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**BEFORE THE
UNITED STATES SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS**

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Good morning Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I am delighted to be here to discuss some of the significant issues and developments that the Securities and Exchange Commission is currently addressing with respect to the fixed income markets. Specifically, I plan to discuss the fixed-income market transparency joint Task Force, which was recently commissioned by Chairman Donaldson, along with a number of issues that the Task Force is currently considering, including corporate bond market transparency, municipal securities market transparency, government securities transparency, and dealer mark-up practices in the fixed-income market. Finally, I will briefly touch upon the development of guiding principles for the fixed-income industry related to the mitigation of research analyst conflicts of interest.

In March 2004, Chairman Donaldson commissioned a joint Task Force to consider issues relating to bond market transparency and mark-up regulation. The Task Force consists of representatives of the Divisions of Market Regulation and Enforcement, the Office of Compliance Inspections and Examinations (“OCIE”), the Office of Economic Analysis (“OEA”), and the Office of the General Counsel. The Task Force was organized to summarize fixed-income market transparency developments, identify current problems, and generate potential solutions.

Preliminarily, the Task Force has found that transparency has improved to varying degrees in each of the fixed income markets over the last 20 years, because of a continued focus on this issue by both Congress and the Commission. Further, recent increases in the availability of information from these markets has enhanced the ability of regulators to surveil these markets for mark-up violations and other illegal activity.

To implement transparency in the corporate bond markets, the Commission persuaded the NASD to create systems to collect transaction reports and disseminate price information. On January 23, 2001, the Commission approved the NASD's proposal to establish the Trade Reporting and Compliance Engine ("TRACE") system for reporting and dissemination of last sale information on corporate bonds not traded on an exchange. On July 1, 2002, TRACE was officially launched. It is currently being implemented in phases, and has not yet been fully implemented. Under the NASD's TRACE rules, dealers must report trades on U.S. corporate bonds to the NASD within 45 minutes of trade execution, which was reduced from 75 minutes on October 1, 2003. Prior to TRACE, real-time transparency of investment-grade corporate bonds was limited to those traded on exchanges -- a very narrow segment of that market.

Although all trades in TRACE-eligible bonds are reported to the NASD, not all TRACE data is disseminated to market users at this time, in part because of industry concerns about the adverse effects that dissemination might have on market liquidity. Dealers initially contended that immediate dissemination of transaction information on anything but the most liquid bonds could discourage dealers from committing capital and assuming risk positions by exposing their intentions to market participants. Thus far, on the basis of available evidence, these concerns remain unsubstantiated. In addition,

resales of securities under Rule 144A of the Securities Act of 1933 are subject to reporting, but not dissemination because of the restrictions on resale contained in Rule 144A. Moreover, certain bonds, including bonds classified as “asset-backed”, are excluded from TRACE-eligibility and transactions in such bonds are not currently reported to the NASD.

Under TRACE, the NASD currently disseminates transaction information on (i) investment grade corporate bonds rated “A3” or higher by Moody’s Investors Service, and “A-” or higher by Standard & Poor’s, with initial issuance size of \$100 million or greater, (ii) investment grade corporate bonds rated “Baa/BBB” with initial issuance of \$1 billion or greater, (iii) an additional 120 bonds designated by the NASD that are rated “Baa/BBB” at the time of designation and with initial issuance of less than \$1 billion, and (iv) 50 high-yield securities. Transactions eligible for public dissemination are distributed to vendors immediately upon receipt by TRACE. Transactions larger than \$5 million in investment grade bonds are reported as “5MM+;” transactions larger than \$1 million in the roughly 50 reported high-yield bonds are reported as “1MM+.”

TRACE data currently includes transaction information on more than 4,200 securities and represents about 75 percent of the dollar value of trading activity in investment grade bonds. Real-time price data is available from several third-party data vendors for a fee. Delayed data (minimum four hour delay) is available free on the NASD website.

The NASD is in the process of expanding price dissemination to cover additional bonds in a new phase of the TRACE rollout, which will reflect the NASD’s experience with earlier phases. The 120 BBB/Baa bonds currently designated by the NASD for

dissemination were selected in order to obtain empirical data about the impact that dissemination may have on the liquidity of such bonds. The 50 non-investment grade bonds designated for price dissemination were also chosen in part to obtain information about the impact on liquidity, if any. The NASD commissioned two studies to address this issue, both of which have been completed. Neither study provided significant evidence that transparency harms liquidity. However, neither study was extensive enough to address all concerns raised by dealers and other market participants.

The NASD's advisory Bond Transaction Reporting Committee ("BTRC") recently made recommendations to the NASD Board to enhance TRACE based on its review of the findings in these two studies. The NASD Board approved the BTRC recommendations, and our understanding is that the NASD intends to file a proposed rule change with the Commission shortly. The NASD plan would make public in near real-time approximately 99% of all transactions (and 95% of the par value) in TRACE-eligible securities. For the remaining transactions in TRACE-eligible securities -- in essence, newly-issued or infrequently traded lower-quality bonds -- dissemination of transaction data would be delayed. I understand the NASD intends to reconsider the need for the remaining restrictions in the near term. Once filed with the Commission, the NASD's proposal will be published for public comment and processed according to statutory procedures. I also should point out that the NASD recently filed a proposal to reduce the reporting period from 45 minutes to 30 minutes in 2004, and, ultimately, to 15 minutes in 2005. There are no plans to reduce the reporting period to less than 15 minutes.

In addition, I should note that data for all TRACE-eligible securities is now available to regulators for surveillance purposes. The NASD is currently implementing a market surveillance plan designed to review market-wide and individual firm activity, monitor compliance with reporting requirements, and detect possible investor abuse and market manipulation. The availability of TRACE information to the NASD for surveillance purposes enhances the NASD's ability to protect investors by detecting abusive activity.

With respect to the municipal bond market, the drive for transparency began before the corporate debt markets. The Municipal Securities Rulemaking Board ("MSRB"), with the Commission's active encouragement, first implemented a municipal securities trade reporting system in 1995, and proceeded thereafter in measured steps. The MSRB started providing daily summary reports of interdealer municipal bond trades in 1995, and expanded the reports to include customer-trade data in 1998. In January 2000, the MSRB began publishing individual transaction data on frequently traded securities in addition to summarizing their high, low and average prices. The Bond Market Association now posts next-day MSRB municipal bond trading reports on its Internet site for *all* municipal bonds that traded at least once on the previous day. The trades reported represent both wholesale (dealer to dealer and dealer to institutional customer) and retail (individual investor) purchase and sale transactions. Each daily report typically includes about 30,000 trades in approximately 11,000 issues out of the 1.1 million issues that are outstanding. The daily report displays exact par value for all trades with a par value of one million dollars and under, and displays an indicator of ">\$1,000,000" for those transactions with a par value greater than one million dollars.

The implementation date of real-time transaction reporting has been delayed by the MSRB several times to ensure that dealers have sufficient time to make necessary changes in their bond processing systems. Real-time transaction reporting in the municipal market -- generally defined as within 15 minutes of the time of trade -- is now scheduled to begin in January 2005. The MSRB has announced certain narrow exceptions to the requirement to report trades within 15 minutes, however, including an exception related to new issues and variable rate instruments. The MSRB intends to disseminate trades reported during the business day immediately upon receipt of the trade report.

In the government securities market, impetus for change began in the late 1980s, when the General Accounting Office ("GAO") published a report recommending increased price transparency in this market. In 1990, the GAO recommended legislation to require interdealer brokers to make transaction prices available to the public. The Commission supported the GAO recommendation, and recommended that legislation require quotation information to be made available as well. Partially in response to these calls for Congressional action, a variety of data network providers have emerged that publicly disseminate quotation and transaction information on treasury bonds and federal agency securities. One example of this is GovPX, a vendor created by a group of primary dealers in government securities, that publicly disseminates information regarding the U.S. Treasury market.

With respect to the markets for foreign sovereign and mortgage-backed securities, the amount of transparency has not changed significantly in recent years. Dollar-denominated foreign sovereign bonds are largely traded through interdealer brokers who

post quotation and transaction information on their brokerage screens. This information is not generally disseminated outside of the dealer network. Pricing information on mortgage-backed securities is widely available through a variety of commercial vendors; some vendors also offer analytical tools to help value these securities. Dealers and some institutional investors have in-house analytical models as well.

Generally speaking, transparency plays a fundamental role in promoting fair and efficient pricing in the fixed-income markets, thereby fostering investor confidence in those markets and encouraging greater participation. Transparency also contributes to efficient price discovery and aids investors in assessing the quality of the prices being offered in the market. In addition, transaction reporting has supplemented the ability of regulators to surveil the bond markets for unfair pricing and abusive mark-ups and mark-downs. The increased availability of information has contributed to greater awareness by SEC and NASD staff of wide variations in pricing and mark-ups. The Task Force, in conjunction with the NASD, is exploring whether these variations create the potential for abuse.

For any type of bond, mark-ups must be reasonable. While NASD has a maximum 5% guideline for equity securities, mark-ups are expected to be significantly lower for bonds. For different types of debt, what is recognized as reasonable depends on such factors as liquidity, credit rating, and yield, and can range from less than one-half of one percent for government debt, to higher amounts for high-yield bonds. For investors as well as regulators, the difficulty lies in establishing the prevailing market price for a bond. This generally is the base line that is used to assess whether a mark-up is reasonable. We believe that increased transparency should enhance the Commission's

and SROs' ability to determine the prevailing market for a bond and thereby ascertain that investors are not being charged abusive mark-ups. In addition, improved transparency will enable investors to better determine the fair price of a bond. This will make them better able to protect themselves against unfair pricing in the first instance.

In the recent past, Commission staff has held joint meetings with NASD staff in an effort to focus on mark-up practices in the fixed income markets and to develop appropriate surveillance and enforcement policies. Moreover, in February 2004, OEA publicly released a major study on municipal bond liquidity that used sophisticated econometric methods to analyze average transaction costs from a one-year sample of all municipal bond trades that occurred in the 1999-2000 time frame. This study concludes that the effective spread for an average retail municipal bond trade was almost 2 percent, in comparison to 0.8 percent for a similarly sized equity trade. Among other matters, this OEA study is part of an ongoing research initiative that constitutes a comprehensive effort to measure the size of bond markups. The Commission has widely disseminated the findings of this staff study, so as to give municipal bond dealers an opportunity to compare for the first time the size of the markups they charge their clients to historical practices. Initial results on a similar analysis for corporate bonds (not yet released) suggest that transaction costs decline with added transparency. The magnitude of the results implies that making the rest of the bonds transparent has the potential to save investors more than \$1 billion per year.

This January, after our review, the MSRB issued a Notice entitled "Review of Dealer Pricing Responsibilities." The Notice was occasioned by NASD's review of transactions with retail customers at prices that were not reasonably related to market

value. The MSRB expressed concern with “transaction chains” where a block of securities was bought from a retail investor, and then, after a series of inter-dealer trades, was sold to another retail customer at a substantially higher price. While no single dealer involved may have made an excessive profit, the large intra-day price differential was absorbed by retail customers at the ends of the chain. Also in January, OCIE and the NASD initiated a coordinated review of municipal brokers’ brokers. The firms selected for examination were based on the above-referenced NASD transaction review.

In addition, the NASD has filed a proposal to add a new Interpretation to its rules for transactions in non-municipal debt securities to address two issues. First, it would address how NASD members are to determine a debt security’s prevailing market price, from which the amount of a mark-up is computed. Second, it would speak to when and how a debt security’s prevailing market price may be determined by reference to transactions with institutions, or to transactions in “similar securities.”

The NASD proposal would establish a rebuttable presumption that, in all cases, the prevailing market price for a debt security would be the dealer’s contemporaneous cost. While this standard is already imposed on non-market making dealers, its universal application would eliminate a more forgiving standard that has been established for market-makers. Regulators and industry participants have found that in the bond market, where there is no sharp delineation between market making and non-market-making firms, the separate standard created a lack of clarity and was a frequent source of disputes.

Moreover, the proposal would list a set of default measures of prevailing market price in cases where the base standard should not apply. NASD’s list includes well-

established factors, as well as new ones that reflect particular attributes of the bond markets. For instance, it would recognize that the market price of a debt security may often be established by reference to others with similar characteristics, such as credit quality. The proposal would also acknowledge the significant role of non-dealer institutions in the bond markets by permitting NASD members to refer to transactions with institutions when determining the prevailing market price of a debt security. In light of the significance of the filing and the Commission's longstanding sensitivity with respect to the regulation of mark-ups, the staff has consulted with NASD and is closely reviewing the proposal.

Another important development in the fixed income market was the Bond Market Association's recent release of the final version of its "Guiding Principles to Promote the Integrity of Fixed Income Research," which is a comprehensive and detailed set of voluntary principles designed to help the BMA's member firms manage potential conflicts of interest that arise in their research activities. The Commission staff, analysts' groups, and a variety of other market participants reviewed drafts of the principles, which are intended to promote an independent flow of unbiased information to the global fixed income capital markets. The BMA's new principles are intended to provide member firms with a common set of standards they can use globally and to complement existing requirements both in the United States and Europe.

The final principles reflect that the nature and intensity of conflicts of interest affecting fixed income research are different than those affecting equity research, but that conflicts are possible in the preparation of fixed income research and needed to be addressed. Moreover, the guiding principles are intended to ensure research analysts are

free from internal or external influences that could inhibit their ability to produce impartial assessments. For example, they recommend that analysts not participate in investment banking activities, which could raise questions about their independence. The BMA purposefully chose a flexible principles-based approach to ensure that differing organizational structures, various types and uses of fixed income research, and the unique aspects of different fixed income markets could all be encompassed within the framework.

Many of the guiding principles are designed to foster a firm culture that promotes the integrity of fixed income research and the ability of fixed income research analysts to express their views without inappropriate pressure from issuers, investment bankers and, significantly, other non-research department personnel, including traders and salespeople. In that regard, the BMA has noted its belief that the principles go further than the regulations or legal settlements covering equity research.

Specifically, the principles recommend that firms prohibit promises of favorable research in exchange for business, prohibit retaliation against analysts for publishing unfavorable research and ensure that research coverage decisions are made by research personnel. In terms of sales and trading activities, the principles recommend firms prevent analysts' recommendations from being prejudiced by the firm's trading activities. In addition, under the principles, traders should not know the content or timing of upcoming reports before they are issued.

The principles also address potential conflicts of interest that arise from the personal interests of analysts. For example, the principles recommend analyst compensation be structured to promote independence and that firms impose limitations

on the personal trading activity of research analysts. Similarly, the principles recommend disclosures to assist investors in distinguishing fixed income research from analyses produced by trading desk personnel as part of their trade execution and/or market making functions. The Commission applauds the BMA for being proactive in connection with analyst conflicts and believes that the implementation of the principles is a positive development for market participants, regulators, and investors in the fixed-income market. The Commission will continue to consider whether further Commission initiatives in this area are needed.

In closing, I would like to note that we believe that transparency is an essential component of an efficient and fair market. In that regard, the Commission has supported increased transparency in the fixed income markets and will work with market participants and regulators in the future to ensure that we continue to increase transparency in the fixed-income markets. Thank you again for inviting me to speak on behalf of the Commission. I would be happy to answer any questions that you may have.