



# TRACE and the US Corporate Debt Market

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# Overview

The purpose of today's discussion is to discuss NASD's Trade Reporting and Compliance Engine ("TRACE") and the US corporate debt market as well as more broadly discussing transparency and corporate debt market structure and regulation.

# Overview (Cont'd)

- TRACE has yielded three broad benefits
  - Regulators and market participants know more about the market.
  - Regulators can use the audit trail of reported trades to regulate the market.
  - Investors and professionals can now access timely information that will enhance their ability to assess the quality and fairness of the price of their transactions as well as the value of bond positions.

# I. Introduction

TRACE launched on 1 July 2002 after approximately 5 years of negotiations with the securities industry.

- US corporate debt securities are primarily traded over the counter.
  - This is the case globally as well.
- Small percentage of bonds are traded on the NYSE and Nasdaq.
- Globally, there has been very little evidence of pure exchange models accommodating corporate bond transactions with real success.
  - EurexBonds in Europe is probably the single largest exchange model and it has only limited activity.
  - Although MTS has been successful in Europe, the success has largely been limited to government bonds – an instrument that is deemed 1) risk free and 2) allows pure interest rate and currency exposure because it is risk free.

# I. Introduction (Cont'd)

## The US Corporate Debt market is characterized by:

- \$ 4.9 trillion of outstanding debt
- \$ 708 billion of new issuance in 2005
- More than 27,000 bonds
- 22,000 average daily trades in 4,700 bonds
- 97% of the \$17 billion in average daily volume is done on a principal basis.
- Total annual turnover is \$ 4.7 trillion

## The market is a dealer driven market.

- Approximately 1,700 brokers/dealers with approximately 500 trading each day.
- Trades are largely conducted by phone, although increasingly firms such as MarketAxess, BondDesk and Tradeweb are assisting the execution of trades electronically.
- Pre-trade transparency or quoting is provided through market data vendors, such as Bloomberg and Reuters. Quotes tend not to be “firm”.

## II. The History

The roots go back to the early 90's and SEC Chairman Richard Breeden.

NASD operated a system called FIPS launched in 1994 to primarily gather and also disseminate High Yield Information.

- In response to the High Yield problems of the late 80's and early 90's.
- Collected all trades for 3000 high yield issues.
- Disseminated information on 50 representative bonds.

New Impetus in late 90's by SEC Chairman Arthur Levitt who was concerned about the lack of transparency in the corporate debt market.

SEC asked NASD to build a system to collect and distribute data.

## II. The History (Cont'd)

Industry Committees were established to guide the process and increase industry buy-in to TRACE.

- Created a phased approach to dissemination:
  - Ensure that there was no damage to liquidity as a result of transparency, and
  - Provide time for the industry to adjust to trading in the new environment.
- Created a phased approach to reporting of trades to:
  - Provide time for the industry to build automation to capture transactions, and
  - Provide time for the industry participants to adjust to new manual processing priorities.

## II. The History (Cont'd)

Planned to have all trades reported within 15 minutes.

- SEC wanted 'real time' reporting.
- Industry couldn't get there right away because processing was largely not automated.
- Initially targeted 60 minutes at launch.
- Extended to 75 minutes to accommodate small firms that wanted to submit trades through the clearing corporation in an effort to achieve STP.

## III. Transaction Reporting/Regulation

All secondary trades must be reported to TRACE within 15 minutes of execution time.

- Time frame was phased in under guidance of BTRC.
- Allowed 75 minutes initially.
- Shortened to 45 minutes in 2003, 30 minutes in 2004 and 15 minutes in 2005.

NASD reviews transaction data via automated surveillance and on-site examination to:

- Ensure compliance with reporting requirements by focusing on timeliness, completeness and accuracy.
- Detect possible investor abuse and market manipulation.

## IV. Dissemination

### NASD and SEC agreed to phased trade data dissemination

- 100% of all trades reported for regulatory purposes from day one.

Phase I, launched on 1 July 2002, was designed to disseminate the most active bonds.

- All investment grade issues with \$1 billion in original issuance or greater and 50 high yield bonds.
- Approximately 500 issues with 50% of investment grade volume and 10% of high yield volume.
- If a bond's rating fell below investment grade, dissemination stopped.

## IV. Dissemination (Cont'd)

### Phase II, launched in March and April of 2003.

- Investment grade issues rated A or better with \$100 million in original issuance or greater.
- 120 selected 'triple B' bonds and 50 high yield bonds.
- Approximately 4400 issues with 65% of the investment grade volume.
- If a bond's rating fell below eligibility, dissemination stopped.
- The BTRC believed that there was general agreement that investment grade bonds were not a problem for transparency, but there was concern as credit quality declined.
  - Crafted an experiment with 'triple B' bonds, the lowest investment grade credit category.

## IV. Dissemination (Cont'd)

### Phase III launched in October 2004 and February 2005.

- Disseminated all publicly traded bonds.
- The largest trades in the least liquid high yield bonds were delayed for 2 or 4 days and the aftermarket in BBB and lower rated new issues delayed for up to 10 days.
- Provided additional time to analyze the impact on liquidity for institutional size trades in the least liquid, low quality bonds.
- Provided additional time to analyze the impact of transparency on the first days of trading on new issue bonds with credit ratings of BBB and below.

### Phase IV launched in January 2006.

- Disseminated all publicly traded bonds in 'real time'.

## IV. Dissemination (Cont'd)

TRACE data currently includes basic trade information.

- Disseminate bond, size, price and yield.
- Disseminated size is capped at \$5 million for investment grade and \$1 million for high yield.

## IV. Dissemination (Cont'd)

Professionals typically access TRACE trade data through market data vendors such as MarketAxess, Bloomberg, Thomson, Reuters or their firm's proprietary applications.

- The data can be disseminated real time.
- The data can also be disseminated on a 4 hour delayed basis.

More than 10,000 professionals access the information on a 'real time' basis through market data vendors or the TRACE web interface.

- Working to expand to retail professionals use through enterprise pricing option.

## IV. Dissemination (Cont'd)

TRACE data is also used by an increasing number of services including Bond Pricing Services which provide end of day prices to Portfolio Managers and Broker Dealers.

- They typically only use TRACE as a benchmark.
- NASD periodically discusses and encourages use of TRACE data.

Interest in historical data has grown since product launch

- Currently available to academics through Wharton and University of Houston/Mergent services.

## IV. Dissemination (Cont'd)

NASD has made increased use of TRACE data by retail investors a high priority.

Retail Investors typically access real time TRACE data at no charge through web sites such as NASD's [nasdbondinfo.com](http://nasdbondinfo.com) or TBMA's [Investinginbonds.com](http://Investinginbonds.com).

- Approximately 19K unique visitors and 60K visits each month to [nasdbondinfo.com](http://nasdbondinfo.com).
- Fidelity.com currently redistributes TRACE data in real time and Schwab has announced plans to do the same.

Aggregate data and most active bonds are carried by New York Times, Wall Street Journal, [WSJ.com](http://WSJ.com), [Barrons.com](http://Barrons.com), [MarketWatch.com](http://MarketWatch.com) and [NewYorkTimes.com](http://NewYorkTimes.com).

- NASD is working with many other sites to carry TRACE data.

NASD launched with Bloomberg a set of retail oriented indices for investment grade and high yield bonds.

## IV. Dissemination (Cont'd)

Many reports from broker dealers have indicated that TRACE data has helped them.

- This is especially true of the small and medium sized broker dealers.

Many reports from institutional investors have indicated that TRACE has become a regular part of their due diligence and their trading practices.

- Some fear broker dealers will reduce capital commitment/trade facilitation.

Many reports from individual investors have indicated that TRACE data has been helpful.

There is no conclusive evidence that there has been any damage to the market place from dissemination.

## V. What We Have Learned About the Market

There are more TRACE participants than originally thought.

- 2,100 participants have signed up.
- 1,700 traded during 2005.
- About 500 trade every day.

Trading activity is less concentrated among dealers than originally thought and than in equities.

- The top 10 participants do 54% of the volume and the top 50 do 92%.
- The top 10 participants do 33% of the trades and the top 50 do 74%.
- The top 10 Nasdaq market makers do 66% of shares and the top 50 do 98%.

## V. Market Lessons (Cont'd)

The market place is far more active than originally anticipated.

- On a typical day, \$16.5 billion turns over in 22k trades.
- Initial estimates were about \$10 billion in volume and 12 to 15k trades.

The breadth of the market is much wider than initially anticipated

- 4,700 of the 27,000 active publicly traded issues, or roughly 17%, trade at least once each day.
- Initial estimates were about 5 to 10% of issues would trade each day.
- About 46% of the eligible issues have at least one trade each month.
  - This is true for investment grade, high yield and convertibles.

## V. Market Lessons (Cont'd)

There is far more retail type activity than originally anticipated.

- 1.7% of volume and 62% of trades are under \$100k.
- Investment Grade: \$10 billion turns over in 15k trades.
  - 2% of volume and 73% of trades are under \$100k.
- High Yield: \$6.4 billion turns over in 7k trades.
  - 1% of volume and 54% of trades are under \$100k.
- Convertibles: \$2 billion turns over in 1,700 trades.
  - .6% of volume and 51% of trades are under \$100k.

## V. Market Lessons (Cont'd)

Although credit quality has an effect on the level of retail type activity, it is significant at all levels.

- AAA/Aaa: 80% of transactions are under \$100k.
- AA/Aa: 72% of transactions are under \$100k.
- A/A: 73% of transactions are under \$100k.
- BBB/Baa: 72% of transactions are under \$100k.
- BB/Ba: 71% of transactions are under \$100k.
- B/B: 38% of transactions are under \$100k.
- CCC/Caa: 42% of transactions are under \$100k.
- CC/Ca: 47% of transactions are under \$100k.
- C/C and D: 41% of transactions are under \$100k.

## VI. Transparency, Corporate Bond Market Structure and Regulation



- It is possible to have “real time” trade reporting and trade dissemination for price comparison, trading and analysis in a market that provides for OTC transactions. TRACE is a successful example.
- Mandatory “real time” trade reporting to a centralized facility and dissemination is the cornerstone to developing a regulatory framework that helps ensure price integrity and best execution. Regulators can assess firms’ execution quality by monitoring how firms are utilizing disseminated prices. In addition, regulators can review firms’ markup practices as well as monitor overall trading activity.

## VI. Transparency, Corporate Bond Market Structure and Regulation (Cont'd)



- A fulsome trade reporting and dissemination functionality will provide
  - All market participants valuable price information, vital not only in investment decisions but in establishing end of day/month pricing for bond positions and portfolios.
  - A “level playing field” that will facilitate competition and efficiency.
  - Regulators with the information necessary to help insure market integrity and investor protection.

*THANK YOU*