NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON DEFINITION OF "TRADED ON AN ESTABLISHED MARKET" WITHIN THE MEANING OF SECTION 1273 AND RELATED ISSUES

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New York State Bar Association Tax Section

Report on Definition of "Traded on an Established Market" within the Meaning of Section 1273 and Related Issuers

I. Introduction[1]

This report of the New York State Bar Association Tax Section analyzes the definition of "traded on an established market" ("public trading") under Section 1273[2] and Treasury Regulations Section 1.1273-2(f) in the context of debt-for-debt exchanges and considers certain alternative approaches to narrow the circumstances in which application of the definition can produce unexpected and inappropriate results. This report updates and supplements our prior report on the same topic submitted on August 12, 2004 (the "2004 Report").[3]

The definition of public trading under Section 1273 is a critical factor in determining the tax treatment of exchanges of outstanding debt instruments for new debt instruments of the issuer ("debt-for-debt exchanges").[4]

In the context of debt-for-debt exchanges, there are three significant tax consequences that depend, in significant part, on whether the old debt instrument or the new debt instrument is publicly traded. For the issuer, if the new debt instrument is publicly traded at a discount to its adjusted issue price, the issuer may recognize cancellation of indebtedness

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1 This report was prepared by an ad hoc committee of the Tax Section of the New York State Bar Association. Jiyeon Lee-Lim and John Lutz are the principal authors of this report. Helpful comments were received from Peter Blessing, Kimberly Blanchard, Doug Borisky, Dale Collinson, Daniel Dunn, Michael Farber, David Garlock, Craig Horowitz, Karen Kim, Stephen Land, Lisa Levy, William McRae, David Miller, Andrew Needham, Erika Nijenhuis, Debbie Paul, Michael Schler, David Schnabel, Alan Schwartz, and David Sicular.

2 Section references in this report are to the Internal Revenue Code of 1986, as amended ("the Code"), unless otherwise indicated.

3 Prior to the 2004 Report, the New York State Bar Association Tax Section submitted a report, "Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-For-Debt Exchanges" on March 25, 1991 (the "1991 Report"), which described debt trading as of 1991.

4 An outstanding debt instrument that is exchanged for a new debt instrument in a debt-for-debt exchange is referred to in this report as the "old debt instrument".

("COD") income. Conversely, if the new debt instrument is publicly traded at an amount greater than the adjusted issue price of the old debt instrument, the excess will generally be treated as "repurchase premium," and is deductible by the issuer in the year of the exchange. To the holder, the amount of gain or loss recognized on a debt-for-debt exchange may differ (and may differ significantly) if either the outstanding debt instrument or the new debt instrument is publicly traded. Finally, the new debt instrument may be treated as having been issued with original issue discount ("OID") or bond premium (with consequences to both the issuer and the holder) upon a debt-for-debt exchange. Consider the following example:

Example 1: In 2007, assume that taxpayer X ("issuer") issues a long term debt instrument for $1,000 cash at an issue price equal to the instrument's stated redemption price at maturity, $1,000. The instrument provides for stated interest that is unconditionally payable in cash at least annually at a single fixed rate within the meaning of Treasury Regulations Section 1.1273-1(c)(1). In 2009, the taxpayer suffers a severe liquidity event that requires it to delay its annual interest payment on the debt instrument. The holders, who are unrelated to the issuer, hold the debt instrument as a capital asset. The issuer and the holders agree to increase the interest rate and otherwise significantly modify the debt instrument in a manner that causes an exchange for Section 1001 purposes. Assume that the "new" interest rate meets the definition of adequate stated interest under Section 1274(c)(2). The principal amount of the instrument was not reduced as part of the modification.

Under current law, if the old instrument and the new debt instrument are not publicly traded, the issue price of the new instrument will be its stated principal amount because the new debt instrument in Example 1 has adequate stated interest.[5] The issuer will not recognize COD income upon the modification.[6] In contrast, unless the exchange qualifies as a corporate reorganization,[7] the holder will recognize capital gain or loss equal to the difference (if any) between the issue price of the new instrument (i.e., the stated principal amount in Example 1) and such holder's adjusted tax basis in the debt instrument. A holder that purchased the debt

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5 Section 1274(a)(1).

6 Section 108(e)(10)(B).

7 Section 354.

at a significant discount to its face amount may recognize capital gain even if there is significant doubt as to the collectability of the debt instrument.

On the other hand, if either the outstanding debt instrument or the new debt instrument is publicly traded within the meaning of Section 1273, the issue price of the new instrument will be the fair market value of the publicly traded property.[8] Assume that the new debt instrument in Example 1 is treated as publicly traded and the trading price was $800 (80 percent of par). Section 1273(b)(3) provides that the issue price of the new debt instrument is $800. Absent a statutory exception, the issuer will recognize $200 of COD income. Section 108 (e)(10)(A) provides that for purposes of determining COD income, the issuer is treated as having satisfied its outstanding indebtedness with an amount of money equal to the issue price of the new debt instrument. For this purpose "issue price" is to be determined under Sections 1273 and 1274, which provide rules for determining the amount of OID in respect of a debt instrument. [9]

Unless the debt-for-debt exchange qualifies as a corporate reorganization, the holder will recognize capital gain or loss equal to the difference (if any) between $800 (i.e., the issue price of the new instrument) and such holder's adjusted tax basis in the debt instrument. An initial purchaser at the old debt obligation's issue price ($1,000) will recognize a $200 capital loss. A secondary market investor that purchased the debt instrument at a significant discount, say at a price of $300, will recognize a $500 capital gain.

In addition, the new debt instrument will be treated as issued with an issue price of $800 and a stated redemption price at maturity of $1,000. Accordingly, the issuer may benefit from $200 of OID deductions and the holder may be required to accrue OID. If the holder's adjusted tax basis exceeds the new debt instrument's issue price (e.g., a transaction that qualifies as a corporate reorganization), such holder may be able to offset the OID with acquisition premium. If the holder's tax basis is less than the debt instrument's face amount, the debt-for-debt exchange will effectively convert some market discount to OID.

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8 Section 1273 (b)(3).

9 See Section 108(e)(10)(B). OID is defined in Section 1273 (a) (1), subject to a de minimis rule, as the excess if any, of the "stated redemption price maturity" of a debt instrument over its "issue price." Stated redemption price at maturity is defined in Sections 1273 (b) and 1274.

As demonstrated by Example 1, there is relative symmetry between the tax consequences to the issuer and the holder in a debt-for-debt exchange if either the old debt instrument or new debt instrument is publicly traded. This result is supported by the specific cross reference in Section 108(e)(10)(B) to the issue price rules under the OID provisions of the Code.

Upon further examination, however, the tax result is counterintuitive. It does not seem appropriate for the issuer to recognize COD income when the principal amount of the debt instrument was not reduced. In Example 1, the issuer recognizes COD income even though the interest rate on the debt instrument was increased. More importantly, the tax result creates asymmetries regarding both the timing and character of income. The issuer is burdened with COD income[10] upon the debt-for debt exchange and benefits (subject to significant limitations) with OID deductions over time. This income acceleration ignores the reality that the issuer is still liable for the full amount of the debt. Also, the possibility of the holder incurring a tax liability as a result of the modification may make the modification more expensive and the holder less willing to modify the debt instrument.

This issue is further complicated by the existing definition of public trading under Treasury Regulation Section 1.1273-2(f). As discussed in our 2004 Report, the definition of public trading does not properly reflect the current market conditions nor does it adequately serve its original purpose. The regulations are unclear in many respects and taxpayers (and their advisors) attempting to apply the definition of public trading in the current market face numerous difficulties.

The tax issues related to debt-for-debt exchanges have been exacerbated during the economic down turn for the past couple of years as many issuers were forced to amend the terms of their debt instruments and the trading value of debt instruments has plummeted. Recognizing this problem, Congress enacted Section 108(i). Section 108(i) provides taxpayers with an election to defer COD income arising from a reacquisition of certain applicable debt instruments during 2009 and 2010 and temporarily suspends the rules governing applicable high

[10] Of course in some circumstances, such as bankruptcy or insolvency, the issuer may not recognize all or a portion of the COD income.

yield obligations with respect to a new debt instruments issued in a debt-for-debt exchange that meets certain conditions. However, as Section 108(i) is a temporary relief that is scheduled to expire at the end of 2010, it is important to establish a permanent solution that can take effect when these relief measures go away.

This report discusses the significance of the public trading definition for Section 1273 purposes. It highlights some of the policy decisions that should be considered as Treasury and the Internal Revenue Service examine Treasury Regulation Section 1.1273-2(f) and the interaction between the OID, retirement premium and COD provisions of the Code. The report discusses certain approaches that would serve to reduce the tension created by the definition of public trading. Finally, the report discusses potential changes to the definition of public trading in light of these policies and the difficulty of applying the existing regulations to current market conditions.

This report does not address the definition of public trading in other Sections of the Code. This issue was addressed in our 2004 Report.

II. Summary of Recommendations

Our principal recommendations are as follows:

First, we recommend that Treasury and the Service use the regulatory authority under Section 446(b) to permit issuers in a debt-for-debt exchange to amortize any COD income or retirement premium over the term of the new instrument. Under this approach, the amortized COD income would effectively offset the amount of OID deductions created by the debt-for-debt exchange and the amortized retirement premium would offset the reduction in the interest deduction. If this approach is adopted, we recommend that Treasury and the Service also consider whether the rules governing applicable high yield debt obligations should be suspended, in this situation. For issuers, this approach would correct the timing asymmetry created under the current law. This approach would not, however, address the timing and the character asymmetries to holders upon a debt-for-debt exchange.

Second, as an alternative to our first recommendation, we recommend that Treasury and the Service use the regulatory authority under Section 1275(d) to provide that the

issue price of the new debt instrument in a debt-for-debt exchange is equal to the lesser of the issue price determined under Section 1274 and the adjusted issue price of the old debt instrument, regardless of whether there is public trading. This recommendation is broadly consistent with the recommendation set forth in our 1991 Report.

Third, if the new debt instrument is trading or quoted at a substantial discount to its stated principal amount because there is doubt as to the collectability of the new debt instrument, we recommend that Treasury and the Service confirm that case law principles applicable to accruals of interest on distressed debt apply to OID on a new debt instrument issued in a debt-for-debt exchange. We recommend that Treasury adopt a bright line standard allowing holders to not accrue OID on the new debt instrument received upon a debt-for-debt exchange if the collectability of the accrued OID is highly unlikely. For example, if the holder purchased (or is treated as purchasing) the debt instrument for less than 50 percent of its stated principal amount, Treasury regulations could provide that the holder is not required to accrue OID on such debt instrument. Treasury and the Service consider a lower percentage for long dated debt instruments.

Fourth, we recommend that the definition of public trading under Treasury Regulations Section 1.1273-2(f) be amended to provide clear and administrable guidance. We recommend a new definition under which a debt instrument is treated as "publicly traded" if (1) either (i) actual recent trading prices are available, or (ii) firm (executable) quotes are readily available from at least one broker, dealer or pricing service, or (iii) soft quotes are readily available from at least one broker, dealer or pricing service and provide a reasonable basis for the issuer to determine the fair market value of the debt instrument, and (2) there has been actual trading of the debt instrument in excess of a de minimis amount (e.g., a trade involving $1 million, or if all trades are less than $1 million, the aggregate amount of such trades exceeds $5 million) within the last 7 days, the debt instrument is held by 10 or more holders and its principal amount exceeds a minimum amount (e.g. $25 million). We recommend that examples illustrating (in the case of soft quotes) facts constituting a reasonable basis to determine fair market value be provided. We also recommend that (f)(4) and (f)(5) of Treasury Regulations be deleted in favor of this simplified approach.

Fifth, we recommend that once a debt instrument is treated as publicly traded, an issuer should be able to determine its fair market value based on quotes or prices available on pricing services and such determination should be respected so long as it is reasonable. In this regard, we recommend that if the trading price of a debt instrument fails to accurately reflect its intrinsic value because of a "market disruption" event, the issue price should be determined under Section 1274 unless another value can be reasonably established as fair market value by a preponderance of the evidence. We recommend that Treasury and the Service provide a clear definition of "market disruption" that takes into account such factors as a significant (e.g., a greater than 50 percent drop in the trading volume over a short period of time). Alternatively, the specific circumstances could be identified by notice or other administrative guidance to determine a market disruption event.

We also have certain other recommendations related to the definition of public trading, which we lay out under Section VI below.

A. Significance of the Definition

i. Issue Price

For Federal income tax purposes, the issue price of a debt instrument is generally determined under Sections 1273(b) and 1274 and the regulations issued thereunder. Under Section 1273(b)(1), if a substantial amount of the debt instruments in an issue is issued for cash, the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold.[11] Under Section 1273(b)(2), if debt is issued for cash and not publicly offered, the issue price is the price paid by the first buyer.

Under Section 1273(b)(3), if a debt instrument is issued for property and either the debt instrument is traded on an established securities market, i.e., publicly traded, or the debt instrument is issued for stock or securities which are publicly traded, or, to the extent provided in regulations, the debt instrument is issued for property (other than stock or securities) of a kind that is regularly traded on an established market, the issue price of such debt instrument is the

[11] In this regard, sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers are ignored. Treas. Reg. Section 1.1273-2(e).

fair market value of such property.[12] The general policy underlying the rules under these Sections is that the issue price of a debt instrument should be the fair market value as long as such fair market value can be determined accurately and objectively. In this context, the concept of public trading is used as a standard for determining when fair market value should be deemed to be determinable in an accurate and objective manner.

If a debt instrument is issued for property and neither the debt nor the stock, securities or property for which the debt is issued is publicly traded (i.e., Section 1273(b)(3) does not apply), then the issue price of the debt instrument is determined under Section 1274. Under Section 1274, generally speaking, the issue price would equal the stated principal amount as long as the debt instrument provides for adequate stated interest. If a debt instrument is governed by Section 1274 and does not provide for adequate stated interest, the issue price of such debt instrument would be the imputed principal amount, which equals the present value of all payments due under the instrument as of the date of issuance computed using the appropriate applicable Federal rate. In general, the stated interest that equals or exceeds the lowest of the applicable Federal rate for the 3 month period ending on the issue date would be considered adequate stated interest.[13] Section 1274(b)(3) has a special anti-abuse rule, in which the imputed principal amount is deemed to equal the fair market value of the property in the case of any "potentially abusive situation."

As discussed above, the issue price often affects the determination of COD income and repurchase premium for the issuer. In computing the COD income under Section 108(e)(10), if a new debt instrument is issued in satisfaction of outstanding indebtedness, the

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[12] The Code describes the public trading concept slightly differently with respect to stock or securities, on the one hand, and other property, on the other. Thus, Section 1273 would apply to a debt instrument if it is issued for "stock or securities which are traded on an established securities market" or "to the extent provided in regulations, … for property (other than stock or securities) of a kind regularly traded on an established market". Section 1273(b)(3) (emphasis added) A similar distinction appears again in Treasury Regulations Section 1.1273-2(f). Thus, the market traded property in paragraph (f)(3) is described as "property of a kind that is traded…". However, the requirement for the trading to be "regular" has been eliminated in the regulations.

[13] Treasury Regulations Section 1.1274-4(a)(1) provides that stated interest is generally considered adequate for this purpose if it equals or exceeds the lower of the lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3 month period ending with the month in which a binding contract is written or the lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3 month period ending with the month in which the sale occurs.

debtor is treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument. Likewise, in determining the amount of repurchase premium in a debt-for-debt exchange, the repurchase price is the issue price of the new debt instrument. For this purpose, the issue price is determined under Sections 1273 and 1274.[14]

The issue price also affects the amount of gain or loss to a holder in a debt-for-debt exchange. When a debt instrument is received as consideration in a taxable exchange, in measuring the amount of gain or loss for the holder, the amount realized generally equals the issue price of such debt instrument, as determined under Sections 1273 and 1274.[15] Additionally, the amount of OID equals the "stated redemption price at maturity" (the sum of all amounts payable on the debt instrument other than qualified stated interest) minus the issue price. With respect to a debt instrument providing for periodic interest payments and a stated principal amount, if stated interest is adequate and is qualified stated interest, whether the debt instrument has OID would depend on whether the issue price is lower than the stated principal amount.

The turmoil in the debt market in 2008 and 2009 brought home the significance of the issue price determination in a debt-for-debt exchange. Many issuers needed to modify their outstanding debt to loosen covenants or to cure current or expected defaults, thereby causing a deemed exchange of such debt. At the same time, the trading value of debt instruments hit a record low. Even senior secured bank loans that historically maintained a par value trading have been hit with depressed value as never seen before. Many forced sales of loans and bonds by investors who had no other liquidity source brought down the trading price of the debt price even further. As a result, many issuers were faced with the risk of recognizing a significant amount of COD income if the new debt instrument was publicly traded. Section 108(i) brought temporary relief for the exchanges occurring in 2009 and 2010.

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[14] Section 108(e)(10)(B).

[15] Treas. Reg. Section 1.1001-1(g)(1).

B. Definition of "Public Trading" under Treasury Regulations Section 1.1273-2(f)[16]

Under Treasury Regulations Section 1.1273-2(f), property is treated as "publicly traded" if it is described in any of paragraphs (f)(2) through (f)(5) at any time during the 60-day period ending 30 days after the issue date of the debt instrument. However, if there is any temporary restriction on trading, whether or not imposed by the issuer, and if the purpose of the restriction is to avoid the characterization of the property as being publicly traded, then the property is treated as traded on an established market.[17]

i. (f)(2) Exchange listed property.

Property is described in paragraph (f)(2) if it is listed on the following:

1. A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (the "Act").

2. An interdealer quotation system sponsored by a national securities association registered under section 15A of the Act.

3. The International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, the Tokyo Stock Exchange, or any other foreign exchange or board of trade that is designated by the Commissioner in the Internal Revenue Bulletin.

ii. (f)(3) Market traded property.

Property is described in paragraph (f)(3) if it is property of a kind that is traded either on a board of trade designated as a contract market by the Commodities Futures Trading Commission or on an interbank market.

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16 The 2004 Report provided a comparison of definitions of public trading under other sections of the Code. As noted in the 2004 Report, the definition of public trading is used in Sections 1092, 453 and 7704. Unlike Section 1273, which uses the concept of public trading to establish value, Sections 1092, 453 and 7704 adopt the concept of public trading to establish liquidity. We also note that the definition of public trading is used in Section 170, where the concept is used for purposes of establishing ascertainable value. The definitions under these sections are not the same, and the degree of difference varies. It is not clear if the differences in the definitions were intentional.

17 Treas. Reg. Section 1.1273-2(f)(6).

iii. (f)(4) Property appearing on a quotation medium.

Property is described in paragraph (f)(4) if "it appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers or traders, or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium)." A quotation medium does not include a directory or listing of brokers, dealers or traders that do not include price information.

Thus, in order to fall under paragraph (f)(4), the system must (i) be generally circulated, (ii) provide recent quotations of identified brokers, dealers or traders or actual prices from recent transactions to permit determination of fair market value, and (iii) such information must provide a reasonable basis to determine fair market value.

iv. (f)(5) Readily quotable debt instruments

A debt instrument is described in paragraph (f)(5) if price quotations are readily available from dealers, brokers, or traders. However, under subparagraph (ii) titled "Safe harbors," a debt instrument is not considered to be described in paragraph (f)(5) if:

1. No other outstanding debt of the issuer or any guarantor is described in paragraph (f)(2), (f)(3) or (f)(4);

2. The original stated principal amount of the debt instrument does not exceed $25 million;

3. The conditions and covenants with respect to the debt instrument are materially less restrictive than the conditions and covenants in all of the issuer's other traded debt (described in (f)(2), (f)(3) or (f)(4)); or

4. The maturity date of the debt instrument is more than 3 years after the latest maturity date of the issuer's other traded debt (described in (f)(2), (f)(3) or (f)(4)).

III. Policy Considerations and Recommendations for Reduced Pressure on Definition

A. Introduction

The tax consequences to both issuers and holders in a debt-for-debt exchange can be dramatically different depending on whether the old debt instrument or the new debt instrument is publicly traded under Section 1273.

Broadly speaking, these tax consequences raise two important tax considerations. First, if the new debt instrument is publicly traded and the trading price is less than the instrument's adjusted issue price, the issuer will suffer a timing mismatch because it may recognize COD income upon the exchange and may benefit from OID deductions over the term of the new debt instrument. The holder may suffer both a timing mismatch and a character mismatch because it may recognize a capital gain or loss upon the exchange and may be required to include OID in income over the term of the new debt instrument. The consequences to the issuer tend to be severe with little or no relief,[18] while relief is available to the holder if the exchange qualifies as a tax-free reorganization.

Second, as previously noted, the policy underlying the public trading rules is that the issue price of a debt instrument should be the fair market value as long as such fair market value can be determined accurately and objectively. The definition of public trading under Section 1273 should be re-examined in light of this policy.[19] These two policy considerations are discussed below.

B. Timing and Character Issues Dependent on the Distinction

There is significant pressure on the definition of publicly traded. As previously discussed in this report, a debt-for-debt exchange can result in an issuer recognizing COD income and potentially benefiting from OID deductions over time (or deducting retirement premium currently and reducing interest deductions over time). In many cases, this result is both surprising and counterintuitive to issuers. Under general tax principles, the issuer is able to

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[18] This anomaly derives from the fact that debt-for-debt exchanges generally give rise to selective realization. In a debt-for-debt exchange, the distressed issuer may recognize COD income without the issuer recognizing a loss on the lower value of its assets.

[19] We discuss several alternative definitions in Section VI below.

exclude the proceeds of a debt instrument from income because it is obligated to repay the proceeds.[20] If that obligation is subsequently discharged, in whole or in part, the issuer generally recognizes income at that time.[21] In most debt-for-debt exchanges and the exchange discussed in Example 1, the issuer is still obligated to repay the principal amount of the old debt instrument, yet the issuer may recognize COD income solely because its debt is treated as publicly traded and traded at a discount. The tax fiction created by the interaction of Section 108(e)(10) and the publicly traded rules under the OID provisions should be addressed.

From the issuer's perspective, under current law, a debt instrument can be treated as publicly traded without any actual trading and, more importantly, without the participation or knowledge of the issuer. In connection with loan modifications, we understand that there sometimes is significant tension between the borrower and the administrative agent managing the loan. The administrative agent may be reluctant or unwilling to share any information about the trading of the loan. In addition, all of the pricing services and trading platforms require subscribers to maintain confidentiality as to indicative pricing. Thus, a holder or a dealer may not be contractually permitted to share indicative pricing with the issuer.

Even if an issuer can determine whether its debt instrument is publicly traded, the fair market value of the debt instrument may be materially different than the available trading price, for example, in the case of a volume discount or control premium, and in a distressed market, in the case of a forced sale. More broadly, the fair market value of the debt instrument will be affected by a number of factors including: (1) the financial condition of the issuer; (2) the supply and demand of U.S. Treasury obligations; (3) the availability and cost of funding; (4) the liquidity of the debt instrument; (5) the market's perception of any changes in law, including bankruptcy and tax law that may affect the issuer or the payments under the debt instrument; (6) the shape of the yield curve; (7) perceived political, social, environmental and other business risks of the obligor; and (8) other market conditions. In many cases, the issuer may not be able to accurately assess these and any other relevant factors. We recommend that once a debt instrument is treated as publicly traded, an issuer's determination of the instrument's

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[20] E.C. Gatlin, 34 BTA 50 (1936); Charles Matarese, TC Memo 1975-184.

[21] Treas. Reg. Section 1.61-12(a).

fair market value should be respected so long as it is based on all information reasonably available to the issuer.

To alleviate some of the pressure on the definition of public trading, this report considers several approaches. The first approach focuses on providing relief for the issuer with respect to the timing of the COD income inclusion by using Treasury's authority under Section 446(b). The second approach looks to Section 1275(d) to address the timing and character asymmetries for both issuers and holders. Third, we consider whether holders of distressed debt should be entitled to rely on existing case law to avoid recognizing OID if the collectability of the interest is doubtful. Finally, this report recommends simplifying the definition of public trading to both provide greater clarity to taxpayers.

First, we recommend that Treasury and the Service consider a rule under which the recognition of COD income is deferred to match the OID deductions that are created as a result of the debt-for-debt exchange.[22] We believe that Treasury has regulatory authority under Section 446(b) to permit issuers to amortize any COD income realized in a debt-for-debt exchange over the term of the new debt instrument so as to align the recognition of COD income with the accrual of OID on such debt instrument.[23] Section 446(b) provides that if the method of tax accounting used by a taxpayer does not clearly reflect income, taxable income is computed under such method as, in the determination of Treasury, clearly reflects income.[24] The Supreme Court has confirmed that Treasury has broad authority to establish methods of tax accounting that clearly reflect income.[25] The authority under section 446(b) encompasses overall methods of accounting, as well as specific methods utilized to report any item of income or expense.[26]

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22 To minimize any mismatching, the rules governing applicable high yield debt obligations may also be suspended with respect to a new debt instrument deemed issued in a debt-for-debt exchange, in a manner similar to Section 108(i).

23 The Tax Section has taken this position in at least one prior report. See New York State Bar Association Tax Section Report on Revenue Procedure 2008-51 (January 20, 2009.)

24 Treas. Reg. Section 1.446-1(b).

25 U.S. v. Hughes Properties, Inc., 476 U.S. 593 (1986); Thor Power Tool Co., v. Comm'r, 439 U.S. 522 (1979); Hansen v. Comm'r, 360 U.S. 446 (1959); Lucas v. American Code Co., 280 U.S. 445 (1930).

26 See Thor Power Tool, 439 U.S. at 531; Wal-Mart Stores Inc., et al v. Commissioner, TC Memo (RIA) 1997-1 aff'd 153 F3d 650 (8th Cir. 1998). See also Charles Morgan, Bridge Loans-Confronting Tax Issues Triggered by the Recent Economic Downturn, J. Tax. Fin. Prod., Vol. 7, Iss. 4 (2009) suggesting that Treasury has ample authority to promulgate regulations under Section 446(b) to require that COD income

This exercise of discretion should be available even in a situation where a method of accounting is not authorized by the Code but results in clear reflection of income.[27]

Treasury and the Service have previously issued regulations under Section 446(b) that require specific methods of accounting for certain types of transactions. For example, in Treasury Regulation Section 1.446-3, specific accounting rules governing the timing of reporting of income, deductions, gains and losses related to notional principal contracts were prescribed, which require that income associated with nonperiodic payments be taken into account over the duration of the contract, rather than at the time of the payment or receipt.[28] Similarly, in Treasury Regulation Section 1.446-4, the accounting method that must be used to account for hedging transactions was prescribed, which requires that income, deduction, gain and loss be reported on a basis that matches the timing of the income, deductions, gains or losses from the item being hedged, rather than simply when realized.[29]

The preamble to Treasury Regulation Section 1.446-4 in its proposed form indicated that "the proposed regulations invoke the Commissioner's authority under sections 446(b), 451, and 461 to require that a taxpayer's method of accounting for hedging transactions clearly reflect income" and that "[i]n general, the proposed regulations require a taxpayer that enters into a hedging transaction as defined in [Section] 1.1221-2(b) to reasonably match the

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recognized in connection with debt-for debt exchanges be amortized into income as an offset to OID over the duration of the new debt instrument.

27 Johnson v. Comm'r, 184 F.3d 786 (8th Cir. 1999) (where accrual basis taxpayer deferred recognition of income attributable to amount received for a vehicle service contract that was put into an escrow account until repairs were performed or the contract was terminated. Commissioner did not exceed his broad powers when he determined that the method of accounting used by the taxpayer did not clearly reflect income); In re EWC, Inc., 114 F.3d 1071 (10th Cir. 1997) (holding that, although Section 448 precluded the taxpayer from using the cash method, the Service was permitted to use the cash method because it clearly reflected income). See also Rev. Proc. 2001-10, modifying Rev. Proc. 2000-22 (stating that the Service exercised discretion under Section 446(b) and Section 471 to except certain taxpayers from the requirement to account for inventories and to allow them to use the cash method of accounting to account for sales of merchandise, which normally must be accounted for on an accrual basis).

28 Treas. Reg. Section 1.446-3(f)(2) (nonperiodic payments generally must be recognized over the term of a notional principal contract in a manner that reflects the economic substance of the contract); see also Preamble to Prop. Treas. Reg. Section 1.446-3, 2004-1 C.B. 655 (addressing method of accounting for contingent nonperiodic payments).

29 Treas. Reg. Section 1.446-4(b).

timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item being hedged."[30]

Under the current regulations, in a debt-for-debt exchange resulting in COD income, the COD income is realized solely because of the operation of Section 108(e)(10)(B) and the OID rules relating to issue price. The outstanding principal amount of the new debt instrument, however, may remain unchanged from the outstanding principal amount of the old debt instrument and the issuer may be legally obligated the repay the same amount after the exchange. Thus, requiring the issuer to recognize COD income upon the occurrence of the exchange may not result in the "clear reflection of income."

We believe that the case law supports Treasury's authority to issue regulations addressing the tax accounting of COD income realized in connection with a debt-for-debt exchange. Pursuant to this authority, we recommend that Treasury and the Service permit issuers in a debt-for-debt exchange to amortize COD income over the term of the new debt instrument. This would result in a better match between the COD income inclusions and the OID deductions created by a debt-for-debt exchange.

We note that if the principles of Section 446 are adopted to alleviate the COD burden on an issuer, they should also equally apply when a debt instrument in a debt-for-debt exchange results in repurchase premium. The new rule would require amortization of any such premium over the term of the new debt instrument, which would essentially offset the reduction in the interest deductions on the new debt instrument caused by the repurchase premium.[31]

Another alternative to alleviate the mismatch problem is to revise the existing issue price rules under the authority given under Section 1275(d). Section 1275(d) authorizes Treasury to issue regulations to modify the tax treatment prescribed by Sections 1271 through 1275 (the "OID rules") (and Section 163(e)) to the extent appropriate) to carry out the purposes of the OID rules. Section 1275(d) has been utilized previously by Treasury and the Service in connection with issuance of regulations for contingent payment debt instruments and variable

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30 Preamble to Proposed Treas. Reg. Section 1.446-4, 1993-2 C.B. 615.

31 See Treas. Reg. Section 1.163-7. Retirement premium is already required to be amortized if the issue price of the debt is determined under Section 1273(b)(4) or 1274.

rate instruments.[32] In addition to permitting the issuance of regulations to provide rules for circumstances not adequately addressed by existing Code provisions, the language of Section 1275(d) permits Treasury to issue regulations even in circumstances where the relevant provisions of the Code may produce a different result--if the purpose of the regulations is to appropriately carry out the purpose of the OID rules.[33] We believe that Section 1275(d) authorizes Treasury to revise the existing issue price rules under Section 1273 as such Section applies to debt-for-debt exchanges to better align the purpose of the OID rules with the COD income provisions of the Code.

To eliminate the tax asymmetries to the issuer and the holder, Treasury and the Service could specify that the issue price of the new debt instrument in a debt-for-debt exchange is equal to the lesser of the issue price determined under the principles of Section 1274 and the adjusted issue price of the old debt instrument, whether or not the old debt instrument or the new debt instrument is publicly traded. By providing that it is the lesser of the issue price under Section 1274 and the old debt instrument's adjusted issue price, the rule addresses situations where the old debt instruments had OID or the outstanding principal amount is reduced as a result of a debt-for-debt exchange. If the old debt instrument was issued at par with adequate stated interest, so long as the stated principal amount of the debt instrument remains unchanged, the exchange of an old debt instrument for a new debt instrument should not give rise to any tax consequences to the issuer simply because either the old debt instrument or the new debt instrument is publicly traded. So long as there is adequate stated interest, the new debt instrument would be treated as having been issued without OID.

Under this approach, a holder who purchased the debt instrument at a discount in the market will generally recognize gain upon the exchange unless the exchange qualifies as a tax-free recapitalization. If the debt is trading at a deep discount and the exchange does not

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[32] See T.D. 8674 (issuing Final Treas. Reg. Sections 1.1275-4 and 1.1275-6).

[33] Section 1275(d) states that "[T]he Secretary may prescribe regulations providing that where, by reason of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, or other circumstances, the tax treatment under this subpart (or Section 163(e)) does not carry out the purposes of this subpart (or Section 163(e)), such treatment shall be modified to the extent appropriate to carry out the purposes of this subpart (or Section 163(e)) (emphasis added). The "subpart" referred to is subpart A of Part V of subchapter P. Subpart A contains Sections 1271-75 and Section 1274A. See Treas. Reg. Section 1.1275-6 dealing integration of debt instruments and qualifying hedges provides rules that would not apply under the Code.

qualify as a tax-free recapitalization, the holder may have a significant phantom income in an amount equal to what would otherwise have been market discount, which is not generally not taxable until paid (in the absence of any election). If it qualifies as a tax-free recapitalization, however, tax consequences should generally be neutral to the holders.

Our 1991 Report addressed the impact of the Revenue Reconciliation Act of 1990 (the "1990 Act") on debt-for-debt exchanges. The 1990 Act added the predecessor of Section 108(e)(10)(B) to the Code and repealed Section 1275(a)(4). Section 1275(a)(4), prior to its repeal, provided that the issue price of the new instrument in a debt-for-debt exchange that qualified as a corporate reorganization was equal to the "adjusted issue price" of the old debt instrument if it is greater than the issue price otherwise determined under Sections 1273 and 1274. That section was intended to prevent the creation of OID or COD income in a debt-for-debt exchange that qualified as a corporate reorganization. It also was subject to some level of abuse by issuers. For example, some issuers were able to avoid COD income by claiming a recapitalization treatment and carrying over the adjusted issue price of the old debt instrument when there was a reduction in the principal amount of their debt in connection with a debt-for-debt exchange. Our 1991 Report recommended that Congress reenact Section 1275(a)(4) and expand it to cover all debt-for-debt exchanges involving a single issuer, whether or not they constitute reorganization and whether or not the issuer was a corporation. Our current recommendation is generally in line with our recommendation in our 1991 Report.

If Treasury and the Service decide to adopt the 1275(d) approach discussed above, it should consider anti-abuse rules to prevent any abuse. For example, if a borrower and lenders plan to modify a debt instrument to reduce the remaining principal amount, they may instead structure it as a reduction in the interest payments so as to avoid any COD income.

Further, we note that, if an issuer with expiring NOLs is engaged in a debt modification with respect to a debt instrument trading at a discount, it may want to trigger COD income rather than avoid it. In that case, the issuer may first repurchase the old debt instrument in the secondary market and then, pursuant to the same plan, issue a new debt instrument to the same investors (or substantially the same investors). To prevent such abuse, Treasury and the Service may consider providing a special anti-abuse rule under which if there is substantial

overlap between the holders of the old debt instrument and the holders of the new debt instrument and if the repurchase and the new issuance are part of the same plan, the two transactions are treated together as an exchange.

The focus of the two alternatives is to mitigate adverse consequences to the issuer who, at a time of severe economic hardship, may also be hit with an unexpected tax burden. If Treasury and the Service decide to adopt one of the alternatives but desires to limit its application, it may consider limiting its application to situations where the debt is substantially distressed.

C. Distressed Debt

The asymmetries that result from a debt-for-debt exchange when either the old debt instrument or the new debt instrument is publicly traded are exacerbated in the case of distressed debt. Consider the following example:

Example 2: The facts are the same as Example 1 but the new debt instrument is publicly traded at a price equal to 20 percent of its stated principal amount. The holder purchased the new instrument for $200. The trading price reflects the market's concern about the issuer's financial viability.

Unless a statutory exception under Section 108 applies, the issuer will recognize $800 of COD income upon the debt-for-debt exchange resulting from modification to the interest rate on the old debt instrument. The holder will not recognize gain or loss because there is no difference between the issue price of the new debt instrument ($200) and the holder's adjusted tax basis in the new instrument ($200). The new debt instrument will be treated as having been issued with an issue price of $200 and a stated redemption price at maturity of $1,000. Accordingly, the issuer may benefit from $800 of OID deductions over the term of the instrument. More notably, the holder will have to accrue $800 of OID over the remaining term of the new instrument.

It seems inappropriate to require the holder in a debt-for-debt exchange to recognize OID if the issuer's financial condition is seriously impaired. Yet, the Service takes the position that a holder must continue to accrue OID even if the holder does not reasonably expect

to ultimately receive the accrued interest because of the issuer's financial condition.[34] In TAM 9538007, the Service ruled that there is no "doubtful collectability" exception to OID accruals under Section 1272 as there is with respect to non-OID accrued interest.[35] Under the TAM, holders of OID instruments must include the discount in income as it accrues notwithstanding the issuers financial condition and the doubt regarding collectability of the debt. The Service reasoned that OID differs from ordinary accrued interest because OID is "deemed paid" and reloaned to the issuer as it accrues. There is no substantive difference between OID accruals and non-OID interest accruals.[36] Both represent accounting methods for interest income.

There appears to be no policy objective served by requiring holders to include OID when the collectability of the interest is in doubt, especially in view of the case law and the Service's published guidance addressing the treatment of accrued interest when there is no reasonable expectation of payment. [37] Treasury and the Service should consider using the authority under Section 446(d) to permit holders to rely on existing case law to not recognize OID upon a debt-for-debt exchange if the collectability of the OID is doubtful. In this regard, we recommend that Treasury and the Service adopt a bright line test to determine whether a holder should recognize OID. For example, in connection with a debt-for-debt exchange, if the new debt instrument is trading at a price less than 50 percent of its stated principal amount, Treasury regulations could provide that the holder is not required to recognize OID and the holder is permitted to adopt an accounting method that properly reflects its expected recovery on the debt instrument. Treasury and the Service may consider a lower percentage for long dated debt instruments.

Of course, this issue is broader than debt-for-debt exchanges and similar arguments can be made for recognizing market discount if a secondary market holder purchases

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34 T.A.M. 9538007

35 See Treas. Reg. Section 1.451-1(a).

36 We previously raised this issue in our August 19, 2008 letter to Treasury regarding "Guidance on Economic Downturn Issues."

37 The "doubtful collectability" doctrine has been applied by case law since the 1930s. See, e.g., Corn Exchange Bank v. U.S., 37 F.2d 34 (2d Cir. 1930) ("A taxpayer cannot be charged to have realized an income unless there exists reason for believing that the income is likely to be paid or can be collected."). See also Jones Lumber Co. v. Comm., 404 F.2d 764 (6th Cir. 1968). The Service has also adopted the doubtful collectability doctrine in Revenue Ruling 80-361, 1980-2 C.B. 164 (relying, in part, on Jones Lumber).

a debt instrument at a substantial discount to its stated principal amount because of the issuer's financial condition. These issues are beyond the scope of this report.

IV. Applying the Current Definition of "Public Trading"

A. A Brief Overview of Trading of Debt in the Current Market

The 2004 Report and the 1991 Report analyzed in detail how bonds trade in the market as of the time of each report. In some respects, there have been significant changes in the way corporate debt trades and is reported during the past 19-year period. In other respects, things have not changed for almost two decades. The trading of debt instruments and their platforms in the current market are described in detail in the Appendix attached hereto.

The size of the corporate bond market has grown significantly during the last two decades.[38] The most fundamental aspect of the bond trading that still remains unchanged despite such growth in the volume of trading is that virtually all trades are done over-the-counter. Typically, traders or people at the sales desk contact customers over the phone about a particular trade and negotiate the trade details. Upon reaching agreement, the back office enters the trade with The Depositary Trust & Clearing Corporation ("DTC"). Thus, bond trading still occurs through privately negotiated transactions, involving large blocks of bonds, and the prices are generally not reported publicly, unless bonds are registered with the Securities Exchange Commission ("SEC").

The listing on stock exchanges has diminished drastically. The New York Stock Exchange ("NYSE") listed approximately 850 bonds at the end of 2006 (out of which 333 were issued by U.S. companies). Even if bonds are listed on the NYSE or other exchanges, almost all the trading of such bonds still takes place over-the-counter.

The Financial Industry Regulatory Authority ("FINRA") has significantly contributed to making bond pricing transparent to the public. In general, for bonds that are registered with the SEC, FINRA publishes on its website (Trade Reporting And Compliance

[38] Approximately $1.2 trillion of corporate bonds were issued in 2007, compared to $743.6 billion in 2003, and approximately $260 billion of corporate bonds that were issued in 1992. See SIFMA Research Quarterly, 2009 Q3; The Bond Market Association, Research Quarterly at 5 (February 2004), and The Bond Market Association, Research Quarterly at 5 (February 2000).

Engine, or, "TRACE") actual trading prices as well as limited trade history. For bonds that are issued under the U.S. Securities Act of 1933 (the "Securities Act") Rule 144A, actual trading prices are generally not available anywhere. However, for all bonds, whether registered or not, there are numerous pricing services and trading platforms providing various types of pricing information for subscribers who pay fees.

According to a Securities Industry and Financial Markets Association ("SIFMA") survey, there were 62 electronic trading platforms in 2006. Almost all services provide evaluated prices or quotes rather than actual trades. For example, there are "daily runs (axes)" sent out by dealers to potential clients through the Bloomberg message system, which provides daily quotes. While most quotes that are publicly available are indicative quotes, depending on the service and the trading platform, it is possible to get executable quotes, and some services distinguish executable quotes with an identifiable mark (such as color). However, if bonds are in fact actively traded, it is our understanding that an investor can obtain executable quotes easily and readily from brokers and dealers making market.

Evaluated prices or indicative quotes may or may not reflect the fair market value. Even for executable quotes, the actual price may vary depending on the size. Some of the services provide the identity of the dealer or broker providing quotes together with the quotes; in other services, the identities of the dealers are not revealed but subscribers may be able to find the identity of a dealer or broker by contacting the service. Some services say that actual trading prices are available on a selective basis.

The mechanics for providing quotes also vary. Some services provide quotes on request while other services post quotes on a central site that can be viewed by all participants or let participants make ongoing buy-sell quotes. The exact details of the type of information and the restrictions and conditions that apply for obtaining information vary greatly depending on the platform.

There has been notable development in the reporting of loan pricing since the 2004 Report. The LSTA/LTC Mark-to-Market service[39] and the Markit pricing service are the

[39] The information prepared by the LSTA/LTC Mark-to-Market service is also available through the SMi (Secondary Market Intelligence) service.

two services that currently provide pricing for loans. Both provide subscribers with pricing on a daily basis, based on indicative quotes provided by dealers and brokers. There is no service that provides actual trading prices of loans. Loan indexes that track loan values on a daily basis (such as the S&P/ LSTA Leveraged Loan Index, which tracks values of 1,000 fully funded secured loans, and the S&P/LSTA US Leveraged Loan Index 100, which tracks values of the 100 largest U.S. leveraged loans) are based on quotes provided by dealers to Loan Pricing Corporation ("LPC") and not based on actual trading values. Unlike bonds, there is no requirement to report trading prices of loans. Therefore, there is no way to ascertain the trading value of a loan. While trading in loans has increased significantly, it is still significantly less frequent than in bonds. For most of the loans, trading is concentrated at the time of the origination or when there are significant events affecting a borrower. The LSTA study shows that the more illiquid, the more volatile, and/or the more discounted a loan, the less accurate the pricing provided by the LSTA/LTC service.[40]

V. Practical Issues in Applying Treasury Regulations Section 1.1273-2(f)

In determining whether any property is "publicly traded" within the meaning of Treasury Regulations Section 1.1273-2(f), the property must be tested under each of paragraphs (f)(2) through (f)(5) (hereinafter, "(f)(2)," "(f)(3)," "(f)(4)," "(f)(5)"). The following illustrates some of the ambiguities and difficulties arising in applying paragraphs (f)(2) through (f)(5) in the current market.

A. Need to update (f)(2)

Paragraph (f)(2) covers the national securities exchanges registered under section 6 of the Act, the interdealer quotation system sponsored by a national securities association registered under section 15A of the Act and certain foreign exchanges. The securities exchanges registered under section 6 of the Act include the NYSE, NASDAQ, the Boston Stock Exchange, the Chicago Board Options Exchange, the Chicago Stock Exchange, the National Stock Exchange (formerly, the Cincinnati Stock Exchange), the International Stock Exchange, the Philadelphia Stock Exchange, and the Pacific Stock Exchange. There is currently no interdealer quotation system registered under section 15A of the Act.

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[40] See the Appendix for a more detailed description of trading of debt instruments in the market.

The International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, which is listed under paragraph (f)(2), does not exist as a single exchange any longer. Accordingly, there is some doubt whether the London Stock Exchange qualifies under (f)(2). The general view of the market is that the Irish Stock Exchange does not qualify under (f)(2). Since the Service has not designated any other foreign exchange or board of trade, the only two that clearly qualify are the Frankfurt Stock Exchange and the Tokyo Stock Exchange. We recommend Treasury to revisit the list and determine if other exchanges need to be added to the list.

A more fundamental issue, however, is whether or not the per se public trading rule for bonds listed on exchanges makes sense in the current market. Whether any bond is listed on an exchange has no bearing on the level of trading. For foreign issuances, the listing is facilitated in order to qualify an exemption from a withholding tax that would otherwise apply from a regulatory requirement for certain investors, and has little or no relevance to trading on the exchange. Indeed, the actual trading of listed bonds is generally carried out over the counter in the same way that non-listed bonds are, and there is no minimum trading volume requirement for bonds to be listed on any exchange**.** This contrasts with the definition used in the Proposed Regulations, where a debt instrument is treated publicly traded only if it is "traded" on an established securities market.[41]

B. Meaning of interbank market in (f)(3)

Paragraph (f)(3) provides that property is publicly traded if it is property of a kind that is traded on a board of trade designated as a contract market by the Commodities Futures Trading Commission. This category includes the CBOE Futures Exchange, the Chicago Futures Exchange, and the New York and Chicago Mercantile Exchanges.

Paragraph (f)(3) also includes property of a kind that is on an interbank market. The term "interbank market" is used in a number of areas of the tax law and no statutory or regulatory definition of the term exists. The Service indicated in F.S.A. 200025020[42] that it

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41 Prior Prop. Treas. Reg. Section 1.1273-2(c), 1986-1C.B.820. Similarly, actual trading is required in order for the mark-to-market rule to apply for PFIC purposes. See Treas. Reg. Section 1.1296-(2)(b).

42 F.S.A. 200025020 (June 23, 2000).

interprets the term to mean "not a formal market, but rather a group of banks holding themselves out to the general public as being willing to purchase, sell or otherwise enter into certain transactions. The Service broadly interprets the interbank market to include all banks and investment banks (as the terms are generally used in the marketplace)." If F.S.A. 200025020's interpretation of interbank market is literally applied to debt instruments as well, almost all debt instruments would likely be treated as publicly traded, as one could find a bank or an investment bank that would be willing to purchase or sell practically any debt instrument susceptible of being transferred. Furthermore, F.S.A. 200025020's interpretation only requires that banks or investment banks be willing to transact, and does not require that any quotations be readily available. In fact, even if banks buy and sell loans, the actual prices of such trades will not be made public.

We believe that that it makes no sense to treat any debt that is "of a kind that is traded on an interbank market" as publicly traded. As the concept is already provided for in the Code, we recommend Treasury and the Service clarify that such debt will be so treated only if the pricing is readily available to the public.

C. Ambiguities in applying (f)(4)

What constitutes a quotation medium within the meaning of (f)(4) has been and continues to be an issue that puzzles numerous taxpayers and practitioners. There is no consistent or uniform practice in applying (f)(4), and there is enormous confusion as to what each word in (f)(4) means. Other than the limited circumstances where (f)(5) applies, (f)(4) is indeed the stumbling block for almost all debt instruments that are issued (or deemed issued) for properties, including a debt instrument that goes through a significant modification. The following illustrates some of the questions surrounding the application of (f)(4).

i. What system is a quotation medium under (f)(4)?

In order for a pricing service or platform to fall under (f)(4), it must be "a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations … of one or more identified brokers, dealers or traders, or actual prices of recent sale transactions (a quotation medium)." While it may not be entirely clear based on the

literal reading, we believe the system must provide sufficient information meeting the requirements of (f)(4) for the particular debt instrument. Thus, a debt instrument should not be treated publicly traded just because it appears on a system that happens to provide sufficient information for other debt instruments if the system does not provide adequate pricing information relating to the particular debt itself.

Among various pricing services available, there is a general consensus that TRACE is a quotation medium meeting the requirements under (f)(4), setting aside the requirement for the information to be "recent." As discussed in detail in the Appendix, TRACE provides on their website actual trading values and limited trading history of bonds that are registered with the SEC.

There are divergent views among practitioners and taxpayers as to whether a Bloomberg listing constitutes (or can constitute) a quotation medium within the meaning of (f)(4), and if so, under what conditions.[43] Depending on each bond, information available on Bloomberg varies. For example, there may be a list of dealers and brokers and their quotes available for certain bonds available on Bloomberg. For some others, there may be an average price and a list of brokers and dealers providing quotes. For a third category, there may be only the Bloomberg valuation and no quotations or information about dealers making market on the bond.

Bloomberg also works as a middleman in transmitting "daily runs" for bonds and loans through their message service. These daily runs are quotes distributed by dealers making market in the particular bond or loan simultaneously to numerous customers on a daily basis. The recipients of the daily runs from each dealer would typically include the dealer's institutional clients who are generally interested in buying the type of debt being sold. For a high yield bond, there may be normally 50-100 recipients of the daily runs. These runs are not distributed to competitors. It appears that such daily runs literally constitute "a system of general circulation … disseminating … recent price quotations … of one or more identified brokers," While (f)(4) refers to "a system of general circulation (including a computer listing

[43] Without explaining the reasoning, the Service once stated in a Field Service Advice that Bloomberg is a quotation medium. See 1996 FSA Lexis 264 ("An example of a quotation medium is the Bloomberg System".).

disseminated to subscribing brokers, dealers or traders)", the general view is that the clause does not require that the quotes be made available to other dealers, brokers or traders, and that the fact that the runs are not distributed to competitors should not itself disqualify a system from being a quotation medium. However, quotations on daily runs are generally indicative, and whether daily runs provide a "reasonable basis to determine fair market value" for a particular debt instrument is a separate issue that needs to be analyzed based on the facts of the debt instrument.

Similarly, there are numerous electronic trading systems, providing varying degrees of pricing information utilizing diverse dissemination technology. Only paying customers of these private trading systems are permitted access to their information. Some platforms permit participants to enter quotations into a central order book, which can be viewed and executed by all participants, while others allow customers to request executable quotes from dealers. Some trading platforms provide fully executable quotations while others do not. Unlike Bloomberg, which has a wide subscription among the public in general (as well as among qualified investors and dealers and brokers), it is very difficult for non-customers to get any information about what is available on these trading platforms in general, let alone with respect to a particular bond. There is no consistent position among practitioners as to whether any of these systems would constitute a quotation medium under (f)(4). All electronic trading systems and pricing services require that their subscribers are bound by a confidentiality agreement.

There is a minority view in the market that an offering memorandum prepared in connection with bonds pursuant to Rule 144A should constitute "a quotation medium" under (f)(4) since it is "circulated" to investors who are offered the bonds pursuant to such offering memorandum and the offering memorandum provides the actual price of the bonds. However, such a view is not supported by the wording of (f)(4) because an offering memorandum is a one-time distribution and not circulated to the public and is rather limited to investors who are offered the bonds pursuant to the offering memorandum. Some also argue that periodic publications prepared by brokers, dealers or traders that summarize volume and prices of trades for the relevant period, often with an analysis and outlook for the bond market, constitute a quotation medium under (f)(4).

ii. Soft quote, average quote, valuation

With the exception of TRACE, almost all pricing services provide quotes or valuations rather than actual trading prices. For those systems providing quotes or valuations, a question arises whether such quote or valuation qualifies as "recent price quotations" contemplated by (f)(4). The question is particularly vexing as most quotes are "soft" or "indicative." Some practitioners take the view that "soft" or "indicative" quotes should not constitute "recent price quotations" since such quotes are more akin to mere advertisement or valuation. However, it is our understanding that even when there are "firm" or "executable" quotes, final prices are determined in negotiations, influenced by the lot size, and often differ from the quotes.

Valuations provided by Bloomberg, LSTA/LTC, Markit and electronic platforms are generally based on indicative quotes. Such valuations are one step further removed from "quotes" as they represent the average of quotes rather than individual quotes. In addition to quotes from dealers, valuations provided by Bloomberg and other valuation services also take into account other market information that their analysts consider appropriate. Practitioners generally take the view that such valuations do not constitute "recent price quotations" within the meaning of (f)(4).

Another question relating to quotes is whether each quote should be identifiable with a particular dealer providing such quote in order to be treated as "quotations… of one or more identified brokers, dealers or traders" within the meaning of (f)(4). Due to concerns relating to confidentiality, pricing services tend to keep a dealer's identity confidential, and reveal its identity only when they think that the confidentiality concern is diminished due to the existence of multiple quotes. Even in such circumstances, the way pricing services reveal the identity of dealers varies. For example, when there are more than two dealers providing quotes, the LSTA/LPC pricing service lists the names of such dealers, along with the average quote. Note that the LSTA/LPC pricing provides only the average quote and does not reveal individual quotes from the dealers. Markit , on the other hand, provides both individual quotes and the names of the dealers providing the quotes when there are more than two dealers providing the quotes. However, in order not to reveal the exact quote from each dealer, it merely provides a list of individual quotes and a list of dealers providing the quotes, and does not state which quote

comes from which dealer. All of this leads to much confusion as to whether an average quote together with a list of dealers providing the quotes, or a list of various quotes together with a list of various names of dealers, will be considered a quotation "of one or more identified brokers, dealers or traders."

From the perspective of the LSTA/LPC and Markit, as well as other pricing services, the decision as to when to reveal the identity of dealers providing quotes and whether to reveal individual quotes is mainly based on concerns of confidentiality. The fact that only one or two dealers provide quotes and thus their names are not revealed does not mean the quotes are less reliable. In fact, if a customer or a client wants to find out who the dealer is in such event, it can do so. LSTA/LPC or Markit would contact the dealer and reveal its name at the request of the customer and the dealer, so long as it is confirmed that the customer is not a competitor.

iii. Recent price quotations/recent sales prices

While (f)(4) requires that the price quotations be recent and that actual prices be of recent sale transactions, it does not provide the definition of the term "recent." The 60-day period described in Treasury Regulations Section 1.1273-2(f)(1) is for the period in which the property must "appear" on one of the listings and does not define what is "recent." Nevertheless, some in the market consider that, in the absence of any guidance as to what is "recent", a quote or a sale within 30 days from the issue date should be considered "recent" for this purpose. However, in the market, any price that is more than one week old would generally be considered stale.

TRACE is helpful in this regard as it provides the history of trades on registered bonds. Other pricing services rarely provide information regarding the actual trading history. In addition, even though quotes and prices on many pricing services are updated on a daily basis, underlying quotes provided by dealers to such services may be stale if there are no actual trades.

iv. Determinability of fair market value

Once it is established that a bond or a loan is listed on a "quotation medium" within the meaning of (f)(4), the next step is to determine whether it provides a reasonable basis to determine a fair market value of the debt instrument. Unless there is an actual price available,

it may be difficult to determine the precise fair market value based on quotes. In most cases, quotes are merely indicative. Sometimes there are significant differences among quotes available in pricing services. Moreover, there is a gap between a bid price and an ask price, as well as a volume discount. Even if actual prices are available, if they involve a de minimis size, it may not be reflective of fair market value. Most loan agreements provide for a minimum of $1 million for trading of loans. Bond generally trade between $1 million and $5 million per trade, although a smaller trade is sometimes made.

As discussed in the Appendix, for some of the pricing services (such as the LSTA/LPC pricing service and the Markit pricing service), their primary objective is to provide valuation for customers who mark to market their assets. These customers are often required to mark to market their portfolio assets under the governing law whether or not such assets are traded. Even if not required, some are motivated to mark to market their assets to better manage the portfolio. While the pricing services mainly base their pricing on quotes from dealers, it is possible that there is no actual trade involving the debt instrument for many months. The LSTA quarterly studies comparing their pricing service to actual trades provide a few helpful data points, including; that the differential between the LSTA/LPC loan pricing service and actual trades is normally about 1%; the accuracy drops significantly when the market is volatile; the differential for illiquid loans is significantly higher, especially in a volatile market;[44] and loans trade infrequently, especially when the market is fragile. All these points support the view that quotes alone may not be sufficient to provide a reasonable basis to determine fair market value unless there are actual and contemporaneous trades that support the quotes. Put differently, the fact that there are quotes available does not mean that the market is liquid.

In an economic downturn, even if there are actual trades going on in the market, the price of such trades may not reflect fair market value if such trades involve forced sales. Fair market value means a price that will be paid between a willing buyer and a willing seller neither being under a compulsion to transact. In a depressed market where investors are forced to sell their portfolio even though buyers have withdrawn from the market, taxpayers should be permitted to attempt to demonstrate that the actual price does not reflect an arm's-length price.

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[44] For the fourth quarter in 2008, the differential between the mean actual trade and the LSTA/LPC pricing for loans that traded four times or less during the quarter was close to 8%.

D. Safe harbor in (f)(5)

Paragraph (f)(5) asks only whether quotations are readily available from dealers, traders and brokers in order to be treated as publicly traded. As a result, it may initially appear that (f)(5) would cause most debt instruments to be within the scope of public trading. However, the exceptions provided under (f)(5)(ii) exclude many loans and bonds from the scope of (f)(5).

Under (f)(5)(ii), a debt instrument is not considered to be described in (f)(5) if no other outstanding debt of the issuer (or of any person who guarantees the debt) is described in (f)(2), (f)(3) or (f)(4). Paragraph (f)(5)(ii) goes on to provide that even if there is such other debt outstanding that meets (f)(2), (f)(3) or (f)(4), the debt instrument in question is still excluded if the relevant debt instrument is subordinated to the issuer's other traded debt or its maturity is longer (by more than 3 years) than the issuer's other traded debt. It appears that these exclusions purport to exclude from public trading those bonds that are more equity-like than other publicly traded debt. A debt instrument whose original stated principal amount does not exceed $25 million is also excluded. Some argue that since paragraph (ii) is titled "Safe harbors" the exclusion is at the option of the taxpayer. However, given the actual wording of paragraph (ii), it would be difficult to consider such exclusions as optional.

Assuming the issuer has another debt instrument already outstanding that potentially meets (f)(2), (f)(3) and (f)(4), there is significant confusion as of what time the outstanding debt's public trading should be tested. If, as we believe, the reason for requiring the existence of other publicly traded debt is to rely on it as evidence of credit spreads of the issuer in determining the trading value of the new debt instrument, it is logical to test the public trading of the outstanding debt as of the issue date of the new debt. However, there is also a minority view that this logical reading is constrained by the wording of the regulation and hence it should be tested as of the issue date of the outstanding debt.

Another significant issue with (f)(5) is that even for an extremely illiquid loan, it is practically impossible to prove that there are no readily quotations available, unless it is automatically excluded under (f)(5)(ii). We believe (f)(5) needs to be significantly revised.

E. 60-day period ending 30 days after the issuance

Even if an issuer comes to a conclusion that its debt instrument does not currently meet the public trading definitions under (f)(2) through (f)(5), if it wants to plan a debt exchange or debt modification on that basis, there is no assurance that the lack of trading within the meaning of (f)(2) through (f)(5) would be maintained for the relevant 60-day period. For example, for an issuer of a distressed debt instrument going through a modification, it is critical to determine whether the debt instrument is publicly traded in order to assess any cancellation of debt income that may result from the modification. Even if the debt instrument is illiquid and there is no public trading for 30 days before the modification, there is no assurance that it will remain so after the modification. Indeed, we understand that when there are discussions regarding potential modifications to the terms of a debt instrument, the trading of the debt instrument may pick up prior to the effective time of the modifications, but that the heaviest trading would generally occur immediately after the effective time. Taxpayers cannot put any temporary restrictions on trading as such restriction would cause the debt instrument to be treated as publicly traded if the purpose "[of the temporary restriction] is to avoid the characterization of the property as one that is traded on an established market."[45]

We note that Section 1273(b)(3) provides that if a debt instrument is issued as part of an issue that is publicly traded, the issue price must be the fair market value. Thus, the Code requires the determination of public trading with respect to the new debt instrument.

VI. Revisiting the Definition of Public Trading

We recommend the following changes to Treasury Regulations Section 1.1273-2(f). Given the confusion and ambiguities in applying the definition, we believe it is critical to modify the definition so that it is easy and clear to apply. We note that our recommendations surrounding the definition of public trading in this report are based mainly on concerns and policies surrounding the determination of the issue price of a debt instrument. We are not suggesting that the same or similar definition would be appropriate for the concept of public trading as used in other Sections of the Code.

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[45] Treas. Reg. Section 1.1273-2(f)(6).

Our principal recommendation in this regard is that (f)(4) and (f)(5) be repealed and a new definition of be provided in their place. We think that there are two basic approaches to the definition that are relatively practical and easy to apply. The first is to define it narrowly focusing on the actual trading prices. Under such narrow definition, a debt instrument would be treated as publicly traded only if its actual trading price is publicly available, subject to a de minimis exception. If this narrow definition is applied in the current market, the only securities that would qualify as publicly traded would be bonds traded on certain exchanges and those registered with the SEC (whose trading prices would be listed on TRACE). No loans in the current market would be treated as publicly traded. If this definition is adopted, we recommend that trades be considered de minimis and ignored if within the past 7 days ending on the exchange date there are no trades, or the only trades are those involving less than $1 million, unless the aggregate amount of such de minimis trades exceeds $5 million.

Under the second, broader approach, a debt instrument would be treated as publicly traded so long as (1) either (i) recent trading prices are available, or (ii) firm (executable) quotes are readily available from at least one broker, dealer, or pricing service, or (iii) soft (non-executable) quotes are readily available from at least one broker, dealer, or pricing service and provide a reasonable basis for the issuer to determine the fair market value of the debt instrument, and (2) the debt instrument is not excluded under certain de minimis exceptions as described below. This second approach of relying on actual trading prices or quotes is similar to (f)(5) and similar to the one recommended in the 2004 Report.

On balance, we continue to believe that a broader definition, such as the second approach above, makes more sense. In the current market, a significant portion of debt instruments trade actively and regularly over-the-counter in privately negotiated transactions and their quotes are readily available, and yet, their actual trading prices are not reported publicly. Limiting the definition of public trading to those for which actual trading prices are publicly available would exclude those instruments. We also believe that the concept of a "quotation medium" in (f)(4) is too confusing and raises endless ambiguities. We think that given that firm (executable) quotes are not distributed widely even for actively traded securities, requiring quotes to be firm (executable) may unnecessarily limit the scope of public trading and exclude non-registered debt instruments that are actively traded. In this regard, we recommend that

examples be provided to illustrate when soft quotes are considered to provide a reasonable basis to determine fair market value – for example, if a dealer or broker provides information about recent trading activities that were within the range of soft quotes at the time of the trades and involved a significant volume.

Quotes should also be readily available. Readily available quotes should be distinguished from an appraisal or valuation in this regard. In order for a quote to be readily available, a broker or dealer should be ready and able to provide the quote without any valuation study or market research (other than contacting potential customers).

We think it is also important to exclude those instruments that have no meaningful trading. We therefore recommend a few clear exceptions from public trading where there is little or no trading. Under such exceptions, even if a trading value or a quote is readily available, a debt instrument is not treated as publicly traded unless there has been at least a de minimis amount of actual trading of the debt instrument within a 7 day period ending on the issue date. As discussed, trading would be considered de minimis if all trades are less than $1 million per trade unless the aggregate of such trades exceeds $5 million. In determining whether there has been any actual trading, we recommend that an issuer be permitted to rely on information from dealers making the market in the debt instrument (or an administrative agent in the case of a loan), in the absence of any actual knowledge to the contrary. We also recommend that the issuer's determination should govern both the issuer's and holders' position, unless a holder discloses an inconsistent position on its tax return.

In addition, as recommended in the 2004 Report, we believe it is reasonable to provide for an exclusion based on a minimum number of holders, under which a loan held by less than a minimum number (for example, 10) of holders is not treated as being publicly traded.[46] We also recommend retaining a minimum threshold amount. The threshold under the

[46] If an exclusion is made based on a minimum number of holders, we think the rule should require that the ownership by less than the threshold number of holders be met throughout the period during which public trading is measured in order for the exclusion to apply. In addition, guidance may be needed with respect to how to count the number of holders (for example, when related holders are treated as a single holder, how to treat pass-through entities that are established to hold the particular debt instrument and how participations are treated for such purpose).

existing (f)(5) is $25 million, but it may be useful to reexamine whether the amount should be increased.

We believe the concept of quotation medium in (f)(4) is confusing and should be eliminated. However, if the concept of quotation medium is retained, Treasury and the Service should consider publishing detailed guidelines (by way of notices or revenue procedures) upon which taxpayers and practitioners can rely to determine whether a particular system qualifies as a quotation medium that would cause trading of bonds to be deemed publicly traded. Such guidelines should list factors to be taken into account in order for any system to qualify as a quotation medium in a manner that is clear and easy to apply.

In addition to our primary recommendation above, we have several other recommendations in this regard. First, we recommend that once a debt instrument is treated as publicly traded, an issuer should be able to determine its fair market value based on quotes or prices available on pricing services and such determination should be respected so long as it is reasonable. We also recommend that the issuer be permitted to use a value different than the actual trading price, if the trading price fails to accurately reflect its fair market value because of a "market disruption" event. In that event, the issue price should be determined under Section 1274, unless another value can be reasonably established as fair market value by a preponderance of the evidence. A similar rule existed under the 1986 proposed OID regulations.[47] We recommend that Treasury and the Service provide a clear definition of "market disruption" that takes into account such factors as a significant (e.g., greater than 50 percent) drop in the trading volume over a short period of time. Alternatively, specific circumstances could be identified by notice or other administrative guidance to determine a market disruption event.

Second, in (f)(2), we recommend that the per se public trading rule relating to bonds listed on certain designated stock exchange be eliminated. As explained above and in the Appendix, the number of bonds listed on stock exchanges has diminished drastically over the last decade, and whether any particular bond is listed or not, most trades are carried out over the counter. Thus, the listing of bonds on any stock exchange no longer provides any meaningful

[47] See proposed Treas. Reg. Section 1.1273-2(c)(1) prior to withdrawal on December 22, 1992.

indicia of public trading. If the per se rule relating to bonds listed on designated exchanges is retained, the list of qualifying foreign exchanges must be updated.

Third, we recommend that(f)(3) be clarified that a debt instrument will not be treated as traded on an interbank market under (f)(3) merely because banks and investment banks hold themselves out to the general public as being willing to purchase, sell or otherwise enter into certain transactions in such debt instrument. If Treasury and the Service intend to keep the interbank market concept, we recommend that it should be limited to those debt instruments of which the trading value is available to the public.

Fourth, we recommend that the anti-abuse rule be revised. Under Treasury Regulations Section 1.1273-2(f)(6), a temporary restriction on trading is ignored. We think that a reverse anti-abuse concept may be warranted, especially if a broad definition is adopted for public trading. Thus, if the rule is changed so that public trading is deemed to exist whenever quotations are available from brokers or dealers, an anti-abuse rule preventing an artificial quotation or listing and disregarding sales between related parties that are made solely to avoid a de minimis rule would be important.

Fifth, we recommend that Treasury and the Service clarify that "recent sale transactions" under Section 1274(b)(3)(B)(ii)(I) and Treasury Regulations Section 1.1274-3(a)(2)(i) does not cover a debt instrument issued in a debt-for-debt exchange. Under Section 1274(b)(3), if a debt instrument is issued in exchange for property in a potentially abusive situation, the issue price of the debt instrument equals the fair market value of the property. Under Section 1274(b)(3)(B)(ii)(I) and Treasury Regulations Section 1.1274-3(a)(2)(i), a potentially abusive situation includes any situation involving "recent sale transactions". We believe that a debt-for-debt exchange that does not involve a publicly traded debt does not trigger the application of the potentially abusive situation rule.[48]

Sixth, we have two recommendations with respect to the requirement of "public trading" in a qualified reopening in Treasury Regulations Section 1.1275-2(k). First, we request

[48] We previously made a similar recommendation. See the New York State Bar Association Tax Section, "Report on Cancellation of Indebtedness and AHYDO Rules under Sections 108(i) and 163(e)(5)(F)" submitted on April 27, 2009.

clarification that such public trading with respect to outstanding notes is measured as of the issue date of the additional notes. We believe that the reason for applying the 110% yield test as of the earlier of the announcement date or the issue date is to treat a reopening as a qualified reopening so long as the yield test is met based on the trading value of the outstanding debt when the additional issuance is announced, even if the test is not met based on the actual sale price of additional notes. This rule makes sense as it is possible that the notes may trade down after the announcement, at which point the issuer is already bound to issue additional notes based on the assumption that they would be fungible with the outstanding notes. In this regard, the public trading requirement ensures that the 110% yield test based on the trading value of the outstanding notes is reliable and reasonable. There is a great deal of confusion in the market whether the public trading requirement must be met during the 60 day period surrounding the original issue date (based on the strict wording of the definition of "public trading") or the issue date of the additional notes. We believe it is logical and recommend that Treasury and the Service clarify that the public trading determination is applied as of the issue date of the additional notes.

Additionally, we recommend that Treasury and the Service amend the 110% yield test so that it is met either (i) if the outstanding notes are publicly traded at the time the additional notes are issued and the public trading price of the outstanding notes meets the 110% yield test or (ii) if additional bonds are sold for cash to unrelated parties and meet the 110% yield test based on the arm's length cash purchase price. The definition of related party under Sections 267 and 707 may be used in this context. If the public trading requirement is indeed designed to ensure that the yield on the debt is accurately measured, such requirement does not seem necessary when the additional debt instruments meet the yield test based on the cash consideration. When additional notes are issued for cash under the same indenture and meet the de minimis original issue discount test or the 6 months and the 110% yield test, there appears to be no reason to deny the fungible treatment merely because the outstanding notes are not publicly traded. In order to prevent any abuse of the rule, the cash purchase price should be an arm's length price that reflects the fair market value of the outstanding bonds.

Lastly, we recommend that any modifications or clarifications to the publicly trading rules be prospective in application.

Appendix

Trading of Debt Instruments

I. Bonds[49]

Each year since 2000, the annual total new corporate bond issuance (including both investment grade bonds and high yield bonds) has ranged anywhere from $600 billion to $1.2 trillion.[50] After reaching the historic record of $1.2 trillion in 2007, the new corporate bond issuance dropped in 2008 to approximately $750 billion but increased again during 2009.[51] Since 2002, the average daily trading volume for corporate bonds has been $14 billion to $18 billion for any given year. As of the end of 2008, the total principal amount of corporate bonds outstanding was approximately $6.2 trillion.[52]

A. Domestic Exchanges

There has been a steady decline in the listing of bonds on domestic stock exchanges. As of the end of 2006, the NYSE listed approximately 850 bonds, of which 333 were issued by U.S. companies, 88 were issued by foreign companies, and the rest were issued by governments and international banks.[53] The total par value of the bonds listed on the NYSE was approximately $919 million. By comparison, as of the end of 2000, there were 1,627 bonds listed on the NYSE and the total par value of the listed bonds was $2,124 million.

To be listed on the NYSE, corporate bonds must be issued by a qualifying issuer and be of a certain minimum size. If it is a non-convertible bond, its principal amount must be at least $5 million; if it is a convertible bond, its principal amount must be at least $10 million (unless the underlying equity is subject to certain reporting requirement in the U.S.). In addition, the bond must be issued by a company whose equity is listed on the NYSE (or who is affiliated

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49 For purposes of this discussion, bonds generally refer to debt instruments that constitute securities within the meaning of the Securities Act of 1933, and loans refer to debt instruments that are not securities within such meaning.

50 SIFMA, Research Quarterly, 2009 Q3. The data does not include bonds maturing within a year, convertible debentures and Federal agency debt.

51 Id.

52 SIFMA, Outstanding U.S. Bond Market Debt.

53 See http://www.nyxdata.com/nysedata/NYSE/factsfigures/tabid/115/Default.aspx.

with a company so listed), be guaranteed by a company whose equity is listed on the NYSE, be rated at least "B" by Standard & Poor's or its equivalent by another nationally recognized securities rating organization ("NRSRO"), or be issued by an issuer who has senior debt that has an investment grade rating or pari passu or junior debt rated at least "B" by Standard & Poor's or its equivalent by another NRSRO.[54]

The NYSE Bonds Trading Platform provides the principal trading platform for bonds listed on the NYSE.[55] In addition to bonds listed on the NYSE, the system permits the trading of the bonds of all NYSE-listed companies and their subsidiaries that are not listed on the NYSE. The majority of NYSE listed bonds are corporate bonds, with some 94% in straight (non-convertible) bonds and 6% in convertible bonds.[56] Not all trades in NYSE listed bonds take place on the NYSE Bond Trading Platform or through NYSE and in fact, most institutional-sized trades in NYSE listed bonds occur outside of NYSE.[57]

The AMEX historically had not listed many bonds.[58] Following the merger of the AMEX with the NYSE, all NYSE Amex (formerly American Stock Exchange) listed bonds transferred to an electronic trading system called NYSE Amex Bonds as of December 1, 2008.

Although the NYSE has the most extensive listing of bonds out of all domestic exchanges, only a small number of corporate bonds actually trade on the NYSE. In 2007, the average daily number of trades was only 14, and the average par value total daily trade was only $359,000.[59] By comparison, the average total daily trade of corporate bonds for 2007 was approximately $16 billion.[60] Throughout the year 2007, in aggregate, there were a total of 3,465 trades and a total of $90 million par value traded in the NYSE.[61] The statistics are consistent

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54 See New York Stock Exchange Listing Manual, Section 102.03.

55 See http:// www.nyse.com/bonds/nysebonds.

56 See id.

57 See Hong and Warga, 'An Empirical Study of Bond Market Transactions', 56 Financial Analysts Journal 32, 34 (March/April 2000).

58 As of the time of the 2004 Report, there were only 25 bonds listed on the AMEX.

59 See http://www.nyxdata.com/nysedata/NYSE/factsfigures/tabid/115/Default.aspx.

60 SIFMA, Average Daily Trading Volume in the U.S. Bond Markets.

61 See http://www.nyxdata.com/nysedata/NYSE/factsfigures/tabid/115/Default.aspx.

with observations of market participants that the vast majority of trades in corporate bonds do not occur through the NYSE and most issuers list their bonds on the NYSE for reasons other than to establish a trading market for the bonds.

B. PORTAL

The NASD (the predecessor of FINRA) created PORTAL (also known as the PORTAL market) for designated foreign and domestic securities that are eligible for resale under SEC Rule 144A.[62] With respect to debt securities, PORTAL accepts only U.S. dollar denominated debt securities issued by domestic private corporations or foreign private corporations, excluding mortgage and asset backed securities, collateralized mortgage obligations, money market instruments and municipal and municipal-derivative securities.[63] Loans are viewed as generally ineligible for PORTAL because practitioners generally take the position that they are not securities for purposes of the Securities Act of 1933.

For U.S. federal income tax purposes, designation of a debt instrument as a PORTAL security has little significance, other than the fact that secondary market transactions[64] in PORTAL debt securities, subject to certain exceptions, are required to be reported under the TRACE system (described below). The PORTAL market does not provide quotations for any of its securities[65] and does not record trades made on PORTAL securities (although trades in PORTAL debt securities are recorded in the TRACE system).

C. TRACE

Trade Reporting And Compliance Engine (TRACE) is a system that requires all FINRA members to report specified trade details of any transaction in a "TRACE-eligible

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62 Rule 6631(b) of the FINRA Rules: "'PORTAL®' or 'PORTAL Market' means Nasdaq's market for designated foreign and domestic securities that are eligible for resale under Securities Act Rule 144A."

63 See Rule 6631(e) of the FINRA Rules.

64 Rule 6633(b) of the FINRA Rules. For this purpose, secondary market transactions do not include purchases by investors from the issuer, under Section 4(2) of the Securities Act, where the participating broker/dealer is acting solely as an agent, or purchases by QIBs in reliance on Rule 144A from a single broker/dealer that is acting as an intermediary.

65 The 1991 Report's description of PORTAL noted that PORTAL lists price quotations in the PORTAL computerized automated trading system. As noted in the 2004 Report, since the 1991 Report, NASD/ FINRA has changed its policy and currently does not list any quotations on the PORTAL system.

security."[66] The substantive rules governing the TRACE reporting requirement remain largely the same since 2004. One notable development is that the dissemination of information by FINRA has been expanded drastically.

All FINRA members must report trade details relating to "TRACE-eligible security" within 15 minutes of the time of execution. A TRACE-eligible security means "all United States dollar denominated debt securities that are depository eligible securities under Rule 11310(d), investment grade or non-investment grade, issued by United States and/or foreign private corporations, and (1) registered with the Securities and Exchange Commission, or (2) issued pursuant to Section 4(2) of the Securities Act of 1933 and purchased or sold pursuant to Rule 144A of the Securities Act of 1933 [(Securities Act Rule 144A)]" but excludes debt issued by government-sponsored entities, mortgage- or asset-backed securities, collateralized mortgage obligations, and money market instruments.[67] TRACE requires the following transaction information to be reported: (1) the CUSIP number or FINRA symbol of the security, (2) the number of securities traded, (3) the price (or the elements necessary to calculate price) of the transaction, (4) a symbol whether it is a buy or a sell, (5) the date and time of trade execution, (6) the counterparty's identifier, (7) capacity – principal or agent, (8) certain broker details, (9) the stated commission, and (10) "trade modifiers" as required by TRACE.[68]

Transactions not required to be reported are: (1) transactions that are part of a primary distribution by an issuer, (2) transactions in securities listed on a national securities exchange if such transactions are executed on and reported to the exchange and the transactions information is disseminated publicly, (3) trades occurring at a price substantially unrelated to the current market price (e.g. gifts), (4) securities executed on a facility of NYSE pursuant to certain NYSE rules, (5) transactions resulting from an exercise of a swap, option, etc., and (6) certain transfers of securities pursuant to an asset purchase agreement.[69]

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66 See Rule 6730(a) of the FINRA Rules. Such reporting is required within 15 minutes of the time of execution.

67 Rule 6710(a) of the FINRA Rules.

68 Rule 6730(c) of the FINRA Rules.

69 See Rule 6730(e) of the FINRA Rules.

TRACE has continuously expanded the scope of information that is subject to dissemination. Currently, TRACE disseminates information on all transactions in TRACE eligible securities, except (1) transactions effected pursuant to Securities Act Rule 144A or (2) transactions carried out (a) pursuant to a merger of a broker-dealer with another broker-dealer, or (b) not in furtherance of a trading or investment strategy.[70] The exclusion of 144A bonds from the scope of dissemination is notable. As a result, although all trades in the TRACE eligible securities – both those registered with the SEC and those issued pursuant to Securities Act Rule 144A – are generally required to be reported to FINRA, only information on trades in the registered securities become publicly available. For this purpose, the registered securities include bonds that are initially issued pursuant to Securities Act Rule 144A and subsequently exchanged with identical bonds that are registered with the SEC (in a so-called A/B exchange). TRACE currently does not collect information on loans or bonds denominated in foreign currency. Neither does it collect or disseminate information on quotations.

Information disseminated by TRACE is publicly available on the official FINRA website, free of charge.[71] For each bond, the posting includes the basic terms, the last sale date as well as the last sale price and yield. It is also generally possible to search the bond's trade history, including the date and time of each trade as well as the price. There is also limited information available regarding the size of the trade.[72]

Trade information eligible for dissemination under TRACE is made public in many ways. In addition to the official FINRA website, various subscription services such as Bloomberg® and MarketAxess® provide near instantaneous access to trade information disseminated by TRACE.

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70 Rule 6750(b) of the FINRA Rules.

71 http://cxa.marketwatch.com/finra/BondCenter/AdvancedScreener.aspx?Type=Corporate

72 For investment grade debt, the TRACE website shows the size up to $5 million and, once it exceeds $5 million, it shows as a trade in excess of $5 million; for other debt it shows the size up to $1 million and once it exceeds $1 million, it shows as a trade in excess of $1 million.

D. Bloomberg[73]

Bloomberg is a financial data service that provides information to investors in a number of ways. Bloomberg subscribers can access actual trading information disseminated by TRACE almost instantaneously. In addition, Bloomberg provides various quotes for all types of bonds.

The level of access and the types of available information available to subscribers vary greatly depending on various factors, including the status of the subscriber seeking the information, and there appear to be no uniform rules as to exactly what level of information is available to particular categories of investors or traders or with respect to particular categories of bonds. Currently, Bloomberg provides very limited information regarding loans and does not provide pricing information on loans, although our understanding is that Bloomberg plans to expand its service to the loan area in the future.

Certain screens are open to all subscribers. They include DES, ALLQ and QR pages. The DES page is a general description screen with respect to each specific bond. The DES page describes the issuer, the size, the issue date and other basic terms of each bond. It also generally provides the Bloomberg fair value. Our understanding is that, with the exception of those bonds whose actual trading price is disseminated by TRACE, the Bloomberg fair value is based on neither quotations nor actual prices but merely shows the valuation performed by Bloomberg analysts. Some bonds have an ALLQ screen providing quotes from various sources. The ALLQ page may show only the Bloomberg fair value ("BVAL"), or, it may also show the names of one or more brokers or dealers and their quotes. Depending on whether a quote is executable, firm or indicative, the quote is given a different color. For some bonds, even if its ALLQ page shows only the Bloomberg fair value, it is sometimes possible to find the name of the broker/dealers providing quotes by searching "Additional Pricing Providers." However, it may not be possible to find the exact quote that such broker or dealer has provided other than through daily runs that are disseminated to potential clients through the Bloomberg message system (See I.H. below). A QR (or QRD) page generally shows quotes for the particular bond throughout the day or a designated period. But if it is an exchange-listed bond, the QR page may

[73] The following discussion is based on information provided on the website for Bloomberg and conversations with Bloomberg personnel and market participants.

show actual reported trades.[74] Unless the bond's price is disseminated by TRACE, the QR page may mostly show only indicative quotes.

In addition to the providing general information on terms and pricing of bonds, Bloomberg also acts as an electronic trading platform. Thus, subscribers can get access to executable bid and ask quotes from brokers and dealers on corporate bonds through Bloomberg if they desire to buy or sell bonds.[75]

E. Interactive Data[76]

Interactive Data is a leading provider of data and evaluated pricing relating to fixed income instruments. Interactive Data Pricing and Reference Data currently provides data for more than 2.5 million global fixed income securities covering corporate debt, high yield securities, government and agency debt, securitized debt, municipal debt, money market securities and hybrid securities. It is a supplier of evaluated pricing to more than 7,000 global financial institutions.

A wide range of data is available, including daily closing prices, evaluations, income data, security master (descriptive) data, and terms and conditions data. For bonds, prices listed on their data are generally evaluated prices, i.e., prices derived by their analysts based on whatever information is available relating to the bonds. The evaluations represent their good faith opinion as to what a buyer in the marketplace would pay for a security in a current sale. Its evaluation methodologies combine in-house modeling techniques and information from market sources. While actual trading values are also included in their data, unless the security is traded on an exchange, it is unclear when and under what conditions their data includes or reveals actual trading values of securities.

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74 Bloomberg, Help Page for QR.

75 SIFMA, eCommerce in the Fixed-Income Markets, the 2006 review of Electronic Transaction Systems, December 2006.

76 The following discussion is based on discussions with the Interactive data employees and information available from their official website (www.interactivedata-rts.com).

Interactive Data is not affiliated with or owned by a securities broker, dealer or underwriter, nor is it actively involved in the business of investment management or securities trading. It does not advise clients on whether they should buy, sell or hold securities.

F. MarketAxess[77]

MarketAxess Holdings Inc.'s website, MarketAxess.com ("MarketAxess"), is a leading Internet-based trading platform for U.S. bonds, emerging-market bonds and Eurobonds. The trading platform portion of MarketAxess is available only to subscribing QIBs. There are no specified criteria for what corporate bonds may be quoted or traded on MarketAxess, but the vast majority of corporate bonds traded on MarketAxess are investment grade bonds and high yield bonds that are near investment grade. Currently, it provides services to approximately 700 institutional investor clients and is connected to 67 broker-dealer clients. Its total monthly trading volume for November 2009 was $29.3 billion, consisting of $17.7 billion in U.S. high-grade volume, $6.3 billion in Eurobond volume, and $5.3 billion in other volume. Quotations on MarketAxess posted by broker-dealers are generally indicative. However, a QIB may request firm quotations from broker-dealers for specific bonds, which quotations will be communicated to the requesting QIB.

In addition to facilitating trades, MarketAxess's Corporate BondTicker® provides recent sale prices for trades disseminated by TRACE as well as all trades executed on MarketAxess (some of which are not otherwise publicly disseminated). Corporate BondTicker is available to anyone paying for the service, including persons that are not QIBs.

G. Other Electronic Systems[78]

In addition to MarketAxess, there are numerous other services providing an electronic trading platform to paying subscribers. A 2006 review by SIFMA lists 62 electronic fixed-income trading systems operating in the U.S., Europe and Asia.

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[77] The following discussion is based on SEC filings of MarketAxess Holdings Inc., information provided on the website for MarketAxess and conversations with representatives of MarketAxess.

[78] Unless otherwise indicated, the following summary is based on SIFMA, eCommerce in the Fixed-Income Markets, the 2006 review of Electronic Transaction Systems, December 2006.

In general, fixed-income trading platforms can be categorized in two main ways. The first way is based on who the participants are in the trade. There are platforms that support trading only between broker-dealers, those that support trading between investors and broker-dealers (either single dealer or multiple dealers), and those that support sales of new bond issues.

The second way is based on the methodology or technology used for pricing and trade execution. There are four categories.

- "Request-for-quote" systems allow customers to request executable price quotations from broker-dealers. The participants requesting the quotes can execute the trade within a specified time limit at the quoted price.

- "Order-driven" systems allow participants to enter quotations into a central order book, which can be viewed and executed by all participants on the platform.

- "Market-making/cross-matching" systems allow participants to make ongoing buy and sell quotations. Trades are executed when bid and offer quotations and amounts match or when a participant accepts a quoted price.

- "Auction systems," most often used for new issues, allow participants to bid simultaneously for a securities offering.

As an example, ICAP Electronic Broking is an inter-dealer platform and an "order-driven" system.[79] It provides executable quotes. ICAP Electronic Broking is a single dealer-to-(buy-side) customer platform with an "order-driven" system as well as a "request-for-quote" system. It provides both executable and indicative quotes.

In addition, dealers run their own electronic services to disseminate trade interest. For example, ConvertBond.com ("ConvertBond") is a website owned by Morgan Stanley & Co. Incorporated ("Morgan Stanley") which specializes in providing information on convertible bonds issued by U.S. companies. The website provides subscribers news and analysis on convertible bonds, including "indicative prices". The indicative prices are generally not based

[79] On its website, ICAP says that its average daily transaction volume is in excess of $2.3 trillion and more than 40% is electronic.

on actual sale prices and merely reflect the valuation of such bonds by Morgan Stanley's convertible bond trading desk.

H. Daily Indicative Quotes (Daily Runs/ Daily Axes)

In addition to various pricing services, another way to find out the value of the bonds is to look at indicative quotations that are distributed widely and constantly to clients or potential clients by various dealers and market makers at least once a day. These daily runs, which are also referred to as "daily axes," are quotes distributed by dealers making market in the particular bond or loan simultaneously to numerous customers on a daily basis. The dissemination is usually done through the Bloomberg message service (MSG). Many market participants regard these daily indicative quotations as an invitation to transact in a particular bond, essentially serving an advertising function. The recipients of the daily runs from each dealer would typically include the dealer's institutional clients who are generally interested in buying the type of debt being sold. For a high yield bond, there may be normally 50-100 recipients of the daily runs. The actual prices at which a bond will sell will depend on many factors, including the size of the sale. Although broker-dealers generally broadcast indicative quotes that are close to what they are willing to buy or sell the quoted bonds at, the actual prices at which broker-dealers will buy or sell quoted bonds may differ from those shown on the indicative quotes. Thus, it is unclear how useful such indicative quotes are in determining the fair market value of a bond. Daily indicative quotes are provided with respect to loans as well as bonds. If the debt instruments are actively and frequently traded, their daily runs would likely indicate their approximate fair market value.

I. Foreign Issuances

Unlike notes issued by U.S. entities, notes issued by European entities are usually listed on an exchange. This is in part because of the fact that most investors in Europe, particularly those in Continental Europe, that are invested heavily in high-yield bonds are often required by their charters to invest in "listed" bonds. In addition, in certain European countries, such as the United Kingdom, Ireland and Spain, in order to qualify for an exemption from the imposition of the withholding tax on interest payments from such countries, it is often required

that the notes be listed on a qualifying exchange. Thus, notes issued by European entities are generally listed on a principal exchange within a month or so of their issuances.

Among the various stock exchanges in Europe, by far the most often used are the Luxembourg Exchange and the Irish Stock Exchange due to their comparatively less burdensome financial requirements. Although not as frequent as the Luxembourg Exchange or the Irish Stock Exchange, the London Exchange and the Frankfurt Exchange are also used for the listings, particularly for bonds issued by those whose equity is already listed on such exchanges.

Once the bonds are listed on an exchange, satisfying the listing requirement, most of the trading will occur over the counter, in the same way bonds trade in the United States. Occasionally, bonds may trade over an exchange, but those trades typically represent very small odd lots and/or trades between retail investors. To keep the listing effective, issuers would be required to comply with financial and reporting requirements. However, there is no requirement that a minimum level of trading occur over the exchange in order to keep the listing effective. As a result, such bonds, like domestic bonds, are mostly traded through market makers and traders to institutional buyers in large blocks in privately negotiated transactions.

II. LOANS

According to the LSTA study, the volume of newly issued corporate loans has increased from approximately $665 billion in 1995 to $1.3 trillion in 2004 and then to almost $1.7 trillion in 2007 before it hit the lowest in 15 years ($547 billion) in 2009. [80] The secondary market trading volume has also dramatically increased over the years. From the second quarter of 2007 through the second quarter in 2008, the quarterly secondary trade volume was $125 billion to $150 billion for each quarter.[81]

There are currently two main services that provide information on loan values.

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[80] Theodore Basta, LSTA Handbook, Loan Valuation: The Origins of Secondary Market Pricing [add cite] Goldsheets, A. Thomson Reuters publication, Vol. XXIV, No. 1 (January 1, 2010).

[81] Theodore Basta, LSTA Handbook, The LSTA Trade Data Study: 4Q 2008. The secondary trading in this context does not include the original syndication; however, it includes participations.

A. LSTA/LPC[82]

The Loan Syndications & Trading Association ("LSTA"), along with Loan Pricing Corporation ("LPC"), a subsidiary of Thomson Reuters, created the LSTA/LPC Mark-to-Market Pricing ("MTM") service in 1999 to enhance liquidity and transparency in the secondary loan market.[83] The pricing information available through LSTA/LPC MTM service is the same as that available through the SMi pricing service.[84] By providing daily valuation of indicative secondary market values of loans, the LSTA/LPC MTM service helps their clients to mark-to-market their loan portfolios. As of the third quarter of 2009, the LSTA/LTC MTM service covers approximately 2,750 loan facilities, almost all of which are U.S. loans.

The MTM service daily collects, audits and aggregates indicative bid and ask prices for each loan covered by their service from the dealer/broker community. Depending on degree of its liquidity, a loan may have one, two, three or more brokers and dealers providing quotes. These quotes are not executable quotes.[85] Based on the quotes, the MTM service prepares, and provides subscribers with, an indicative price to mark-to-market their positions.

There is a detailed set of operational policies and procedures governing the process to improve accuracy. Each price provided by the MTM service goes through an audit process, which includes monitoring price volatility (whether the price provided is reflective of current market conditions) as well as identifying any human errors. If any issue is identified relating to any pricing information, the price in question will not be released unless the issue is resolved by, for example, an analyst contacting the appropriate broker/dealer.

To improve transparency, the service provides the names of the dealers and brokers in cases where there are more than 2 broker-dealers providing the quotes. Even if the names of the dealers and brokers are provided, only the average quotes are provided and the

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82 The following summary is based on discussions with officers of LSTA.

83 The MTM service is also called the Secondary Mark-to-Market Pricing Service, or the SMPS.

84 SMi represents Secondary Market Intelligence, which is an online service connected to Thomson Reuters. SMi shares the same loan pricing information that LSTA/LPC MTM service prepares.

85 The quotes provided by dealers and brokers for this purpose are distinguished from the daily indicative quotations described above under I.H.

individual quotes are not revealed. The LSTA/LPC MTM service does not provide any information as to how liquid or actively traded loans are.

There is no regulatory authority or set of statutes that govern the provision of quotes by brokers-dealers to the LSTA/LPC MTM service. Dealers contributing the quotes are mostly chosen at the origination of a loan and are continuously subject to review by the LPC. The subscribers of the MTM service are bound by the terms of an agreement between LPC and each subscriber, which include a confidentiality clause and restriction on use. Thus, information provided by the MTM service is largely private.

In 2006, the LSTA started collecting actual trade data and comparing the actual trading value with the LSTA/LTC MTM pricing information. This LSTA trade data study is a comprehensive study that is published quarterly, measuring and comparing a variety of different factors relating to loans. The study includes a comparison (on a post hoc basis) of the secondary actual market trade price to the LSTA/LPC MTM mean (and median) indicative prices on each trade date.

Actual trading prices of loans are highly confidential. When LSTA collects the actual trading values to prepare its quarterly studies, it obtains them on a strictly confidential basis. While the administrative agents for a loan facility is notified of outright transfers by assignment of ownership of positions in the loans, they do not know at what price the loan is being sold. Even if the administrative agent is the same bank that is making market for the loan, it is our understanding that the trade desk would normally not share the pricing information with the administrative agent.

The following points are derived from the LSTA quarterly studies and provide helpful guidance in understanding loan pricing. The examples below compare the fourth quarter in 2008 (when the market was down and the trading was volatile) and the third quarter in 2009 (the latest data available).[86]

[86] See LSTA, The 3Q09 LSTA Secondary Trading & Settlement Study (November 5, 2009).

- The mean (actual) trade[87] to the MTM price differential for the entire loan portfolio over the years has been normally about 100 basis points.

- The accuracy drops significantly for loans in general when the market is volatile. For example, the differential for the fourth quarter in 2008 (when the market was illiquid and volatile) was 240 basis points, while the differential for the third quarter in 2009 was 107 basis points. During the third quarter in 2008, the loans that showed a differential of 0-100 basis points represented only 43% of the total loans, while those that showed a differential exceeding 250 basis points represented about 27%. By comparison, during the third quarter in 2009, the loans that showed a differential of 0-100 basis points represented 75% of the total loans, while those that showed a differential exceeding 250 basis points were reduced to 9%.

- The differential for illiquid loans is significantly higher, especially in a volatile market. For the fourth quarter in 2008, the differential between the mean (actual) trade and the MTM price for loans that traded four times or less was close to 800 basis points. For the third quarter in 2009, the differential for such loans was about 315 basis points.

- The higher the price, the more accurate the MTM prices are. For loans that are quoted at a price at or above 90% of their face amount, the differential between the MTM price and the trading price was 150 basis points in the fourth quarter in 2008 and 82 basis points in the third quarter 2009. For loans that are quoted at a price below 80% of their face amount, the differential was 250 basis points during the fourth quarter in 2008 and 150 basis point during the third quarter in 2009.

- Many loans trade infrequently, and especially so in a down economy. On average, during a given quarter, about 30-40% of loans trade four times or less, and about 30-40% of loans trade twenty times or more. During the fourth quarter of 2008 when the market was illiquid, about 40% or more of the total loans traded four times or less, and about 29% of the total loans traded twenty times or more during the quarter. The third quarter in 2009 shows that the loan trading volumes have returned to normal ranges, with

[87] The mean here is a simple average of all quotes.

approximately 30% of the total loans trading four times or less, and approximately 37% trading twenty times or more, during the quarter.

B. Markit Loan Pricing[88]

Like the LSTA/LPC MTM service, Markit also provides subscribers with loan valuation on a daily basis. The main purpose of the Markit loan pricing service is to assist subscribers in marking-to-market their loans in order to meet regulatory or other requirements or for internal and back office purposes. Markit handles loans denominated in U.S. dollars or Euros issued by U.S. and European issuers. Most loans covered by Markit are large loans. It currently covers approximately 6000 loans, treating each tranche under a single loan facility as a separate loan.

Markit's valuation is based on information voluntarily provided by the dealers, who each day supply Markit with the price at which they believe a loan would trade.[89] The price provided by dealers is not a firm quote. The Markit loan pricing could be used as a teaser, although this occurs rather infrequently. If a customer is interested in contacting a dealer a particular loan posted on Markit, such customer could contact Markit, which may contact the dealer on behalf of the customer. Once it communicates a customer's interest to a dealer, Markit's role as a go-between ends, and it does not participate in the negotiations or actual transactions between a dealer and a customer.

One of the main roles that Markit plays in the market is streamlining information relating to loans. Unlike bonds which are easily identifiable (due to the mandatory and universal use of a CUSIP numbers), the adoption of common identifiers for loans has not yet become comprehensively observed and remains aspirational to some extent, with the result that a single loan tranche or facility may be referred to in several different ways by market participants, making it difficult to be certain that the same obligations is being referenced. By collecting raw data in the market and processing them in an organized manner, Markit improves the ability of market participants to interpret available market information and analytics.

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88 The following summary is based on discussions with officers at Markit.

89 Thus, the methodology used by LSTA/LPC MTM service and the one used by Markit appear to be the same. However, since they are both based on quotes rather than actual prices, one market participant noted that the value provided by the two services are not always the same.

Markit generally posts the average price for each loan without providing the identity of dealer providing the price. However, if there are more than two dealers providing quotes for a single loan facility, Markit provides the names of the dealers as well as quotes from each dealer. However, even for those loans for which Markit provides a list of the dealers and a list of the quotes, Markit simply lists them separately and does not provide information as to which specific quote comes from which dealer.

Markit does not collect information on actual trading and does not provide any data as to the relationship between the prices posted on Markit and actual trading values. Most loans are not actively traded. It is believed that out of approximately 6,000 loans, on average, 50 or so may be actively traded.

C. Daily Indicative Quotes (Daily Runs/Daily Axes)

Daily indicative quotes explained in I.H. above are distributed for loans as well as bonds. As is the case with bonds, market participants regard these daily runs as an invitation to transact in the particular loan. The quotes are only indicative and the actual trading prices may be very different from the quotes.