

NASD Amends Proposed Debt Mark-Up Policy to Exclude Certain Transactions with Institutional Customers

On October 31, 2006, the National Association of Securities Dealers (NASD) filed with the Securities and Exchange Commission (Commission) its most recent amendment to its rule proposal to add a new interpretation regarding mark-ups and mark-downs in debt transactions.¹ On November 21, 2006, the Commission published the NASD's amended proposal for comment.² Comments will be due 21 days after publication in the Federal Register.

Most significantly, the latest amendment proposes to exclude from Rule 2440's requirements transactions with "qualified institutional buyers" (QIBs) in non-investment grade debt securities. The NASD also has proposed to eliminate transaction size as a relevant consideration when assessing whether a dealer's "contemporaneous cost" is the best indication of prevailing market price, and has made minor revisions to two other factors that may be used to overcome the proposed contemporaneous cost presumption. A number of other, less significant changes do not appear to affect the substance of the proposal.

Background

NASD Rule 2440 requires that members charge customers fair prices and commissions. Interpretive Material 2440 (IM-2440) provides guidance on what constitutes a fair mark-up or mark-down for purposes of the rule. Under IM-2440, also called the Mark-Up Policy or 5% Policy, it is a violation of both Rule 2440 and Rule 2110 (Standards of Commercial Honor and Principles of Trade) "for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission which is not reasonable." Although the Mark-Up Policy applies to over-the-counter transactions in both equity and debt securities, considerable confusion and controversy have arisen regarding how its terms should be applied in the debt markets and, in particular, how a debt security's "prevailing market price" should be determined in the absence of an actively traded market for the security.

Prior efforts by the NASD to clarify how the Mark-Up Policy should be applied in the debt markets have been unsuccessful.³

In September 2003, the NASD filed with the Commission the first iteration of its current proposal, which would add a new interpretation under Rule 2440 applicable to transactions in debt securities.⁴ Proposed Interpretive Material 2440-2, also referred to as the Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities (Proposed Interpretation or Proposed IM-2440-2), would supplement existing IM-2440 by addressing how "prevailing market price" should be determined in the markets for debt securities. The Mark-Up Policy would be renumbered as IM-2440-1 and remain generally applicable to transactions in debt securities. Following two amendments, the Commission published the proposal for comment on March 9, 2005.⁵ The NASD responded to these comments in October 2005 and addressed some of the concerns raised by commenters in subsequent amendments in October and November 2005.⁶ The NASD's most recent filing substantially enhances prior efforts directed at recognizing institutional participation in the debt markets and supersedes prior versions of the proposal.

The Proposed Interpretation starts with the premise that when a dealer is not acting as a market maker, the mark-up or mark-down of a debt security must be evaluated in relation to the security's prevailing market price, presumptively the dealer's contemporaneous cost of obtaining (or proceeds from selling) the security. A "contemporaneous" transaction is one that "occurs close enough in time to the subject transaction that it would reasonably be expected to reflect the current market price for the security."⁷ The Proposed Interpretation limits the circumstances in which the contemporaneous cost presumption may be rebutted. A more detailed overview of this process is provided below, following the discussion of the most significant changes made by Amendment No. 5.

Exclusion of Certain Transactions with Institutional Customers

Amendment No. 5 proposes a significant exemption from Rule 2440 and the Mark-Up Policy for transactions with certain institutional customers in non-investment grade debt securities. The Proposed Interpretation accomplishes this exemption by excluding QIBs from the definition of “customer” as that term is used in Rule 2440 and its interpretive materials when a transaction involves a non-investment grade debt security.⁸

In order for a transaction with an institutional customer to be excluded, each of the following conditions must be satisfied:

- The institutional customer must be a “qualified institutional buyer,” as that term is defined in Rule 144A of the Securities Act of 1933.

In general terms, a QIB is a registered dealer or any of certain specified types of entities—acting for its own account or for the accounts of other QIBs—that owns and invests, on a discretionary basis, at least \$100 million in securities of issuers with which the dealer or entity is not affiliated. The term also includes a registered dealer acting in a riskless principal transaction on behalf of a QIB, as well as any entity—acting for its own account or for the accounts of other QIBs—in which all equity owners are QIBs.⁹

- The member firm buying or selling to the institutional customer must conclude that (a) the QIB is capable of evaluating independently the investment risk involved in the transaction, and (b) the QIB is in fact exercising such independent judgment in deciding to enter into the transaction.

The Proposed Interpretation directs member firms to use the institutional suitability standards set forth in NASD IM-2310-3 (Suitability Obligations to Institutional Customers) to make these determinations. Accordingly, under the Proposed Interpretation, a member firm may rely on the same two factors to fulfill its suitability and fair pricing obligations to an institutional customer meeting the definition of QIB.

- The transaction must involve a non-investment grade debt security, as defined in the Proposed Interpretation.

In order for a security to be non-investment grade debt for purposes of the Proposed Interpretation, one of the following circumstances must exist:

- a) A nationally recognized statistical rating organization (NRSRO) has assigned the security a rating lower than one of the four highest generic rating categories¹⁰ (e.g., below BBB or Baa); or
- b) For a security that no NRSRO has rated, either:
 - i. The dealer has analyzed the security as non-investment grade, retains credit evaluation documentation, and demonstrates to NASD (using credit evaluation or other demonstrable criteria) that the security’s credit quality is in fact equivalent to a non-investment grade debt security; or
 - ii. The security was initially offered and sold and continues to be offered and sold pursuant to an exemption from registration under the Securities Act of 1933.¹¹

The proposed exemption echoes comments received during the first notice and comment period.¹² The Bond Market Association (BMA) argued in its comments that institutional customers do not require the same protections as retail customers, and that the Proposed Interpretation should include a framework for institutional customers comparable to that employed in the suitability context. Although the NASD had previously declined to propose an institutional customer exemption,¹³ Amendment No. 5 specifically incorporates existing NASD institutional suitability standards and existing Commission regulations classifying sophisticated institutional investors to create such an exemption.¹⁴

If the Proposed Interpretation is adopted, member firms relying on the exemption should be mindful that the anti-fraud provisions of the Exchange Act and NASD rules continue to have general applicability to all securities transactions, and that trading that is suggestive of customer abuse may remain subject to challenge under these rules notwithstanding the proposed exemption.¹⁵

Elimination of the “Size Proposal”

As amended by Amendment Nos. 3 and 4, the Proposed Interpretation provided that transaction size (large or small) may indicate that the member’s contemporaneous transaction in the security was executed away from the prevailing market price. Thus, transaction size would have been a means of rebutting the presumption that contemporaneous cost should be treated as the best indication of a security’s prevailing market price.

Amendment No. 5, however, proposes to eliminate this so-called size proposal.¹⁶ It also proposes to eliminate transaction size as a basis for discounting pricing information in the “Pricing Hierarchy,” discussed below. Finally, the amendment would eliminate transaction size as a factor relevant to the evaluation of price and yield information for “similar” securities.

Adjustment to Factors That May Overcome the Presumption

Amendment No. 5 adjusts the wording of the three types of events that, following elimination of the size proposal, remain as factors that may overcome the presumption that contemporaneous cost provides the best indication of prevailing market price.¹⁷ In prior versions, the Proposed Interpretation stated that the presumption may be overcome when “interest rates or the credit quality of the security changed significantly, after the dealer’s contemporaneous transaction.” Amendment No. 5 separates these two types of events and gives them slightly different standards. “Significance” is no longer the standard for interest rates, which instead may overcome the presumption if they “changed after the dealer’s contemporaneous transaction to a degree that such change would reasonably cause a change in debt securities pricing.”¹⁸ The revised version continues to require that a change in the security’s credit quality be “significant” in order to overcome the presumption, although prior guidance made clear that a change in rating or other official pronouncement from an NRSRO was not a prerequisite. The standard for news is unchanged from Amendment No. 4, which added it as a factor; news may overcome the presumption if it “had an effect on the perceived value of the debt security after the dealer’s contemporaneous transaction.”¹⁹

Overview of the Proposed Debt Mark-Up Policy as Amended

Amendment No. 5 has not altered the basic structure of the Proposed Interpretation, which lays out an analysis to determine the prevailing market price in relation to which a mark-up or mark-down will be evaluated.

Step 1: Overcoming the Presumption

There is a presumption that the prevailing market price is the member’s contemporaneous cost of obtaining the security (in the case of a sale to a customer) or proceeds from selling the security (in the case of a purchase from a customer). Other evidence of prevailing market price will be considered

only if (a) the member has engaged in no contemporaneous transactions, or (b) the member can demonstrate that, in the particular circumstances, its contemporaneous transactions are not indicative of prevailing market price.

The member may be able to overcome the presumption if an event occurred after the member’s contemporaneous transactions. Events that may be used to rebut the presumption include a change in interest rates to a degree that reasonably would affect debt security pricing, a significant change in the security’s credit quality, or the distribution of news that affects the perceived value of the security.²⁰

Once the presumption has been overcome, due to either a lack of contemporaneous transactions or a qualifying event after any contemporaneous transactions, a series of factors may be considered to determine prevailing market price.

Step 2: The Hierarchy of Pricing Information

If the presumption has been overcome, the next step is to consider three types of pricing information, which the NASD refers to as the Pricing Hierarchy. These factors must be considered in order, with each subsequent factor becoming relevant only if the preceding factor is not available. The factors in the Pricing Hierarchy are:

- First, prices of contemporaneous inter-dealer transactions in the security.
- Second, prices of contemporaneous dealer transactions in the same security with institutional accounts with which any dealer regularly effects transactions in the security.
- Third, for actively traded securities, contemporaneous bid or offer quotations in the security through any inter-dealer mechanism through which transactions generally occur at displayed quotations.²¹

Step 3: Analysis of “Similar” Securities

If none of the factors in the Pricing Hierarchy is available, member firms must consider a non-exclusive list of four factors involving “similar” securities:

- Prices of contemporaneous inter-dealer transactions in a similar security, or prices of contemporaneous dealer transactions in a similar security with institutional accounts with which any dealer regularly effects transactions in the similar security.
- Yields calculated from prices of contemporaneous inter-dealer transactions in similar securities.

- Yields calculated from prices of contemporaneous dealer transactions in a similar security with institutional accounts with which any dealer regularly effects transactions in the similar security.
- Yields calculated from validated contemporaneous inter-dealer quotations in similar securities.²²

In this context, a similar security “should be sufficiently similar to the subject security that it would serve as a reasonable alternative investment to the investor.” According to the Proposed Interpretation, it should be possible to estimate a market yield for the subject security from the yield of the similar security. For a security with several components, the price or yield of each component must be considered.²³

Step 4: Economic Models

Finally, if pricing and yield information regarding similar securities is also unavailable, pricing or yield derived from economic models may be considered—if they take into account appropriate factors (e.g., credit quality, interest rates, industry sector, time to maturity, call provisions and other embedded options, coupon rate, and face value) and consider all applicable pricing terms and conventions.²⁴ The Proposed Interpretation makes clear the NASD’s expectation that records of economic models relied upon to price debt securities transactions may be requested by examination staff.

Conclusion

The scope and potential impact of the Proposed Interpretation remain unclear in a number of areas. For example, while the Proposed Interpretation would impose the contemporaneous cost presumption on transactions by

a member firm not acting as a market maker in the security, the scope of market maker status in the debt markets remains unclear.²⁵ Despite a prior proposal by the NASD to define “market maker” for purposes of mark-ups in debt securities,²⁶ a more recent acknowledgement by the NASD that market makers exist in the debt markets,²⁷ and industry calls for a definition, the NASD has declined to provide a definition specific to the debt context. Instead, the NASD cites the Exchange Act’s definition of the term,²⁸ stating that “a dealer in debt securities must meet the legal requirements of Section 3(a)(38) to be considered a market maker.”²⁹

Viewed against the background of enforcement activity related to mark-ups in recent years, the Proposed Interpretation has the potential to alter significantly broker-dealers’ risks and expectations associated with debt mark-ups. The proposed exemption for certain transactions with QIBs in non-investment grade debt securities addresses some of the primary criticism directed at the NASD’s application of the Mark-Up Policy to the debt markets by narrowing the categories of institutional trading subject to pricing regulation, and by narrowing the circumstances in which transactions in certain low-grade debt securities—which tend to carry comparatively higher mark-ups reflecting associated illiquidity, market risk and sales efforts—will be subject to challenge. If adopted, the Proposed Interpretation will have a significant impact on the NASD’s enforcement program under Rule 2440. It remains to be seen, however, how the NASD will square the policy choices reflected in the Proposed Interpretation with its pending debt mark-up investigations and with recent multimillion-dollar settlements involving trades with institutional customers in distressed debt securities.

NOTES

1. Amendment No. 5: Additional Mark-Up Policy for Transactions in Debt Securities, SR-NASD-2003-141 (Oct. 31, 2006). The full filing, which includes an exhibit showing changes from Amendment No. 4 to Amendment No. 5, is available at http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_017721.pdf
2. *Notice of Filing of Amendment Nos. 3, 4, and 5 to a Proposed Rule Change Relating to Additional Mark-Up Policy for Transactions in Debt Securities*, Except Municipal Securities, Exchange Act Rel. No. 54,799 (Nov. 21, 2006) (Proposing Release). The Proposing Release is available at <http://www.sec.gov/rules/sro/nasd/2006/34-54799.pdf>.
3. *See Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 by the National Association of Securities Dealers, Inc., Relating to the Application of NASD's Mark-Up Policy to Transactions in Government and Other Debt Securities*, Exchange Act Rel. No. 40,511 (Sept. 30, 1998), 63 Fed. Reg. 54,169 (Oct. 8, 1998); NASD Notice to Members 94-62 (Aug. 1994). For a description of the Proposed Interpretation prior to Amendment No. 5, as well as a broader overview of mark-ups, see Brandon Becker, Todd Wiench and Julia Lee, *Mark-Ups and Recent Developments in Best Execution*, SIA Compliance & Legal Division Fall Compliance Seminar (Nov. 13, 2006) (discussing the Proposed Interpretation at pages 31-36).
4. *Additional Mark-Up Policy for Transactions in Debt Securities*, SR-NASD-2003-141 (Sept. 16, 2003). This and other filings related to the proposal are available on the NASD's website, www.nasd.com.
5. *Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. to Adopt an Additional Mark-Up Policy for Transactions in Debt Securities Except Municipal Securities*, Exchange Act Rel. No. 51,338 (Mar. 9, 2005), 70 Fed. Reg. 12,764 (Mar. 15, 2005); Amendment No. 2: *Additional Mark-Up Policy for Transactions in Debt Securities*, SR-NASD-2003-141 (amended Feb. 17, 2005); Amendment No. 1: *Additional Mark-Up Policy for Transactions in Debt Securities*, SR-NASD-2003-141 (amended June 29, 2004).
6. Amendment No. 4: *Additional Mark-Up Policy for Transactions in Debt Securities*, SR-NASD-2003-141 (amended Nov. 22, 2005); Amendment No. 3: *Additional Mark-Up Policy for Transactions in Debt Securities*, SR-NASD-2003-141 (amended Oct. 11, 2005); *Response to Comments on Additional Mark-Up Policy for Transactions in Debt Securities*, File No. SR-NASD-2003-141 (Oct. 4, 2005) (NASD Response to Comments).
7. Proposed IM-2440-2(b)(3).
8. Proposed IM-2440-2(b)(9).
9. For the complete definition of QIB, which contains a number of provisions specific to particular categories of QIBs (e.g., registered investment companies and banks), see Securities Act of 1933, Rule 144A(a)(1).
10. Specifically, the proposed interpretation states that (a) if rated by only one NRSRO, the rating must be lower than one of the four highest generic rating categories, or (b) if rated by more than one NRSRO, the rating "by any of the NRSROs" must be lower than one of the four highest generic rating categories. Proposed IM-2440-2(b)(9) (emphasis added).
11. The proposed exemption as currently drafted excludes securities exempt from registration only if they also are unrated or have received a non-investment grade rating. As a result, the proposed exemption would not apply to structured products that, although sold in private placements, are rated investment grade.
12. *See* Letter from Micah S. Green, President, and Michele C. David, Vice President and General Counsel, Bond Market Association, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, Re: SR-NASD-2003-141 (Apr. 5, 2005), available at <http://www.sec.gov/rules/sro/nasd/nasd2003141/mdavid040505.pdf>.
13. *See* NASD Response to Comments, at 20 ("The lack of information regarding mark-ups distinguishes the regulatory scheme for mark-ups from the various regulatory approaches to suitability and institutional customers.").
14. The QIB standard, however, is more restrictive than the suitability rule's requirements for what is an "institutional customer." Under IM-2310-3, an institutional customer includes any entity other than a natural person, although the interpretation also states that its guidance "is more appropriately applied" to entities that hold or manage at least \$10 million in securities investments.
15. For an overview of liability for excessive mark-ups under Exchange Act Section 10(b) and Rule 10b-5, see Becker *et al.*, *supra*, at 4-7. *See also*, e.g., NASD Rule 2110 (Standards of Commercial Honor and Principles of Trade); NASD Rule 2120 (Use of Manipulative, Deceptive or Other Fraudulent Devices); NASD Rule 2320 (Best Execution and Interpositioning).
16. Proposing Release, at 29. The NASD explains in the rule filing that the exclusion of certain institutional customers' transactions "more clearly and more broadly" addresses commenters' concerns that led to the size proposal (and its predecessor, the "Specified Institutional Trade" concept, which was proposed in Amendment No. 1).
17. Proposed IM-2440-2(b)(4).
18. *Id.*
19. *Id.*
20. *Id.*
21. Proposed IM-2440-2(b)(5).
22. Proposed IM-2440-2(b)(6).
23. Proposed IM-2440-2(c)(1). The Proposed Interpretation provides a non-exclusive list of factors that may be considered in determining whether securities are "similar." *See* Proposed IM-2440-2(c)(2).
24. Proposed IM-2440-2(b)(7).
25. For a discussion of market maker status in the debt markets, see Becker *et al.*, *supra*, at 36.
26. *See Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 by the National Association of Securities Dealers, Inc., Relating to the Application of NASD's Mark-Up Policy to Transactions in Government and Other Debt Securities*, Exchange Act Rel. No. 40,511 (Sept. 30, 1998), 63 Fed. Reg. 54,169 (Oct. 8, 1998) ("In the debt securities markets, a market maker is a dealer who, with respect to a particular security, furnishes bona fide competitive bid and offer quotations on request and is ready, willing, and able to effect transactions in reasonable quantities at his or her quoted prices with other brokers or dealers." (Emphasis added)). With respect to its proposed definition, the proposing release stated: "This language recognizes that dealers in debt markets may act effectively as market makers in a group of securities without publishing continuous two-sided quotations for each security within the group." *Id.*
27. *See* NASD Response to Comments, at 5 n.17 ("NASD continues to embrace the concept of market makers in the debt markets.").
28. Section 3(a)(38) of the Exchange Act defines the term "market maker" as "any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis." 15 U.S.C. § 78c(a)(38).
29. Proposing Release, at 15 n.19.

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