



NASD Response to European Commission Call for Evidence

NASD appreciates the opportunity to provide an overview of the TRACE initiative in the U.S. over-the-counter corporate debt market and the experience and evidence to date as response for the “Call for Evidence: Pre- and post-trade transparency provisions of the Markets in Financial Instruments Directive (MiFID) in relation to transactions in classes of financial instruments other than shares” requested June 12, 2006.¹

NASD strongly believes that TRACE has dramatically improved the understanding of the market, and as many of the academic studies indicate, TRACE has lowered investor transaction costs. There is little doubt that price transparency allows dealers to better assess the quality of executions they provide, and similarly, such transparency provides investors with information to better assess the quality of executions they receive. The usefulness to the marketplace of the information is evident in the widespread distribution to professionals (more than 35,000) achieved in a relatively short time period. In addition, regulators are better equipped with facts and tools to ensure market integrity and investor protection, which is ultimately the mission of the NASD.

Much of what has been accomplished with TRACE occurred with the substantial input and involvement of the industry. Industry involvement was significant at the outset. In the latter part of the 1990s, the SEC with the urging of Congress noted that the corporate bond market could benefit from further transparency, and directed the NASD to work with the industry to develop a reporting and dissemination system for all corporate bonds and preferred securities. Initially, the industry expressed concern about the concept. Among the concerns were:

- The Corporate Bond Market was purely an institutional market where only sophisticated investors traded;
- The marketplace was highly illiquid and that very few issues traded;
- Transparency would not impact the most liquid bonds and most of the investment grade marketplace where issues traded based on US Treasury benchmarks since most investors already knew the pricing levels for these bonds. Transparency would add little to no value to this sector of the market;

¹ The comments provided in this letter are solely those of NASD staff.

After very significant discussions with the industry, it was agreed to approach the market slowly and phase in implementation to allow the market to adjust to the changing dynamic and to monitor transparency's effect on liquidity. The ultimate system developed in response became known as the Trade Reporting and Compliance Engine or "TRACE".

Launched on July 1, 2002, the TRACE system provides a database of public secondary market corporate debt transactions to enable regulators to take a proactive role in supervising the corporate debt market. In addition, it is the first intraday consolidated source of transaction information in the U.S. Over The Counter corporate fixed income market through which investors and professionals receive information on the actual sale price of U.S. corporate bonds.

As part of TRACE, NASD undertook several major initiatives including the creation of an industry committee to advise the NASD Board on transparency issues and develop a methodology for phasing the dissemination. Implementation of phased-in dissemination occurred in consultation with the Bond Transaction Reporting Committee ("BTRC"). This advisory committee of the NASD Board of Governors was made up of 10 members: five industry representatives nominated by the Bond Market Association ("TBMA") and five members nominated by NASD staff. The primary role of the BTRC was to review the impact of transparency and make recommendations to the NASD Board concerning the approach to TRACE dissemination. TBMA staff was present and their input was provided throughout the process.

The BTRC worked with NASD staff to retain a team of econometricians to support the analysis of TRACE data to determine the impact of transparency. All analyses were designed and conducted in collaboration with and direction from the BTRC. Based on these analyses and data generated by NASD staff from TRACE, the phase-in process was extended and modified from potentially nine months to the three plus year process that ultimately followed. All phases of dissemination were recommended by the BTRC and approved by the NASD Board. The final and most controversial phase of dissemination calling for real time dissemination of all issues including the least liquid high yield bonds was unanimously approved by the BTRC. The SEC generally found that the NASD phased-in approach struck the appropriate balance between concerns about liquidity and the need to make transaction information publicly available on an immediate basis.

As part of the deliberative process that surrounded TRACE dissemination, NASD gathered some valuable experiences and observations regarding the corporate bond market. For example, during the phase-in process an NASD commissioned econometric study designed a controlled experiment around selected BBB bonds to determine if there was an effect on these bonds from transparency. The BTRC and the econometric team agreed on the approach and analyses to be conducted. The results did not indicate any damage to liquidity on the selected

bonds as a result of transparency. A second formal study was prepared by the econometric team in consultation with the BTRC that focused on high yield bonds and the result again was that there was no empirical evidence of damage to liquidity across this segment of the market as a result of transparency.

In addition, it has become clear that a number of industry observations about the market prior to the introduction of TRACE were not accurate, two of which are highlighted below:

- Probably the most surprising outcome was that this market was not the solely an institutional market, and that 65% of trades were 'retail sized', below \$100,000 in par value (although TRACE does not gather data that precisely identifies transactions done by retail investors, the BTRC felt that trades below this size were highly likely to be retail in nature). Retail sized transactions represented more than 35% of transactions at every credit quality level. It should be noted that these small transactions represented less than 4% of the par value traded. So although the original incentive to provide transparency was about institutional investors and ensuring market integrity, NASD rapidly became concerned about the need to protect retail investors in this market place;
- The market place was more liquid than was originally thought, although not as liquid as the equity markets. In 2005, 16% of issues traded each day and 50% of issues traded at least once in a thirty day period. In addition, 5% of issues traded at least 10 times per day. All of these percentages are far higher than was initially projected based on industry input.

More recently, there have been reports that dealers may be abandoning the corporate bond market as a result of TRACE and subsequent reduced profitability. NASD staff monitors the number of firms that participate in TRACE and their activity levels and has not identified any clear trend. Between 2002 and 2005, the daily number of dealers in the corporate bond market was volatile, but increased from an average of 489 to 502 although the number did peak at 521 in 2003. As with liquidity, these trends are contrary to concerns raised when looking at investment grade and high yield participation: While investment grade dealers declined by 7% from 420 to 390 the number of high yield dealers increased by 35% from 258 to 347 in spite of dramatically increased transparency during this time

NASD carefully monitors volume levels in the market as a proxy for liquidity. The last several years have made that particularly difficult since the Federal Reserve Bank has raised interest rates 17 times from June of 2004 through June of 2006 which has reduced overall par value traded. This happened at the time when TRACE significantly increased transparency in the high yield market, the sector of most concern to the Industry. This was also a period when two of the largest issuers of debt instruments, General Motors and Ford, were down graded from investment grade to high yield. NASD compared the par value traded in publicly traded

high yield bonds, excluding all GM and Ford activity, to the par value traded in 144A issues which are not transparent from 2003 to 2005. The volume in publicly traded issues that became increasingly transparent during that time decreased by 8.6% from \$5.8 billion to \$5.3 billion while the 144A issues declined by 10.5% from \$1.91 billion to \$1.71 billion in par value traded. Although not conclusive, this indicates that it is unlikely that TRACE had a significant negative effect on volume and liquidity in this, the sector of highest industry concern.

In addition, concerns have also been raised that transparency has made it difficult for large trades to get done and that liquidity in the largest trade sizes has declined. Data indicate however that average trade size has increased by 15% from \$770,000 in the third quarter of 2005 to \$885,000 in the third quarter of 2006. This is evident across all credit qualities, and is even more apparent in high yield. Investment Grade trade size showed an increase of 12.6% from an average trade size of \$736,000 in the third quarter of 2005 to \$829,000 in the third quarter of 2006. High yield increased 19% from an average trade size of \$823,000 in the third quarter of 2005 to \$980,000 in the third quarter of 2006.

NASD continues to hear concerns expressed by some industry participants about the impact of TRACE. It also continues to hear reports of how TRACE has helped investors, both institutional and retail, to get fair executions. Based on these reports, it seems clear that TRACE has had an impact on the way both dealers and investors operate in the marketplace. Trading practices and strategies have evolved and will continue to evolve as time passes. However, NASD has not seen any conclusive empirical evidence of damage to the marketplace resulting from TRACE. NASD recognizes that the complete story on the impact of transparency on the market will need several complete market cycles and most likely many years to make a final determination. Market reactions to transparency will be different at various times in the market cycle, and market participants will require time to adjust to transacting in a more public environment. NASD remains committed to monitoring the marketplace to help insure its soundness and integrity.