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***Testimony before
The Committee on Banking, Housing and Urban Affairs
United States Senate***

Oversight Hearing on Bond Market Regulation

I. Introduction – The Bond Market Association Mission

Thank you Chairman Shelby, Ranking Member Sarbanes and members of the committee for this opportunity to provide an update on the bond markets. With offices in Washington, New York and London, The Bond Market Association represents securities firms and banks that underwrite, trade and sell debt securities and other financial products on a global basis. Our members account for the overwhelming majority of bonds underwritten and dealt in the United States and also include the 23 primary dealers of U.S. Treasury securities as recognized by the Federal Reserve Bank of New York. Our affiliate organizations, the American Securitization Forum and the European Securitization Forum, represent all classes of participants—including issuers, investors, dealers and others—in the fast-growing securitization markets on the two continents. The Asset Managers Forum, another Association affiliate, represents the operational, accounting and regulatory interests of firms that manage bond investments, or “buyside” participants in the fixed-income markets.

As the voice of the fixed-income markets, the fundamental mission of The Bond Market Association is to advocate public policies before Congress and regulators that will enhance market efficiency and safety. The Association also plays an important role in establishing standard market practices and documentation for common transactions as well as promoting guidelines for the business conduct of market participants. In addition, the Association is fully committed to the goal of investor education, both through the Association itself and through The Bond Market Foundation, our educational, 501(c)3 partner. The Association maintains an award-winning website, *investinginbonds.com*, with a wealth of information—including up-to-date bond prices—for individual investors. The Foundation has created websites including *unwantedchange.com* and *tomorrowsmoney.org* (also available in Spanish at *ahorrando.org*) to help educate the public on the fixed-income market and the need for basic financial planning. The Foundation is currently working with several state treasurers on financial literacy campaigns.

II. The Bond Markets

Market Structure and Participants

The Primary Market

The principal purpose served by the bond markets is to link those with money to lend through the purchase of debt securities—pension funds, insurance companies, banks, mutual funds, individuals and others—with those who seek to borrow money to finance investment—homebuyers, corporations, states and localities, the federal government and others. Lenders in the bond markets are investors and borrowers are issuers. Bonds can be thought of as loans in the form of securities.

The bond markets are overwhelmingly dominated by institutional investors who held 89 percent of the market in 2003. (See Appendix.) Of the \$880 billion in trades on an average day in 2003, approximately \$760 billion was conducted on the behalf of large, sophisticated institutional investors such as investment companies, pension and hedge funds. These market participants have the necessary expertise to value fixed-income securities and maintain relationships with bond dealers. Although recent studies have shown the actual numbers of smaller “retail-type” trades are increasing, these trades continue to represent a small portion of overall volume.

Bond issuers include any entity with a need for financing and the capacity to attract investors. On the public side, this includes all levels of government: federal, state and local. Public schools and public institutions such as hospitals also have the authority to issue bonds, as do other state and local authorities. For federal, state and local governments, who are unable to raise equity capital by issuing stock, bonds are the principal sources of long-term capital available to finance investment. Corporations also issue bonds to meet funding needs, typically in far greater volumes than stock.

For corporations, bonds can provide a lower cost source of capital than bank borrowing, and an attractive solution to the financing of long-term projects. For large corporations, the bond market is the only practical way to raise significant volumes of debt capital to finance investment. But, they also carry a contractual obligation for the issuer to make certain payments. Dividends paid on stocks, by contrast, are generally declared at the discretion of the company. Bond issuers and investors (in most non-sovereign bonds) enter a formal contract, called an indenture. This agreement describes certain requirements the issuer must satisfy, known as covenants. Usually intended to protect investors, a covenant might, for example, require a company to maintain a certain minimum cash flow to ensure sufficient funds will be available to make the bond’s interest payments.

Bond dealers are securities firms or—in the case of U.S. government and agency securities—departments of commercial banks engaged in the underwriting, trading and sale of debt securities. Investment bankers work with issuers to develop the structure and price of a bond issue in order to minimize the issuer’s financing cost. Structure includes

elements such as the bond's maturity, the frequency of interest payments, and the seniority of the debt relative to the issuer's other financial obligations. Any credit enhancement, such as a guarantee or bond insurance, is also considered part of a bond's structure. Pricing a bond issue entails gauging investor interest in the transaction and pricing the bond so its interest rate is attractive to both the issuer and the investor. This process takes into account the credit quality of the bond issuer and current market interest rates among other factors.

Because the investors know the return on a bond held to maturity, they may consider it a more predictable investment than a stock. The return on stocks is based on dividends and capital appreciation. Investors cannot be certain the company will pay a dividend or how the market will value the stock over time. Investors cannot be certain how the market will value a bond over time either, but they can remain confident the bond issuer is contractually obligated to make interest, or coupon, payments and ultimately a principal payment.

Bonds offer all investors the opportunity to diversify the risk in a portfolio. Investment advisors recommend that investors invest in a mix of both bonds, or bond mutual funds, and stocks. Not only do bonds provide a steady stream of income, but they also provide a hedge against the volatility of stocks.

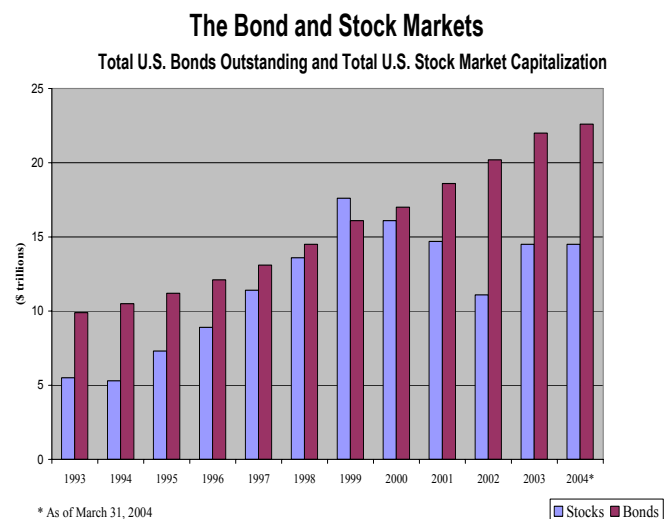
The Secondary Market: Bonds do not Trade Like Stocks

The return that bonds provide investors is usually based on interest and principal payments. Bond prices rise and fall inversely to their yield, which is a function of a bond's price and interest rate. A bond issued with a 5 percent yield will drop in price if market conditions require a higher yield. If market interest rates fall below 5 percent, the price of the bond will rise to bring the yield, once again, in line with the market.

With \$22.6 trillion in outstanding securities, the bond markets dwarf the \$14.5 trillion equity markets. Yet, generally, the \$880 billion in bond trades that take place on a daily basis do not occur on a centralized, organized exchange or trading system as does the \$85.5 billion in daily stock trades.

Instead, the secondary market for bonds is a decentralized, over-the-counter (OTC) market.

U.S. securities exchanges are based on the concept that market makers will continuously offer to buy and sell securities by quoting a bid (buy) and offer (sell), because there is a steady stream of other customers who are willing to buy and sell the same securities.



However, it is practically impossible for dealers to quote continuous two-way prices in the debt markets.

First, with varied maturities, yields and other structural features, bonds are far less homogeneous than stocks. Consequently, it would be impossible for a single dealer—or even all dealers combined to be able to make continuous price quotes in all outstanding debt securities. This is made even more difficult by the fact that the number of bonds is orders of magnitude greater than the number of stocks. The same company whose stock is available for purchase by the public might also have issued dozens or hundreds of separate bonds each with a unique set of features. Ford Motor Company, for example, has \$28 billion in stock outstanding but \$180 billion in long-term debt. There are approximately 4.4 million mortgage- and asset-backed, municipal, corporate and government securities outstanding while there are just 8,159 securities listed on the major stock exchanges.

Second, dealers are less willing to make continuous price quotes because bonds are inherently less liquid than stocks. The vast majority of bonds rarely trade. To take the corporate market as an example, a 1996 estimate by the Association revealed that of then 400,000 corporate bonds outstanding, only 4 percent or 16,000 traded at any point during that year. The \$3.7 trillion Treasury market is the most actively traded, or liquid, of all the bond market sectors. Yet even among Treasuries, trading is mostly concentrated in freshly issued or “on-the-run” securities. This means that the secondary market for most bonds is inherently less liquid than for equity securities. The vast majority of investors are “buy-and-hold” investors—they tend to hold on to bond investments for significant periods rather than trade them actively—and because the objective of investors is a particular structure, level of interest income and credit risk, and there is a large number of new issues, older issues are less attractive than new issues. Secondary market investors are more willing to purchase bonds that are part of large issues (those over \$1 billion), because they are more likely to already own bonds from such an issue.

For these reasons, the dealer market is a more likely source of liquidity for the secondary bond markets than a centralized exchange would be.

In recent years, market participants and entrepreneurs have developed electronic trading platforms to execute trades in fixed-income and other credit market products online. The Bond Market Association publishes an annual review of electronic transaction systems for fixed-income securities, which may be found on our website at http://www.bondmarkets.com/research/ecommerce/ETS_Report_1103.pdf.

Some of these are inquiry systems, which enable an investor to seek prices simultaneously from a number of dealers and others with respect to named securities. Cross-matching systems generally bring both dealers and institutional investors together in electronic trading networks that provide real-time or periodic cross-matching sessions. Buy and sell orders are automatically executed when matching buy and sell orders are entered at the same price or when the posted prices are “hit” or “lifted.” These matching systems have achieved only limited acceptance and success.

Multi-dealer systems, on the other hand, represent one of the most successful models for electronic bond trading. They link dealers and their institutional customers. Examples include platforms such as MarketAxess and Tradeweb. These platforms provide price discovery and trade execution and processing. To the extent that some of the securities traded on these platforms are not publicly registered (having been issued privately under a special exemption), the systems in such cases are only available to qualified institutional buyers (QIBs).

In sum, there are several important characteristics distinguishing the bond markets from the stock markets. These differences have resulted in a market structure and regulatory system for bonds that is distinct from the same systems for stocks. These characteristics include:

- Market diversity – There are many millions more different bonds outstanding than stocks.
- Market structure – Bonds trade almost exclusively on an over-the-counter, dealer-based, principal market rather than on an exchange or national market system.
- Issuance – A significant portion of bond issues are sold as private placements under the Securities and Exchange Commission’s Rule 144A, which puts them out of the reach of individual and small institutional investors. In 2003, 144A bonds accounted for 30 percent of corporate bond issuance.
- Liquidity – Most bonds rarely trade, and most investors are “buy and hold” investors.
- Institutions – The vast majority of bonds outstanding are owned by institutions in portfolios managed by professionals. The vast majority of trading volume involves institutions.

Bond Dealers and Capital at Risk

The willingness of dealers to put capital at risk is critical to the bond markets and is the source of market liquidity. When an investor wants to sell a bond in the secondary market, he or she usually sells the bond to a dealer. The dealer then attempts to resell the bond to another investor. This function is known as “market-making.” The period between a dealer’s purchase of a bond and when the dealer sells the bond is described as the time the bond is in the dealer’s “inventory.” As long as a dealer holds a bond in inventory, the dealer is at risk of a market loss if the bond’s price falls. An active and liquid market depends on the willingness of bond dealers to buy and sell bonds actively and put capital at risk. As compensation for this risk, a dealer attempts to earn a “spread” between the price paid for a bond and the price at which it is resold. By contrast, brokerage firms in the equity markets are usually compensated by a commission for purchasing stock on the behalf of an investor, as agents rather than principals.

Integral to this process and overall efficiency in the market is inter-dealer trading and the role of the inter-dealer broker. Competing dealers often want to trade bonds with each

other, and prices in the inter-dealer market help determine prices for non-dealers. However, dealers do not want to communicate directly with their competitors. Inter-dealer brokers intermediate trading between bond dealers. By posting inventories with an inter-dealer broker, bond dealers are able to find the best prices from other dealers without revealing their positions or strategies. The functions and services of inter-dealer brokers have become automated to a significant degree, especially in the markets for more liquid products such as Treasury securities, and a large volume of inter-dealer transactions are executed electronically.

Current Market Conditions and Derivatives

For several years now, interest rates have remained at historic lows. Conditions are changing, however, and many market observers anticipate that interest rates will continue to rise in the coming weeks and months, with a resulting drop in bond prices. Already, for example, the yield on the 10-year Treasury note, a benchmark for bond market performance, has risen from 3.11 percent at its lowest point in the current market cycle on June 13, 2003 to 4.75 at market the morning of Tuesday, June 16, 2004. (Of course, for investors considering entering the market today, higher yields translate into higher interest payments than were available previously.)

The bond markets have experienced rising-rate environments numerous times in the past. Rates were also at a low point in 1993 before a rapid rise led to extraordinary losses in many fixed-income portfolios. Much has changed since 1994, suggesting the market is better prepared than 10 years ago to weather rising interest rates. Hedging and risk management have improved significantly. The undeniable trend in the financial markets over the last decade has been the development of products, strategies and technologies which allow market participants to parse various types of risk and price, hedge and manage them separately. Market participants use these tools to implement sophisticated risk management practices which reduce overall systemic risk and increase market efficiency.

Credit derivatives, or the commitment of a “seller” of protection to make certain payments if a given credit event—such as a default—occurs, are one example. These contracts permit bond dealers and portfolio managers to hedge against, or buy protection from, certain credit events. Financial contracts, such as interest rate swaps, provide similar protection against movements in interest rates. Products such as credit derivatives and interest rate swaps have made it much cheaper, safer and more efficient for all issuers, investors and dealers to manage risk.

By redistributing risk, derivatives aid liquidity in the bond markets. A bond dealer who is exposed to a significant concentration of risk associated with a company or an issuer can use a credit derivative to limit potential losses. In a credit default swap, for example, the buyer of protection could receive payment upon an issuer’s default on bonds owned by the protection buyer. Armed with such protection, the dealer is more likely to continue to put capital at risk by actively dealing in the same or similar bonds, aiding liquidity in that security.

The ability to better manage risk has been aided by laws and regulations, such as the Commodity Futures Modernization Act of 2000, which recognize the importance of

instruments such as swap contracts in enhancing risk management. Federal Reserve Board Chairman Alan Greenspan has been an ardent supporter of derivatives as a risk management tool. In 2002 he noted, “these increasingly complex financial instruments have especially contributed, particularly over the past couple of stressful years, to the development of a far more flexible, efficient, and resilient financial system than existed just a quarter-century ago.”

Even with these mitigating factors, however, it is likely that total rates of return on many bond investments will not keep pace in the coming months with the stellar performance that most bonds offered over the past several years. All investments carry the risk of loss, bonds included. It is simply not possible to predict with certainty the effect of interest rate changes on the portfolios of the thousands of public and private investors in the United States.

The Bond Market Association’s Investor Education Initiative

The Association, along with our educational not-for-profit partner, The Bond Market Foundation, addresses the need of the general public to have more knowledge and information about savings and investment planning, especially given the present market conditions. We have constructed interactive and educational internet-based tools to help typical investors as well as underserved audiences—women, young adults and Americans who speak Spanish—access basic quality information on saving and investing, including bonds, and their role in the economy, communities and in retirement and financial planning.

The Association is continually updating the content of *investinginbonds.com*, with new data, information and features. These sites have become a daily source for bond price information in the municipal, corporate and government bond markets. Articles explaining the implications of the anticipated increase in interest rates and new fixed-income products such as Treasury Inflation-Protected Securities (TIPS) continue to drive traffic to the site. In May alone, *investinginbonds.com* registered 70,000 unique visitors. A recent addition is the Income Calculator with which investors can test various yield and price scenarios, calculate convexity, duration and various yield values, and map cash flows. The calculator was provided in cooperation with BondDesk Analytics and TIPS, Inc.



Produced by the Foundation, *tomorrowmoney.org* is a step-by-step guide to help people start saving and investing today. It is presented as a public service, targeted at two audiences—women and young adults just starting out—and

A screenshot of *Investinginbonds.com*.

anyone else who needs motivation, confidence and beginning skills to build a saving and investing plan. *Ahorrando.org* is the Spanish-language version of *tomorrowsmoney.org*. The Foundation's other website, *unwantedchange.org*, provides important financial information for individuals faced with the stress of sudden change in their lives such as the loss a spouse.

III. Regulation of the Bond Markets

There are multiple levels of regulatory scrutiny and oversight of the U.S. bond markets and bond market participants. Government and industry regulation of bond market participants is undertaken mainly by the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD) and the Municipal Securities Rule Making Board (MSRB) in addition to the oversight of municipal issuers by state and local officials. In addition, the New York Stock Exchange (NYSE) serves as a frontline regulator as well, enforcing NASD, SEC and MSRB rules on its members. Along with the NYSE, the MSRB and the NASD are self-regulatory organizations, or SROs. The NASD enforces many of the SEC's and all of the MSRB's rules in addition to some rules of its own rules on member broker-dealers. The Treasury Department is the principal rule maker in the market for its securities as well as the debt instruments of certain government-sponsored enterprises. Federal bank regulators oversee the securities operations of most banks.

It is the Association's view that the bond markets need strong and sufficiently funded regulators to assure integrity, efficiency, fairness and safety. The scope and nature of regulation, however, should not dilute the markets' dynamic ability to create a structure that best meet the needs of all participants for a fair and efficient system. Innovation within the parameters of fundamental regulation should be embraced. Rules that arbitrarily restrain the market without a corresponding benefit should be avoided.

Government Regulation

Under the Securities Act of 1933 and the Securities Exchange Act 1934, the SEC is charged with protecting investors by maintaining the integrity of the securities markets. As broker-dealers, bond dealers are supervised in several ways by the SEC. Net capital rules require bond dealers to maintain a certain amount of liquid capital—cash or assets easily converted into cash—depending on their level of indebtedness. The rule is intended to ensure broker-dealers can meet obligations to other market participants or retail customers. Broker-dealer internal controls and risk management capacity are also supervised by the SEC. Rules on books and records detail what sort of documentation broker-dealers should create in the course of doing business and which of those records should be preserved.

Under the SEC's suitability rules as applied to retail investors, broker-dealers must "know their customer," or make assurances that the financial products recommended to retail customers are consistent with the customer's investment goals, risk tolerance and other factors. Broker-dealers are also fully subject to the anti-fraud provisions of the federal securities laws that generally prohibit the misrepresentation of facts in the course of securities transactions, as are all participants in the bond markets, including governmental entities. The anti-fraud rules apply to purchases and sales of all bonds

including corporate, municipal, federal agency and Treasury. Violations of the anti-fraud provisions can lead to civil and criminal penalties. Bond dealers are also subject to periodic examinations to ensure compliance with regulations.

The Securities Act of 1933 also requires the registration of many securities issues, and the Securities Exchange Act of 1934 requires periodic financial disclosure by many issuers of securities. Both requirements are also subject to the SEC's anti-fraud authority. Under rule 144 and 144A, an exception is made if the securities are not offered to the public, but in a private placement.

The SEC's anti-fraud authority also applies to the municipal market, including state and local government bond issuers. In addition, while generally prohibited from regulating the ability of state and local governments to offer debt securities to the public, the SEC has rules requiring underwriters of municipal securities to obtain and review disclosure documents, known as Official Statements, from issuers and make them available to investors and other market participants before offering securities for sale.

The Treasury Department's authority over the market for its securities was established by the Government Securities Act of 1986 and amendments enacted in 1993. The Treasury Department requires that government securities dealers be registered with the SEC and maintains extensive rules related to government securities auctions or, in the case of bank dealers, the bank's principal banking regulator.

Self Regulation

As SROs, the MSRB and NASD craft market rules with input from the public and the boards of both entities include public representatives. The rules are subject to approval by the SEC, but the organizations have a heavy influence on broker-dealers as frontline regulators for the corporate and municipal debt markets.

The MSRB was created under the Securities Acts Amendments of 1975. The law specifically extended the SEC's authority to broker-dealers in municipal securities. The MSRB's mandate is the promulgation of market rules for dealers, dealer banks and brokers, but not issuers of municipal securities.

While issues such as record keeping, clearing and settlement and quotation conventions are addressed by the MSRB's 39 general rules, the regulation of fair practices has dominated the MSRB's agenda. Generally, the fair practice rules prohibit deceptive and unfair practices in the conduct of the municipal securities business. Dealers are subject to suitability requirements with respect to their retail customers similar to those articulated in the SEC rules. The MSRB also sets out a process for the arbitration of dealer-customer disputes. Issues such as political contributions to municipal issuers and the use of consultants to solicit municipal underwriting business are also covered by the MSRB's fair practice rules.

The majority of firms doing business with members of the public are required under federal securities laws to become a member of the NASD. The NASD serves as the enforcement arm of the SEC and the MSRB and also promulgates some of its own rules.

As part of its powers, the NASD reviews its member firms for compliance with its rules and can sanction those found in violation.

State, Local and IRS Regulation of Municipal Issuers

While neither the federal securities laws nor the MSRB have direct regulatory authority over issuers of municipal bonds—except with respect to the application of anti-fraud rules—such securities offerings are carefully overseen in a variety of ways depending on the nature of the issuing entity. State constitutions routinely prescribe limitations on the level of debt a state may incur. Similarly, political subdivisions of the states such as cities, counties and school districts have their own rules on bond issuance. Some jurisdictions require an affirmative vote—even a super-majority in some cases—by the public before a bond issue can be authorized. In some states, local bond issues must be approved by a state body.

Municipal issuers also face oversight in the form of the auditing powers of a superceding political authority. Cities and counties, for example, may be subject to audits by a state agency. School districts may have their balance sheets and budgets examined by a state education authority.

Because municipal bonds are exempt from federal income tax, the Treasury Department and the Internal Revenue Services (IRS) also have oversight authority. The IRS has the power to strip a municipal bond of its tax-exemption if, for example, it is found to be issued for a prohibited purpose or for other violations.

TBMA “Voluntary Regulation”

Setting Standards of Practice

The Association at times identifies issues that regulators are not addressing that affect a sector of the bond markets. In such an instance, or if the Association identifies the opportunity to improve market efficiency or liquidity by standardizing an approach to a given transaction, Association members work together to develop a set of uniform practices or a model agreement. Examples of this type of voluntary regulation exist across the sectors of the bond markets.

For repurchase agreements (repo), for example, Association members developed the Master Repurchase Agreement (MRA) and the Global Master Repurchase Agreement (GMRA). These agreements cover such issues as events of default and timing of payments and transfers. For a market where billions of dollars in contracts are traded daily, the MRA and GMRA eliminate much of the legal risk in repo transactions allowing market participants to operate more efficiently.

In the mortgage-backed securities (MBS) sector, participants rely on the Association’s Uniform Practices to guide them through the questions that might arise on trading, delivery, clearance and on settlement guidelines and calculation formulas for the mortgage- and asset-backed markets. The guidelines are intended to serve the needs of back-office, trading, research and compliance professionals.

Other examples of the Association facilitating the standardization of a fundamental transaction are the Master Agreement Among Underwriters (MAAU) and the Master Selling Agreement (MSG) for municipal offerings. There are thousands of state and local governing bodies with authority to issue municipal bonds. The MAAU and MSG reduce the administrative and compliance burdens municipal underwriters can face when dealing with a variety of issuers.

The Guiding Principles to Promote the Integrity of Fixed-Income Research

A current example of the Association moving proactively to address an issue of interest to participants in the fixed-income markets is the recently completed set of principles on integrity in fixed-income research. In the wake of the controversies in the equity markets around the question of research independence, the Association set out to create a guide for research on fixed-income securities. *The Guiding Principles to Promote the Integrity of Fixed-Income Research* is the result. It is a comprehensive set of voluntary principles designed to help the Association's member firms manage potential conflicts of interest that arise in their research activities.

Regulators, analysts' groups and a host of other market participants have extensively reviewed the principles which are intended to promote an independent flow of unbiased information to the global fixed-income capital markets. Association members collectively undertook the development of these principles independent from regulators, despite an apparent lack of abuse in the fixed-income sphere. The Association purposefully chose a 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 accommodated within the framework.

The *Guiding Principles* seek to ensure research analysts are free from internal or external influences that could inhibit their ability to produce impartial assessments. For example, they recommend analysts not participate in investment banking activities, which could raise questions about their independence. The *Guiding Principles* also address potential conflicts of interest that arise from the personal interests of analysts recommending that firms impose limitations on the personal trading activity of research analysts.

Firms are encouraged to 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 some ways, the *Guiding Principles* go further than the U.S. regulations or legal settlements covering equity research, by addressing conflicts between research and sales and trading activities. Specifically, the *Guiding Principles* recommend firms prevent analysts' recommendations from being prejudiced by the firm's trading activities. In addition, traders should not know the content or timing of upcoming reports before they are issued.

Guidance for Credit Derivatives and Debt Securities Markets

As a member of the Joint Market Practices Forum, a group of four financial market trade associations representing a wide range of credit market participants, the Association worked to develop a set of principles and recommendations for the handling and use of

material nonpublic information when managing credit risk. The document is intended as a set of guidelines for use by financial institutions that use securities and securities-based swaps to manage and hedge their credit portfolios. The Forum issued an exposure draft of these recommendations in May 2003, and considered comments on that draft in producing the final version.

The recommendations are meant to ensure material nonpublic information obtained by financial services firms in the ordinary course of their lending or other relationships with a company is not inappropriately shared with or used by other business units or personnel within the same institution that transact in the securities and credit derivative markets. Material nonpublic information is information that is not available to the public and that can be considered important in making investment decisions.

The Municipal Council

The Municipal Council is comprised of 19 municipal market participants, and works to improve secondary market disclosure in the municipal markets. One recent initiative was the development of an information clearing house that is expected to serve as a one-stop filing place for issuers' secondary market disclosure documents and to improve the way the documents are indexed at the existing nationally recognized municipal securities information repositories and state information depositories.

IV. Policy Issues in the Sectors of the Bond Market

Mortgage- and Asset-Backed Securities

Debt securities whose interest and principal payments flow from secured assets, such as loans, comprise a relatively new sector of the bond markets. Securitization, as the process is known, got its start in the early 1970s with the first issuance of mortgage-backed securities. Today, it is the largest and fastest growing sector of the bond markets with \$7 trillion in securities outstanding.

In a securitization transaction, investors purchase the rights to receive payments made on a group, or pool, of loans or other cash-producing assets. Securitization increases the efficiency of the financial markets by speeding the reallocation of capital. For example, if a bank can sell the home mortgages it holds to investors, it can use the money it receives in return to make other mortgages. Securitization can also smooth out geographic differences in supply and demand of funds available to loan. And by attracting funds from a variety of investors, securitization effectively expands the pool of capital available to lend and helps reduce rates on car loans, student loans, home mortgages and a variety of other consumer lending.

Congress accommodated development of the securitization markets in several ways. First, Congress created Ginnie Mae, Fannie Mae and Freddie Mac to bolster the market for home mortgage loans by buying pools of mortgages and selling securities backed by the pools. In the case of Ginnie Mae, these securities are backed by the full faith and credit of the federal government. In addition, Congress sanctioned a vehicle called a real estate mortgage investment conduit, or REMIC, designed to facilitate the issuance of mortgage-backed securities (MBS). These efforts are examples of public policies with

positive effects on the financial markets and more importantly, on consumers, investors and others who benefit from efficient markets.

More recently Congress and the Financial Accounting Standards Board (FASB) examined the legal underpinning of the securitization trust—also called the special-purpose entity, or SPE—following the Enron bankruptcy. Enron had used SPEs to inappropriately remove liabilities from its balance sheet when it retained the economic risk and the control of the assets. FASB drafted new rules on the use of SPEs that alter the circumstances under which a corporation would be required to consolidate the assets in an SPE on its balance sheet. The Association worked with both Congress and FASB during this process to assure the ability of corporations to conduct appropriate transactions would not be limited by rules seeking to curb abuses.

The Association is also working with Congress on a common-sense solution to predatory lending that will not impair the secondary market for mortgage-backed securities. Several state and local anti-predatory lending statutes extend liability for lending abuses to loan purchasers, or assignees. The varying laws make securitization of loans in the affected jurisdiction more risky and less attractive to secondary market participants. Association members believe Congress should enact a single preemptive predatory lending law that holds loan assignees responsible only for those lending violations that can be detected by a review of a standard loan file.

Municipal Bonds

Municipal bonds are one of the most popular sectors of the bond market among retail investors. These securities are issued by state and local governments and government authorities for their own benefit and the benefit of non-profit hospitals, schools, colleges and universities. Presently, there are about \$1.9 trillion in municipal bonds outstanding. Over the years, these bonds have funded millions of miles of roads, 90 percent of public school construction and countless improvements to public infrastructure, among other projects.

The Internal Revenue Code confers a special tax-exempt status on most bonds issued by state and local governments. Investors who buy the securities pay no federal income tax on the bonds' interest payments. And if an investor resides in the state where the bond is issued, state income tax is usually waived as well. The federal tax-exemption on state and local government bonds is a form of financial assistance from the federal government to states and localities. Because they pay no taxes on their interest income, municipal bond investors accept a lower pre-tax rate of return on their investments. Issuers, then, can pay lower interest rates and still keep the after-tax return on municipals on par with similar taxable bonds. The tax-free status makes municipal bonds the lowest cost financing available for most governments.

The municipal bond market is most retail of all the U.S. market sectors. Unique among the bond markets, about one-third of municipal bonds are owned by individuals directly or through mutual funds. The majority of municipal bonds, however, do not trade every day and prices for municipal bonds are not as readily available as stock prices. Since 1995, the Association has worked with the MSRB to bring greater price transparency to the municipal bond market with real-time trade reporting. The Bond Market Association

makes municipal bond prices available on its website, *investinginbonds.com*, on a next-day basis. The retail nature of the municipal market makes it especially important that price transparency help ensure dealers are executing municipal bond transactions at prices that reflect current market yields. At the same time, the Association has stressed the need to balance the benefits of transparency with the costs to liquidity. Some market participants, dealers and investors, are concerned that price transparency may do more harm to the market than good when imposed on the least liquid segment of the market or those bonds that rarely trade.

Bonds that have been outstanding for a long period of time or have uncertain credit standings can be difficult to value. Dealing in and holding such bonds presents greater market risk for dealers than bonds that trade frequently and can quickly be resold. In addition, quoting prices on illiquid securities—especially those that are unique in terms of credit or cash flow—can be more labor intensive than for more liquid securities. A bond that traded this morning will not necessarily trade this afternoon, tomorrow or next week. Disseminating price information immediately following a large transaction in bonds of this type signals other market participants that a seller is disposing of a large block of bonds. Knowing the bond holder is eager to sell may cause market participants to understate prices for the bonds. In turn, these circumstances may limit dealer participation in illiquid securities. The Association supports immediate price dissemination for nearly all municipal bond transactions. For a narrow set of bonds that comprise about 5 percent of the market, however, such disclosure could have a negative effect on liquidity. The Association has asked the MSRB to withhold dissemination of price information for these bonds pending further study to verify the benefits of dissemination outweigh any negative effect on liquidity.

Investment-Grade Corporate Bonds

Corporate bonds are debt obligations of private and public corporations. Companies use the proceeds from selling bonds for a range of purposes including financing new investment and creating jobs. At the end of March 2004, there were \$4.6 trillion in investment grade and high-yield corporate bonds outstanding. Investors are generally institutions such as pension funds, endowment funds, mutual funds and insurance companies seeking the steady income and low credit risk bonds can provide.

Similar to the MSRB's effort to develop a real-time price reporting system for trades in municipal bonds, the NASD, as of July 1, 2002, began requiring its members to report corporate bond trades. Through its Trade Reporting and Compliance Engine, or TRACE, the NASD maintains a database of transactions for about 25,000 bonds. TRACE-eligible securities include most U.S. dollar-denominated corporate bonds. Mortgage- and asset-backed securities are specifically excluded from TRACE reporting. Initially, TRACE provided real-time price information for 500 of the largest investment-grade bonds or those with an original issue size greater than \$1 billion—responsible for about 50 percent of market volume. In 2003, the NASD increased the number of bonds for which it disseminated information to 4,200 and has a pending proposal to release price information on an immediate basis for approximately 23,000 bonds—enough to account for 99 percent of market volume. This information is available to the public on a delayed basis. The NASD makes the real-time information available on a fee-basis through vendors.

The Association has supported the NASD's development of the TRACE system and provided comment on each phase of the system's implementation. Indeed, the TRACE system represents a good example of a partnership between a regulator and the industry being regulated. TBMA and the NASD, for example, each provide representation to the Bond Transaction Reporting Committee (BTRC), the group of industry professionals that advises the NASD Board on TRACE implementation issues. The Association has particularly appreciated the NASD's gradual approach to increasing price transparency. As with municipal bonds, it is possible the adverse effect on liquidity for bonds that do not trade frequently could outweigh the benefits of price transparency.

Securities Lending and Repurchase Agreements

Repos and securities lending transactions are important for liquid capital markets. They represent a secure method of obtaining funding and securities for market participants. Economically, a repo is a loan secured by a Treasury security or other financial instrument. The loan is structured as a sale of a security for cash with an agreement to repurchase the security at some time in the future. Repos can be as short as overnight or as long as several months. Most repos are very short term. If the borrower of funds fails to repay the loan, the lender can liquidate the securities held as collateral to repay the debt. The repo lender is able to make a safe, short-term investment. By providing a ready source of funding, repos and securities lending are critical to bond market liquidity, particularly the Treasury markets. The ability of participants in the wholesale capital markets to finance and hedge positions with repos and securities lending transactions is a fundamental reason for the efficiency of the U.S. capital markets and ultimately help keep borrowing costs low.

Approximately \$1.7 trillion in repo and securities lending transactions were outstanding per day on average in 1996 while today an average \$4.49 trillion per day are outstanding. Hundreds of billions of dollars in repo transactions are conducted daily to fund the positions of bond market participants and repos are the principal means used by the Federal Reserve to conduct open market operations.

For several years, Congress has discussed improvements to the bankruptcy and banking laws that would simplify the treatment of financial contracts such as repos and securities lending transactions in the event of the insolvency of one of the parties to the transactions. The changes would facilitate closeouts and netting so counterparty obligations could offset one another. The resulting market certainty would improve efficiency in the broader capital markets. In addition, the bill would expand the list of repo collateral eligible for special treatment under the bankruptcy code. Both the House and Senate have approved these financial contracts provisions several times as part of comprehensive bankruptcy reform legislation, but have failed to agree on a final bill because of unrelated issues. Most recently, the House approved such legislation in March 2003. The Senate, however, has yet to consider the legislation.

The Association is also focused on the potentially negative effect the Basel Committee on Banking Supervision could have on the repo market with its efforts to draft a new bank capital accord. The current approach, the Third Consultative Paper (CP3), issued in April 2003, fails to account for methods widely used to mitigate risk exposures. Actual capital

charges for banks would not reflect true balance sheet risk under the proposal. The undue capital charges would inhibit bank activity in the repo market and ultimately result in less efficient and more costly markets.

Treasuries

The estimated \$3.7 trillion in publicly held securities issued by the U.S. Treasury play a huge role in the world of finance. The fact that Treasury securities are denominated in U.S. dollars and are backed by the full faith and credit of the federal government have made these debt instruments the safest investment in the world. As a result, the financial markets view Treasury securities as a benchmark, or a guide to interest rates, and use Treasuries to set prices on many other types of debt securities.

Treasury securities are held by U.S. and foreign investors and by central banks and governments throughout the world. This universal acceptance extends to Wall Street where financial engineers use Treasury securities in a variety of investment and risk management products. The Treasury market is the most liquid in the world with over \$400 billion in transactions per day, and well over \$1 trillion per day including securities bought or sold under repurchase agreements.

A significant participant in the Treasury market is the Federal Reserve, which uses the securities to implement monetary policy. The Fed either buys and sells Treasuries outright—these operations are known as coupon passes and happen relatively infrequently—or enters into Treasury-backed repo transactions to influence the amount of money in circulation, which occur on an almost daily basis. The New York Federal Reserve Bank also acts as agent for the Treasury Department in its auctions of bills, notes and bonds. In addition, the Fed operates Fedwire, the clearing and settlement system for trades in Treasury securities, and serves other important functions.

The Treasury market—especially for its size—operates efficiently and generally free of problems. The market is supported by a complex and sophisticated automated infrastructure for clearing and settling the huge volumes of transactions executed daily. Regulation of the market began with the enactment of the Government Securities Act of 1986, which brought previously unregulated government securities dealers under the SEC's supervision for the first time, and subsequent amendments enacted in 1993.

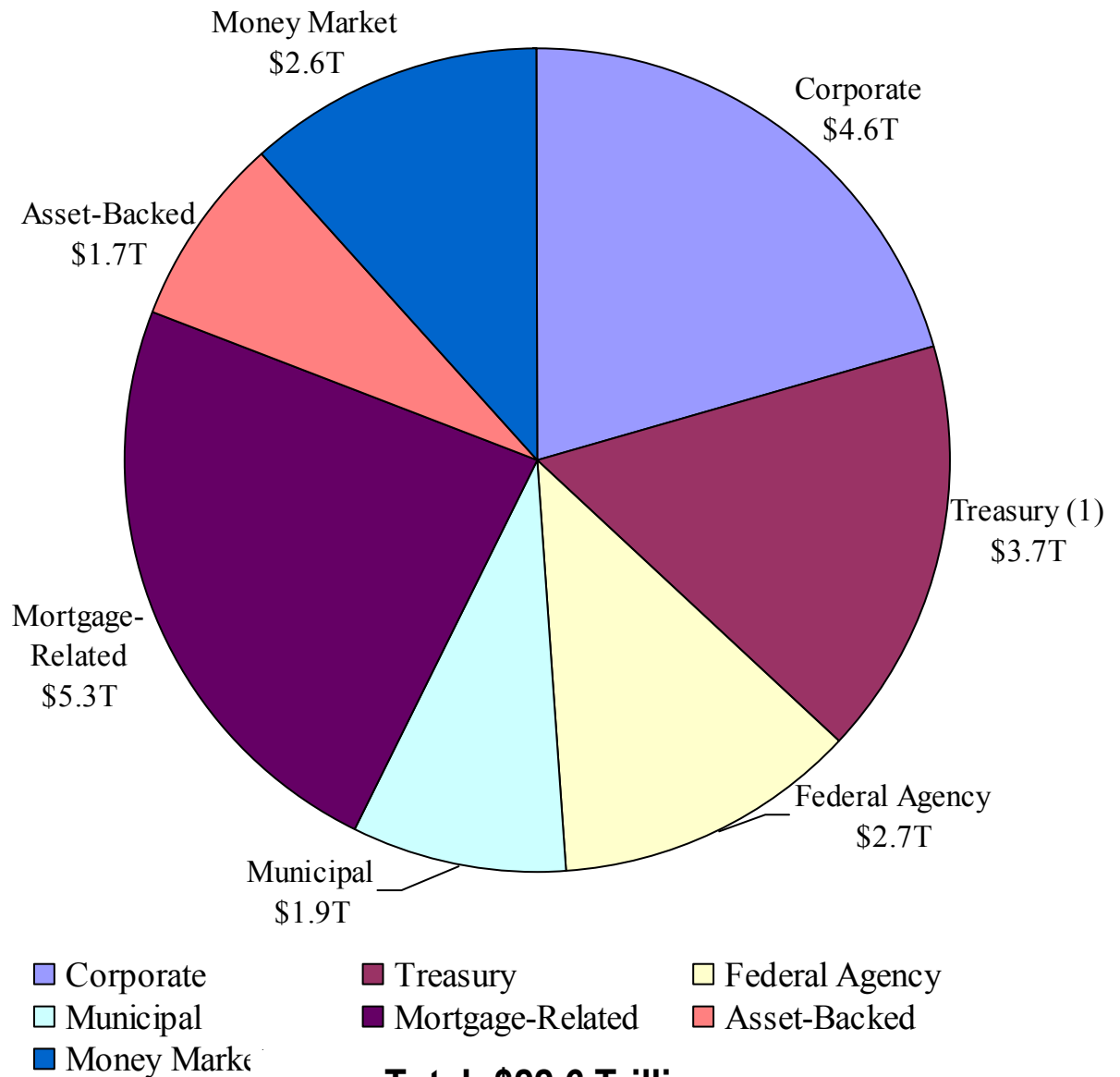
Shortly after the 1986 law policy makers grew concerned that—despite its size—prices in the Treasury market were not sufficiently transparent. Investors could be denied the best prices because the information flow in the Treasury market was not robust. An investor would have had no way of knowing whether a dealer's prices matched the best offer available for that particular security. In response to the concerns of regulators and Congress, in 1990 major bond dealers and other industry participants formed GovPX, an information service designed to bring real-time price information on a 24-hour basis to market participants around the world. Today, real-time Treasury bond prices are available widely to all market participants, and the market is truly price transparent. This development was achieved without the direct intervention of policy makers.

V. Conclusion

The bond markets are a dynamic, well-regulated part of the financial markets that facilitate trillions of dollars in capital formation for both public and private entities. Bond market participants foster financial innovations that help mitigate risk and lower costs for consumers and robust competition helps ensure this will continue to be the case. Over the years the diverse sectors of the bond markets, ranging from the well-known Treasury market to the less known market for repurchase transactions, have always come together in the face of a marketplace or regulatory challenge. Working through the Association, market participants have offered their expertise to regulators and lawmakers in the development of countless rules and legislative initiatives. The result has been better informed regulation that minimizes unnecessary market inefficiencies. The Association looks forward to continuing its partnership with Congress and the regulatory agencies.

Appendix: A Statistical Picture of the Bond Markets

Outstanding Bond Market Debt As of March 31, 2004*



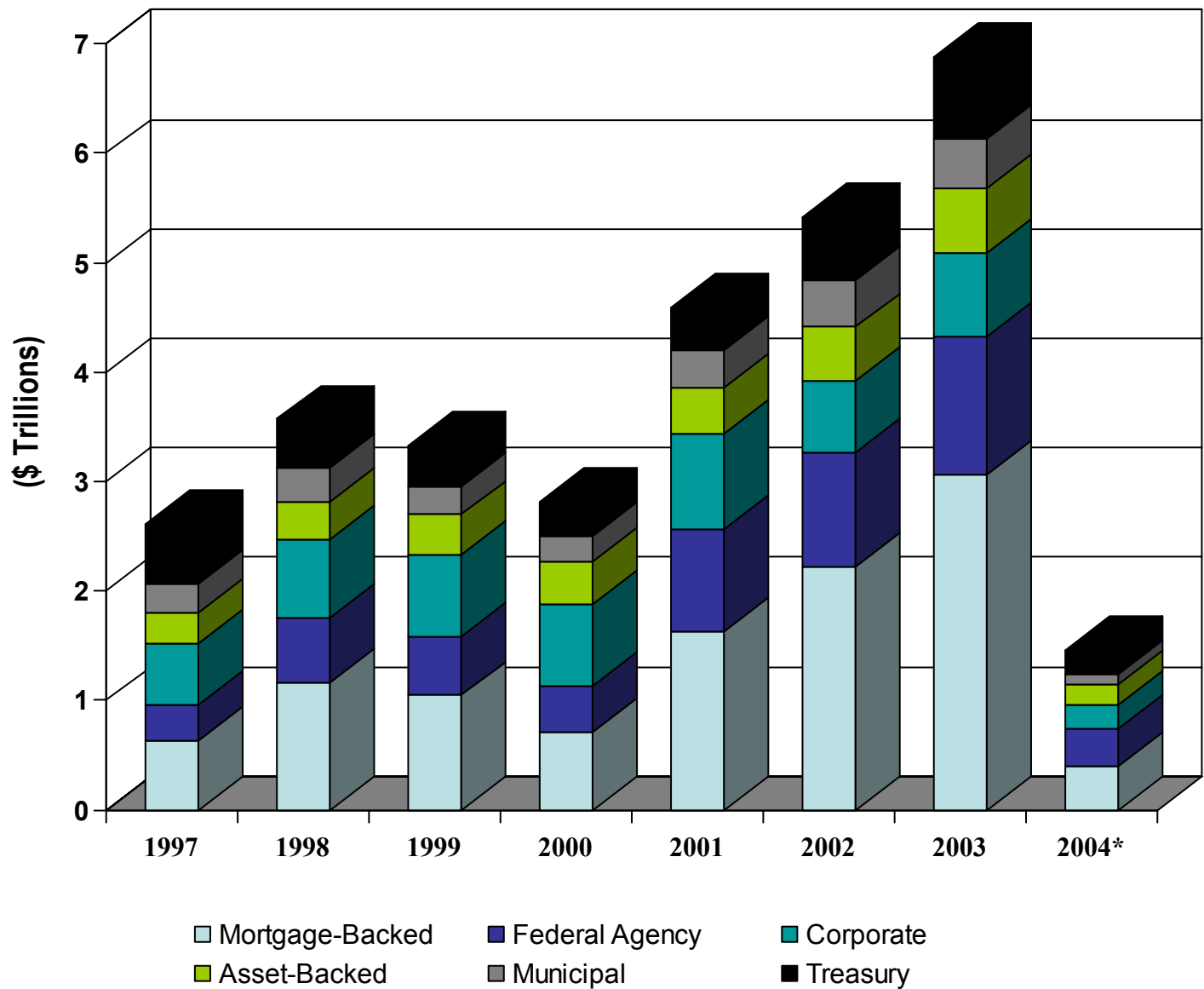
(1) Includes marketable public debt

* The Bond Market Association estimates

Sources: Federal Reserve System, U.S. Treasury, GNMA, FNMA, FHLMC

Issuance in the U.S Bond Markets

As of March 31, 2004



Sources: U.S. Treasury, Thompson Financial Securities Data, Federal Agencies, Inside MBS& ABS

Household Holdings of Fixed-Income Securities As a Percentage of Total Debt Outstanding

	1997		1998		1999		2000		2001		2002		2003	
	\$	%	\$	%	\$	%	\$	%	\$	%	\$	%	\$	%
Treasury (1)	\$585.9	16.3%	\$547.4	15.5%	\$620.2	17.0%	\$401.5	12.0%	\$296.5	8.8%	\$187.6	5.2%	\$214.7	5.4%
Agency (2)	298.7	10.5%	268.3	8.1%	301.0	7.7%	348.3	8.0%	269.9	5.4%	95.4	1.7%	269.6	4.4%
Corporate and Foreign Bond (3)	535.0	14.8%	633.6	15.2%	822.2	17.6%	892	17.6%	1,009.7	17.7%	1,175.0	19.0%	980.4	14.3%
Commercial Paper	56.1	5.9%	57.6	5.0%	67.7	4.8%	72.6	4.5%	41.8	2.9%	47.6	3.5%	46.0	3.6%
Municipal	473.7	35.9	491.5	35.0%	450.2	30.9%	460.7	31.1%	511.9	31.9%	618.3	35.1%	680.6	35.8%
Total	\$1,949.4	15.8%	\$1,998.4	14.7%	\$2,261.3	15.0%	\$2,175.1	13.7%	\$2,129.8	12.5%	\$2,123.9	11.5%	\$2,191.3	10.9%

(1) Excludes savings bonds.

(2) Includes agency debt and agency MBS.

(3) Includes corporate bonds, ABS, private-label MBS and Yankee bonds.