corporate bond market for regulatory purposes since its inception on July 1, 2002. NASD has taken an aggressive phased approach to dissemination of this data to investors and professionals. Phase I, which was launched at inception, provided for dissemination of all transaction data in investment grade bonds greater than \$1 billion in original issuance and 50 representative high yield bonds. This phase gave investors access to approximately 31 percent of all transactions (34 percent of par value) and 38 percent of investment grade trades (45 percent of par value).

Phase II was introduced in April of 2003 and provided for dissemination of data on all investment grade bonds that were rated A or better and were at least \$100 million in original issuance, as well as data on 120 representative Triple B rated bonds and 50 representative high-yield bonds. This phase, which is currently in effect, gives investors access to approximately 43 percent of all transactions (45 percent of par value) and 61 percent of investment grade trades (68 percent of par value).

In April 2004, NASD's Board of Governors voted to make all publicly traded TRACE eligible issues subject to dissemination. Under this proposal, information on 100 percent of TRACE eligible issues would be accessible to the public. Trade information on 99 percent of all corporate bonds will be disseminated immediately, thereby giving investors contemporaneous access to marketplace prices and transaction data. The transactions that would be disseminated on a delayed basis would be limited to certain transactions in lower rated securities executed during a short period after issuance and for trades over \$1 million in par value in non-investment grade securities that are infrequently traded.

The proposed increase in dissemination of corporate bond information previously described continues NASD's efforts to put more information in the hands of investors and other market participants. In a very short period of time, TRACE has brought unprecedented transparency to the corporate bond market. NASD will continue to work with the SEC and the industry to sustain this trend.

### **Sales Practices**

In addition to having increased price information, NASD believes that it is imperative that investors understand the various risks, as well as the rewards, associated with debt securities. With the growing retail participation in bonds and evidence that investors may not fully understand the products (and particularly given that interest rates are likely to rise from their current and historically low rates), NASD recently issued a

notice to the firms it regulates to remind them of their sales practice obligations in connection with bonds and bond funds.

These sales practice obligations include:

- Understanding the terms, conditions, risks, and rewards of bonds and bond funds they sell (performing a reasonable-basis suitability analysis);
- Making certain that a particular bond or bond fund is appropriate for a particular customer before recommending it to that customer (performing a customer-specific suitability analysis);
- Providing a balanced disclosure of the risks, costs, and rewards associated with a particular bond or bond fund, especially when selling to retail investors;
- Adequately training and supervising employees who sell bonds and bond funds;
- Implementing adequate supervisory controls to reasonably ensure compliance with NASD and SEC sales practice rules in connection with bonds and bond funds;
- Informing customers that brokers receive compensation for bond trades – that when a firm buys or sells a bond, the customer is charged for the service, in the form of either a commission, or a mark-up or mark-down.

NASD also regularly reminds firms that they need to take appropriate steps to ensure that their employees understand and inform customers about the risks as well as the rewards of the products they offer and recommend, including corporate bonds.

Investor education is another important tool. As part of our Investor Brochure series, NASD offers information on investing in bonds, the different types of bonds, and understanding bond prices, quotations, and ratings. This information can be found on the NASD Web site. We are also developing additional ways to help investors understand investing in bonds – along the lines of explaining what "junk" bonds are, how to use NASD BondInfo, and the importance of asset allocation and diversification within a bond portfolio.

### **NASD Regulatory Functions Regarding Corporate and Municipal Bond Markets**

While TRACE applies to the corporate debt market, NASD's regulatory responsibilities extend to both the corporate and municipal bond markets. The MSRB imposes requirements on firms for reporting municipal bond transactions and NASD, as discussed above, imposes TRACE requirements for reporting corporate bonds transactions. These sources of data provide NASD with a comprehensive picture of these two markets with more than 50,000 daily transactions.

TRACE and the MSRB's transaction information enable NASD to create an audit trail of the activity in these markets and undertake comprehensive automated surveillance. NASD market surveillance systems utilize the TRACE and MSRB data to check for compliance with applicable rules and to detect potential violations. Compliance checks focus on the timeliness, completeness, and accuracy of the required reports. Ensuring timely, correct and complete reporting by the firms is a top priority because accurate reporting is essential to ensure the integrity of the information disseminated to the public and for effective automated market surveillance.

Automated detection patterns are used to address customer protection concerns such as the levels of commissions and markups or markdowns charged to investors. NASD and MSRB rules prohibit firms from charging customers prices that are not reasonably related to the current market price of a security. With the increasing level of retail participation in the fixed income market, this is clearly a high-priority concern.

The NASD surveillance systems are also used to detect potential market manipulation. Unlike equities, there is no centralized market structure for debt securities where quotes are published or transactions may be executed (or facilitated). Accordingly, the challenges when policing for potential market manipulation are somewhat different from those in the equity markets. Nonetheless, there are certain types of conduct that can result in prices that are manipulated or artificial market activity. We try to detect that type of activity through automated surveillance.

NASD's nationwide staff performs routine examinations of each broker-dealer registered with NASD. For those firms participating in the corporate and municipal bond markets, the exams seek to determine whether such firms are complying with NASD and MSRB rules as well as applicable Federal securities laws. Examinations begin with a detailed review of data that is available through NASD systems, such as securities industry registrations, firm financial data, and firm trading data. The examiners review the firm's books and records, such as financial computation work papers and subsidiary ledgers, order tickets and confirmations, and complaint and correspondence files. Examiners check to see that the firm's records support the regulatory reports that the firm has made to NASD in the case of trade reporting and other filings.

NASD is also committed to supporting securities firms' compliance efforts by providing firms specific feedback in the form of performance statistics to enable firms to monitor their transaction reporting compliance on an individual and industry-wide basis. With a glance at the statistics, a firm can quickly see its actual rate of compliance with the reporting requirements. This is another way that NASD is working to ensure that there is integrity in the bond markets.

When NASD finds that broker-dealers have violated any of the applicable rules, it may take informal or formal action against firms and individuals, as appropriate. NASD rules provide for a range of formal sanctions including fines, disgorgement, suspension, and expulsion from the industry. NASD may also order restitution to investors.

## **CONCLUSION**

NASD is committed to fulfilling its regulatory responsibility of ensuring that broker-dealers engaged in the bond markets comply with the federal securities laws and regulations, including NASD's TRACE and other NASD rules and the rules of the Municipal Securities Rulemaking Board. We will continue to work with the SEC and the securities industry to increase access by the public and professionals alike to vital bond market data. This commitment is a vital part of our mission to protect investors and ensure market integrity.