

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

—

**REPORT ON  
DEFINITION OF “TRADED ON AN ESTABLISHED MARKET”  
WITHIN THE MEANING OF SECTION 1273**

**August 12, 2004**

## TABLE OF CONTENTS

	Page
I. Introduction .....	1
II. Summary of Recommendations.....	2
III. Background .....	4
A. The Determination of the Issue Price of a Debt Instrument .....	4
B. Definition of “Public Trading” under Treasury Regulations	
Section 1.1273-2(f) .....	6
1. (f)(2) Exchange listed property.....	6
2. (f)(3) Market traded property.....	7
3. (f)(4) Property appearing on a quotation medium .....	7
4. (f)(5) Readily quotable debt instruments .....	8
C. Comparison with Definitions of “publicly traded” in certain other Sections .....	8
1. Section 1092 .....	9
2. Section 453 .....	9
3. Section 7704.....	10
D. Relevance of “Issue Price” and “Public Trading” .....	12
1. Cancellation of debt income/retirement premium .....	12
2. Amount of gain or loss to holder .....	13
3. Original issue discount.....	13
4. Qualified reopening .....	14
5. Rev. Proc. 2001-21 .....	15
6. Contingent payment debt instrument issued for property.....	16
IV. Rethinking “Public Trading” .....	17
A. Summary of Trading of Bonds in the Current Market.....	17
B. Practical Issues in Applying Treasury Regulation Section 1.1273-2(f) .....	19
1. Need to update (f)(2).....	19
2. Meaning of interbank market in (f)(3) .....	20
3. What systems fall under (f)(4)? .....	20
4. Firm v. soft quotes .....	22
5. Recent pricing information .....	23
6. Determinability of fair market value.....	23
7. Safeharbors in (f)(5).....	23
8. Uncertainty in planning.....	24
9. Accessibility of quotation medium .....	24
C. Policy and Recommendations.....	25
1. Policy issues.....	25
2. Recommendations.....	27

Appendix

Page

Trading of Debt Instruments ..... A-1

A. Domestic Exchanges ..... A-1

B. PORTAL ..... A-2

C. TRACE ..... A-3

D. Bloomberg..... A-5

E. ValuBond ..... A-5

F. MarketAxess ..... A-6

G. ConvertBond.com ..... A-7

H. Other Electronic Systems..... A-7

I. Foreign Issuances ..... A-8

J. Loans..... A-9

**New York State Bar Association**  
**Tax Section**  
**Report on Definition of “Traded on an Established Market”**  
**within the Meaning of Section 1273**

**I. Introduction<sup>1</sup>**

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<sup>2</sup> and Treasury Regulations Section 1.1273-2(f) and offers recommendations for certain changes to such definition.

The definition of public trading under Section 1273 plays an important role in determining the issue price of a debt instrument. Generally, unless a debt instrument is issued for cash, the issue price of the debt instrument could be significantly different depending on whether either the debt instrument or the property for which the debt instrument is issued is publicly traded. The issue price of a debt instrument in turn is critical in determining, among other things, the amount of cancellation of indebtedness income realized in the transaction (if an outstanding debt obligation is discharged with a new debt obligation), the amount of gain or loss realized by a holder in the transaction (if the consideration received in a sale or disposition includes a debt instrument), and the amount of original issue discount on a debt instrument. In addition, there are other instances where the existence of public trading is a prerequisite for qualifying for special treatment (such as a qualified reopening of debt instruments).

The definition of public trading under Treasury Regulations Section 1.1273-2(f) was proposed in 1993 in its current form and finalized in February 1994. Our report in 1991 (“the

---

<sup>1</sup> This report was prepared by an *ad hoc* committee of the Tax Section of the New York State Bar Association. Jiyeon Lee-Lim is the principal author of this report, with substantial assistance from William Lu. Helpful comments were received from Howard Adams, Kimberly Blanchard, Samuel Dimon, William Dixon, Joe Forrester, Edward Gonzalez, David Mayo, David Miller, John Narducci, Erica Nijenhuis, Michael Schler, David Sicular, Lewis Steinberg and Yaron Reich.

<sup>2</sup> Section references in this report are to the Internal Revenue Code of 1986, as amended (“the Code”), unless otherwise indicated.

1991 Report”) prepared in connection with the addition of Section 108(e)(11) and the repeal of Section 1274(a)(4) under the Revenue Reconciliation Act of 1990 analyzed in detail how bonds traded in the market at the time of the report.<sup>3</sup> The trading market for debt instruments as well as the information reporting relating to such trading have developed significantly over the last decade, however, and in the context of numerous new and evolving systems for trading bonds and disseminating information regarding bonds, it appears that the definition of public trading under Section 1273 does not properly reflect the current market conditions nor does it fully serve its original purpose. In addition, the regulations are unclear in many respects as they apply to particular systems and are subject to varying interpretations. Taxpayers attempting to apply the definition of public trading in the current market thus face numerous ambiguities and difficulties.

The concept of “public trading” is used in several other Sections but the precise wording of the definition of public trading varies under each Section. It is not clear whether such variations were intended, thereby creating more ambiguities in applying the definition.

## **II. Summary of Recommendations**

Our principal recommendations are as follows:

First, we recommend that the definition of public trading under Treasury Regulations Section 1.1273-2(f) be amended so that debt instruments are deemed publicly traded if quotes are readily available from brokers, dealers or traders, subject only to an exclusion based on the minimum size and/or the minimum number of holders. If such definition is adopted, we recommend that the issuer and the holders of a debt instrument be required to take a consistent position. We also recommend that the Treasury and the IRS provide guidance as to when quotes are treated as “readily available from brokers, dealers or traders”. For example, quotes may be treated as readily available from brokers, dealers or traders only if such quotes are based on actual trading prices or firm quotes or are provided by a broker, dealer or trader who is making a market in the relevant debt instrument. In addition, if quotes are based on actual trading or firm

---

<sup>3</sup> Section 11325(a) of the Revenue Reconciliation Act of 1990 amended the Code by adding Section 108(e)(11) and repealing Section 1275(a)(4) from the prior law. The Tax Section submitted a report commenting on the treatment of debt-for-debt exchanges after the enactment of such provisions of the 1990 Act. See New York State Bar Association Tax Section, Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges. Section 108(e)(11) was redesignated as Section 108(e)(10) in 1993.

quotes, the rule may require that such trading or quotes involve a minimum size. We believe that the recommended definition would make more sense in the current bond market where, despite an unprecedented growth in the volume of trading, almost all bonds are traded over the counter in privately negotiated transactions and there is no comprehensive listing of prices and quotations on any system.

Second, we note that it is extremely difficult to determine whether any particular system in the current market qualifies as a quotation medium within the meaning of Treasury Regulations Section 1.1273-2(f)(4). We recommend that if the concept of “quotation medium” is retained, the Treasury and the IRS publish detailed guidelines, upon which taxpayers and practitioners can rely to determine whether a particular system will qualify as a quotation medium and, as a result, bonds traded on or through such system will be deemed publicly traded. In this regard, the Treasury and the IRS may consider a special rule under which bonds included in a bond index meeting certain criteria are presumed to be publicly traded.

Third, we recommend that the Treasury and the IRS consider eliminating the per se public trading rule relating to bonds listed on certain designated stock exchanges. Our recommendation reflects the fact that the number of bonds listed on stock exchanges has diminished significantly over the last decade and that almost all trades of debt instruments are carried out over the counter even when debt instruments are listed on a stock exchange. If such per se rule is retained, we recommend that the list of qualifying stock exchanges be updated.

Fourth, the meaning of “interbank market” under Treasury Regulations Section 1.1273-2(f)(3) is unclear. We recommend that it be clarified that a debt instrument will not be treated as traded on an “interbank market” for this purpose 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.

Fifth, we recommend that the Treasury and the IRS clarify that the determination of fair market value is an issue that is separate from the determination of whether there is public trading. Due to the significance given to the existence of a quotation medium under the current Treasury Regulations in determining whether a debt instrument is deemed to be publicly traded, some practitioners take the view that the quote and/or the price appearing on a quotation medium

for a debt instrument should represent its fair market value. However, we believe that the price or the quote of a debt instrument appearing on any particular quotation medium is not always determinative of its fair market value.

Sixth, we recommend that any clarification or change be prospective.

Seventh, we do not believe there is any need for requiring debt instruments to be publicly traded in order to qualify for the qualified reopening rules when additional debt instruments are sold for cash in an arm's length transaction. Accordingly, we recommend that the Treasury and the IRS consider removing the requirement of public trading under the qualified reopening rules if additional debt instruments are sold to unrelated parties for cash.

Eighth, if the definition of public trading is broadened, we recommend that the anti-abuse rule be broadened to cover not only a temporary restriction on trading but also the converse, i.e., a temporary or tax-abusive listing or trading, in order to prevent a debt instrument from being treated as publicly traded when there is no meaningful quotes or trading activities with respect to such debt instrument.

### **III. Background**

#### **A. The Determination of the Issue Price of a Debt Instrument**

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. 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.

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.<sup>4</sup> 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 the 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 fair market value of such property.<sup>5</sup>

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.<sup>6</sup> Section 1274(b)(3) has a special anti-abuse rule, in which the imputed principal

---

<sup>4</sup> 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).

<sup>5</sup> The Code describes the public trading concept slightly differently with respect to stock or securities, on one hand, and other property, on the other. Thus, Section 1273 would apply for 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.

<sup>6</sup> Treasury Regulations Section 1.1274-4(a)(1) provides that the 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 on the month in which the sale occurs.

amount is deemed to equal the fair market value of the property in the case of any “potentially abusive situation”.

In summary, unless a debt instrument is issued for cash, the first question to be answered in determining the issue price would be whether either the debt instrument or the property for which the debt instrument is issued is “publicly traded”. If the answer is positive (i.e., one or the other or both are publicly traded), the issue price would be the fair market value of the debt instrument or such property. If the answer is negative (i.e., not publicly traded), subject to narrow exceptions, the issue price would be the stated principal amount if the debt instrument provides for adequate stated interest or the imputed principal amount if it does not provide for adequate stated interest.

**B. Definition of “Public Trading” under Treasury Regulations Section 1.1273-2(f)**

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.<sup>7</sup>

**1. (f)(2) Exchange listed property.**

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

(i) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (the “Act”). This includes the New York Stock Exchange (“NYSE”), the American Stock Exchange (“AMEX”), 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.

---

<sup>7</sup> Treas. Reg. Section 1.1273-2(f)(6).

(ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Act. The only interdealer quotation system that currently meets this definition is the National Association of Securities Dealers Automated Quotation System (“NASDAQ”).

(iii) 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. So far, the IRS has not designated any other foreign exchange or board of trade that would qualify under this category.

**2. (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. This category includes the New York and Chicago Mercantile Exchanges.

**3. (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 does not include price information.

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

#### 4. (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:

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

(ii) The original stated principal amount of the debt instrument does not exceed \$25 million;

(iii) 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

(iv) 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)).

#### C. Comparison with Definitions of “publicly traded” in certain other Sections

Whether property is “traded on an established market” is important under other Sections as well, but the way the term is defined under each Section is not consistent throughout the Code. The following summarizes, and compares with the definition under Section 1273, the definitions of public trading under Sections 1092, 453 and 7704.<sup>8</sup> Unlike Section 1273 which uses the concept of public trading to establish “valuation,” Sections 1092, 453 and 7704 adopt the concept of public trading to establish “liquidity”.

---

<sup>8</sup> There are other Sections that use the concept of public trading as well, such as Sections 1(h), 280G and 1296.

## 1. Section 1092<sup>9</sup>

The definition of “actively traded” under Section 1092 is generally similar to the definition of “traded on an established market” under Treas. Reg. Section 1.1273-2(f), although there are notable differences in some of the details. Both definitions treat property listed on (1) exchanges registered under section 6 of the Act, (2) interdealer quotation systems sponsored by a national securities association registered under section 15A of the Act and (3) certain foreign exchanges, as property that is actively traded or traded on an established market.<sup>10</sup> They both treat property listed on either interbank markets or boards of trade designated as a contract market by the Commodities Futures Trading Commission as actively traded property.<sup>11</sup> Solely for debt instruments, both sets of rules provide that debt instruments for which quotations are readily available from brokers, dealers or traders are actively traded/traded on an established market subject to certain exceptions.<sup>12</sup>

## 2. Section 453

The installment method rules under Section 453 do not apply if the debt obligation is issued by a corporation and is readily tradable in an established securities market. The definition of “established securities market” under Treasury Regulations Section 15A.453-1(e)(4)(iv) includes “(A) an national securities exchange which is registered under section 6 of the Act, (B) an exchange which is exempted from registration under section 5 of the Securities Exchange Act

---

<sup>9</sup> The straddle rules prevent a taxpayer from recognizing a loss when it has not economically suffered such loss because it holds an offsetting position. Whether personal property is actively traded is relevant for purposes of determining whether such property is liquid or easily offset. See Treasury Decision 8491.

<sup>10</sup> Both rules list the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, and the Tokyo Stock Exchange. Only the definition under Section 1092 includes the London International Financial Futures Exchange and the Marche a Terme International de France as qualifying exchanges. The rules under Section 1273 provide that other foreign exchanges or boards of trade will qualify if designated by the Commissioner, whereas the straddle rules provide that any foreign securities exchange or board of trade that satisfy “analogous regulatory requirements” as those governed by sections 6 and 15A of the Act will, apparently without separate designation, qualify. Therefore, with respect to foreign exchanges and boards of trade, the definition under Section 1092 is more flexible and potentially broader than the definition under Section 1273.

<sup>11</sup> Literally, the straddle rules require that such board of trade be domestic, whereas the regulations under Section 1273 do not.

<sup>12</sup> Both sets of rules also have substantially identical exclusions. The straddle rules’ definition of actively traded was finalized on October 14, 1993, while the definition of traded on an established market under Section 1273 was finalized shortly thereafter on February 2, 1994.

of 1935 (15 U.S.C. 78e) because of its limited volume of transactions, and (C) any over-the-counter market”. An over-the-counter market is reflected by the existence of an interdealer quotation system.<sup>13</sup> For this purpose, an interdealer quotation system is “any system of general circulation to brokers and dealers which regularly disseminates quotations of obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the ordinary course of his business and containing only quotations of such broker or dealer”.<sup>14</sup>

### 3. Section 7704

The publicly traded partnership rules under Section 7704 treat certain partnerships as corporations if interests in such partnerships are “traded on an established securities market” or are “readily tradable on a secondary market or the substantial equivalent thereof”. Although the publicly traded partnership rules apply only to equity interests rather than debt instruments and the relevance of an “established securities market” in the context of such rules is very different from the relevance of such term under the rules under Section 1273, the publicly traded

---

<sup>13</sup> Treas. Reg. Section 15A.453-1(e)(4)(iv). Unlike the rules under Section 1273, the interdealer quotation system under Section 453 is not limited to ones created by NASDAQ. Under the installment method rules, if an obligation issued by a corporation is “designed to be readily tradable in an established securities market,” the receipt of such obligation is not eligible for installment method treatment. An obligation is readily tradable “if it is regularly quoted by brokers or dealers making a market in such obligations or is part of an issue a portion of which is in fact traded in an established securities market”. Treas. Reg. Section 15A.453-1(e)(4)(iii). So long as an obligation is regularly quoted by market makers, such an obligation is readily tradable without exceptions like those found under Treas. Reg. Section 1.1273-2(f)(5). Although the Section 453 regulations, which were originally promulgated by the Treasury in 1958 and amended in 1972, are significantly older than the regulations under Section 1273, the former is arguably more reflective of the way bonds trade than the latter.

<sup>14</sup> Id. Interestingly, unlike the quotation medium defined in Treas. Reg. Section 1.1273-2(f)(4), which refers to a quotation medium that disseminates “one or more identified brokers, dealers, or traders”, the definition of public trading under Section 453 provides that a quotation sheet prepared and distributed by a broker or dealer containing only quotations of such broker or dealer is not enough to make it an interdealer quotation system. (emphasis added) Thus, a computer system that is of “general circulation” containing only the quotations of a single broker-dealer may qualify under the rules under Section 1273 as an established market but not as an established securities market under the installment method rules. The prior proposed regulations under Section 1273 borrowed the definition of “established securities market” from prior Treas. Reg. Section 1.453-3(d)(4), and presumably, any differences between the two current definitions are intentional. A similar definition of interdealer quotation system is found in Treas. Reg. Section 1.844-5(d)(2)(iv). A slightly different definition of interdealer quotation system can be found in Treas. Reg. Section 1.170A-13(c)(7)(xi)(B)(2)(ii): “...any system of general circulation to brokers and dealers that regularly disseminates quotations of obligations by two or more identified brokers or dealers, who are not related to either the issuer of the security or to the issuer's agent, who compute the average trading price of the security. A quotation sheet prepared and distributed by a broker or dealer in the regular course of its business and containing only quotations of such broker or dealer is not an interdealer quotation system”.

partnership regulations provide an interesting contrast to the regulations under Section 1273. National securities exchanges registered under section 6 of the Act and foreign exchanges are treated as established securities market under the publicly traded partnership regulations.<sup>15</sup> In addition, the publicly traded partnership regulations include in the definition of established securities markets any “national securities exchange exempt from registration under section 6 of the [Act] because of the limited volume of transactions”, any “regional or local exchange”,<sup>16</sup> and any “interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise”.<sup>17</sup> The publicly traded partnership regulations also look to whether the partnership interests are “readily tradable on a secondary market or the substantial equivalent thereof”, which test is met if such interests are regularly quoted by any person, such as a broker or a dealer, making a market in the interests, firm bid or offer quotes are regularly made by any person to the public, holders of such interest have a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining information of offers to buy, sell, or exchange such interests, or prospective buyers and sellers otherwise have the opportunity to buy, sell or exchange such interests in a similar time frame and with similar regularity and continuity as any of the foregoing.<sup>18</sup> The publicly traded partnership regulations draw a distinction between firm and soft quotes in determining whether a partnership interest is publicly traded. Furthermore, the publicly traded partnership regulations generally provide that, with limited exceptions, the

---

<sup>15</sup> The foreign exchanges listed under the publicly traded partnership regulations are the same as those listed under the regulations under Section 1092. Compare Treas. Reg. Section 1.884-5(d)(2), which treats as “established securities market”, subject to a determination by the IRS to the contrary, any “foreign securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority of the country in which the market is located, is the principal exchange in that country, and has an annual value of shares traded on the exchange exceeding \$1 billion during each of the three calendar years immediately preceding the beginning of the taxable year”.

<sup>16</sup> See Treas. Reg. Section 1.7704-1(b)(2) and (4).

<sup>17</sup> See Treas. Reg. Section 1.7704-1(b)(5). In contrast to both the regulations under Section 1273 and those under Section 1092, such interdealer quotation system need not be sponsored by either NASDAQ or any other national securities association registered under section 15A of the Act. Furthermore, the quotations must be “firm” quotations under the publicly traded partnership regulations, whereas neither the regulations under Section 1273 nor the regulations under Section 1092 explicitly require that the quotations be firm.

<sup>18</sup> See Treas. Reg. Section 1.7704-1(c)(2). The publicly traded partnership regulations provide a number of exceptions from the definition of “readily tradable on a secondary market or the substantial equivalent thereof”. One particular exception ignores transfers made on a “qualified matching service”, which is a service that consists of a computerized or printed listing system that lists bid and/or ask quotes that are not firm quotes, and certain other conditions are met. See Treas. Reg. Section 1.7704-1(g).

existence of even an informal market (e.g. market makers and other avenues of trading) demonstrates that an interest is publicly traded.

In summary, the definition of public trading under Section 1273 is not the same as the definitions under other Sections of the Code, and the degree of difference varies. It is not clear if the differences in the details of the definitions were intentional or not.

#### **D. Relevance of “Issue Price” and “Public Trading”**

##### **1. Cancellation of debt income/retirement premium**

For a variety of reasons, a company with outstanding debt often finds itself in need of exchanging the outstanding debt for new debt with different terms or otherwise modifying certain terms of its outstanding debt obligation. Depending on the terms and the degree affected, such exchange or modification could result in a “significant modification” within the meaning of Treasury Regulations Section 1.1001-3. Also, a debt obligation of an entity may be assumed by an affiliated entity for business reasons. If so, unless such assumption by a different obligor is specifically excluded under Treasury Regulations Section 1.1001-3(e)(4), it would generally constitute a significant modification. If there is a significant modification, the outstanding debt is deemed to be exchanged for the new debt, in which event, the obligor may realize cancellation of debt income or retirement premium. In computing the cancellation of debt income under Section 108(e)(10), if a new debt instrument is issued in satisfaction of outstanding indebtedness, the 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 retirement 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.<sup>19</sup>

Thus, the determination of the issue price may be critical for companies effecting a debt-for-debt exchange. Under the rules discussed above, when a debt instrument is issued for another debt instrument, its issue price would be drastically different depending on whether either the new debt instrument or the old debt instrument is “publicly traded”. If either the new debt instrument or the old instrument is “publicly traded,” the issue price of the new debt

---

<sup>19</sup> Section 108(e)(10)(B).

instrument would be the fair market value of the publicly traded debt. By comparison, if neither the new debt instrument nor the old debt instrument is “publicly traded,” the issue price of the new debt instrument would in most circumstances be the stated principal amount of the debt instrument (or the imputed principal amount).

For example, suppose an issuer has notes outstanding that provide for adequate stated interest, the aggregate principal amount of the notes is \$1,000, and the notes are traded in the market at 70% of the face amount. Assume that the debt is modified significantly (e.g., the maturity date is significantly extended), resulting in a deemed exchange of the note for a new note under the principles of Treasury Regulations Section 1.1001-3. If the notes are treated as publicly traded, the issuer would realize \$300 of cancellation of debt income, whereas if the notes are not so treated, the issuer would not realize any cancellation of debt income.

## **2. Amount of gain or loss to holder**

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.<sup>20</sup> Thus, depending on whether there is public trading of the debt instrument or the property for which the debt instrument is exchanged, the amount realized could be drastically different –i.e., the stated principal amount of the debt instrument (or, if the debt instrument does not provide for adequate stated interest, the imputed principal amount) or its fair market value.

In the above example, assume an investor X purchased the note at \$800 and the exchange does not constitute a recapitalization. If the notes are treated as publicly traded, X would realize \$100 of loss. If the notes are not treated as publicly traded, however, X would realize a gain of \$200, despite the fact that the value of the note is only \$700.

## **3. Original issue discount**

The amount of original issue discount on a debt instrument equals the “stated redemption price at maturity” (the sum of all amounts payable on the debt instrument other than qualified

---

<sup>20</sup> Treas. Reg. Section 1.1001-1(g)(1).

stated interest) minus the issue price. Accordingly, 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 original issue discount would depend on whether the issue price is lower than the stated principal amount.

In the above example, if the notes are deemed to be publicly traded within the meaning of Section 1273, the deemed new note would be treated as issued with original issue discount of \$300. If an investor X purchased the notes in the market at \$800 immediately before the modification, without the modification and the deemed new issuance, X would have a market discount of \$200 with respect to the note, which will not be included in X's income until X sells the notes (absent an election to accrue such market discount currently). However, after the modification and the deemed new issuance, X would be required to accrue the original issue discount over the term of the deemed new notes (although X may be able to deduct \$100 of loss or to offset the OID partially with an acquisition premium of \$100). By comparison, if the notes were not publicly traded and the stated interest were adequate, the market discount of \$200 would remain as such after the modification and the deemed exchange.

#### **4. Qualified reopening**

Debt instruments issued as part of the same issue will have the same issue price. In general, for debt instruments issued after March 13, 2001, two or more debt instruments are part of the same issue if the debt instruments (i) have the same credit and payment terms, (ii) are issued pursuant to the common plan or part of a single transaction or a series of related transactions, and (iii) are issued within a 13-day period.<sup>21</sup> In addition, under the "qualified reopening" rules, additional debt instruments issued in a "qualified reopening" are deemed part of the same issue as the original debt instruments. As a result, such additional debt instruments would have the same issue date and the same issue price as the original debt.

---

<sup>21</sup> Treas. Reg. Section 1.1275-1(f)(1). The 13 day rule seems to be too restrictive given that typically over-allotment options or "green-shoe" options given to underwriters in connection with sale of convertible bonds allow underwriters to exercise such options within 30 days. It appears that debt instruments sold pursuant to the exercise of an over allotment or green-shoe option should be deemed to be the same issue as the debt instruments originally issued. In this regard, the Treasury and the IRS may consider extending the 13 day period to a 30 day period.

For debt instruments other than tax exempt obligations or contingent payment debt instruments or Treasury securities, a reopening is a qualified reopening if one of the following two sets of conditions are met. First, a reopening is a qualified reopening if (i) the original debt instruments are publicly traded within the meaning of Treasury Regulations Section 1.1273-2(f), (ii) the reopening date of the additional debt instruments is not more than six months after the issue date of the original debt instruments and (iii) as of the date on which the price of the additional debt is established (or, if earlier, the announcement date), the yield on the original debt instruments based on their fair market value is not more than 110% of the original yield on their issue date (or, if the original debt instruments were issued with no more than a de minimis amount of original issue discount, the coupon rate). Alternatively, a reopening is a qualified reopening if (i) the original debt instruments are publicly traded within the meaning of Treasury Regulations 1.1273-2(f), and (ii) the additional debt instruments are issued with no more than a de minimis amount of original issue discount.

Under these rules, the public trading of debt instruments is a requirement under either the 6 months/110% test or the de minimis test for the qualified reopening.<sup>22</sup> Accordingly, unless additional notes are issued within 13 days after the initial issuance, in order to constitute the same issue with the original debt, not only must the additional debt instruments be issued within a certain price range but there must also be public trading of the debt instruments.

## **5. Rev. Proc. 2001-21**

Revenue Procedure 2001-21 provides for an election to treat the substitution of a debt instrument as a realization event even though it does not result in a significant modification within the meaning of Treasury Regulations Section 1.1001-3.<sup>23</sup> Thus, under the Rev. Proc., when two or more debt instruments are substituted with new debt, even if the substitution does

---

<sup>22</sup> The logic behind the public trading requirement is not entirely clear. If the requirement is designed to ensure that the yield on the additional debt is accurately measured, such requirement does not seem necessary when the additional debt instruments are issued for cash. Moreover, there appears to be a fundamental gap between commercial reality and the tax rules governing additional issuances. Indentures quite often permit issuance of additional notes with the same terms. By comparison, for tax purposes, in order to meet the same issue definition, not only should the notes meet a strict yield test but also the notes must be publicly traded.

<sup>23</sup> 2001-1 C.B. 742. Rev. Proc. 2001-21 modifies and supercedes Rev. Proc. 2000-29, 2000-28 IRB, which modified Rev. Proc. 99-18, 1999-1 C.B. 736.

not result in a significant modification of the old debt under Treasury Regulations Section 1.1001-3 and, consequently, is not a realization event under Treasury Regulations Section 1.1001-1, the issuer and the holders can make an election, by agreeing in writing, to treat the substitution as an exchange.

However, the Revenue Procedure requires not only that the new debt and the old debt be publicly traded within the meaning of Treasury Regulations Section 1.1273-2(f), but also that neither the old debt nor the new debt be issued with more than a de minimis amount of original issue discount. Thus, the application of the Rev. Proc. is severely limited and the Rev. Proc. fails to provide relief in situations where tax fungibility would be really helpful – i.e., when additional bonds are issued under the same indenture but at a discount exceeding a de minimis amount.<sup>24</sup>

## **6. Contingent payment debt instrument issued for property**

Treasury Regulations Section 1.1275-4 governs the taxation of a debt instrument that constitutes a contingent payment debt instrument. Under such regulations, the tax consequences would significantly differ depending on whether the contingent payment debt instrument is issued for money or publicly traded property or for non-publicly traded property. The contingent payment debt instrument issued for money or publicly traded property would be taxed based on a hypothetical comparable yield and the projected payment schedule, subject to adjustments based on actual contingent payments. By comparison, the contingent payment debt instrument issued for non-publicly traded property would be separated into the non-contingent components and the contingent components. The non-contingent components would generally be treated as a separate debt instrument with no interest being treated as qualified stated interest, while the contingent payment would be generally includible in gross income (and deductible from gross income) in taxable years in which the payment is made.

---

<sup>24</sup> Rev. Proc. 2001-21 states that the Rev. Proc. is designed to ameliorate a fungibility issue for tax purposes when, for example, the later issue is issued with original issue discount: “Under section 1.1275-2(j), however, some or all of the newly issued debt may have original issue discount in varying amount, depending upon the term of the outstanding debt for which the newly issued debt was substituted. As a result, the newly issued debt may not be fungible”. But the Rev. Proc. requires that neither the old debt nor the new debt be issued with more than a de minimis amount of original issue discount in order to qualify for the election. If neither the old debt nor the new debt were issued with more than a de minimis amount of original issue discount and if the notes are publicly traded, it is very likely that the conditions for a qualified reopening are met (under Treas. Reg. Sections 1.1275-2(k)(3)(iii)), and if so, there would be no need for an election under the Rev. Proc.

#### **IV. Rethinking “Public Trading”**

##### **A. Summary of Trading of Bonds in the Current Market**

The 1991 Report analyzed in detail how bonds trade in the market as of the time of the report. In some respects, there have been significant changes in the way corporate bonds trade during the 13 year period. In other respects, things have not changed much from the time of the 1991 report. 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 decade.<sup>25</sup> 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 would enter the trade with Depository 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.

The listing on stock exchanges has diminished drastically. The NYSE listed approximately 1,273 bonds at the end of 2003 (out of which 595 were issued by U.S. companies), and only 25 corporate bonds issued by 16 companies are currently listed on AMEX.<sup>26</sup> Even if bonds are listed on the NYSE or other exchanges, almost all the trading of such bonds still takes place over the counter. One survey conducted by the Bond Market Association indicates that the average daily volume of trading of all bonds over the NYSE was

---

<sup>25</sup> Approximately \$743.6 billion of corporate bonds were issued in 2003 (see The Bond Market Association, Research Quarterly at 5 (February 2004)), compared with approximately \$260 billion of corporate bonds that were issued in 1992 (see The Bond Market Association, Research Quarterly at 5 (February 2000)). The total value of corporate bonds outstanding as of 2001 was approximately \$5.7 trillion. See Securities Industry Fact Book 2002 at 22.

<sup>26</sup> This is down from the approximately 250 corporate debt issues listed on AMEX at the time of the 1991 Report.

less than 0.1% of the average daily trading of corporate bonds by primary dealers for bonds with maturities of greater than one year alone during the last quarter of 2002.<sup>27</sup>

Unlike equity securities, bond trades have generally not been subject to many regulatory reporting requirements. The continuing lack of transparency in the bond market prompted the creation of the “Trade Reporting and Comparison Engine” or “TRACE”, which is designed to provide a systematic reporting of prices for bonds.<sup>28</sup> As explained in the Appendix, TRACE requires all NASD members to report trade details of any transaction in TRACE eligible securities. While TRACE currently only disseminates trades that meet certain criteria, TRACE’s objective is to disseminate all or almost all transactions involving TRACE eligible securities.

Bloomberg continues to provide valuable information relating to bonds traded in the market. A screen designated for a specific bond available to all subscribers, however, does not generally provide actual prices and merely provides Bloomberg fair value (which is generally based on the internal valuation by Bloomberg analysts). While such screen may also provide the list of willing buyers and sellers, it does not show the bid or ask quotations. Certain subscribers can get access to special Bloomberg screens providing bid and ask quotations and, sometimes, even trading prices. However, for competitive reasons, a broker or dealer would generally not allow other broker or dealer access to its quotations but would rather allow such access to only certain investors or others having a special relationship with such broker or dealer. The quotes are mostly “indicative” quotes while some are designated “executable”.

---

<sup>27</sup> See New York Stock Exchange Factbook 2003 at [http://www.nysedata.com/factbook/viewer\\_edition.asp?mode=table&key=1596&category=1](http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=1596&category=1); The Bond Market Association, *Research Quarterly* (February 2003).

<sup>28</sup> An article relating to the creation of TRACE notes:

On July 1 of this year, the corporate bond market will begin to emerge from “a needlessly dark corner of our capital markets,” as former SEC Chairman Arthur Levitt described, “into a new age of transparency”. ... When the system becomes operational on July 1 ..., TRACE will benefit the market, dealers, traders, investors, issuers and the general public by providing a level of transparency never before seen in the corporate bond market. In a 1998 speech, Levitt noted that, despite its unprecedented growth, the corporate bond market failed to keep pace with transparency improvements made in other markets such as Treasuries, high yield and Municipal bonds. Then and now, the corporate bond market stands alone in the last sizable financial market that lacks price transparency.

Fixed Income Research and Strategy, Volume 2, Issue 1, January 2002, “TRACE: The Dawning of a New Era in Corporate Bond Price Transparency”. TRACE, sponsored by the National Association of Securities Dealers (“NASD”), replaced NASD’s Fixed Income Pricing System known as FIPS.

There has been unprecedented development in internet-based trading. On one survey performed in 2003, the Bond Market Association reports that 77 electronic fixed-income trading systems operate worldwide, with 46 in the United States. The most notable of them include ValuBond, MarketAxess, and ConvertBond.com. These web trading systems often provide trading information relating to bonds as well as price quotations. The way trades are executed vary depending on the precise mechanics of each trading platform and such mechanics are frequently updated and modified. For example, ConvertBond used to provide quotations on convertible bonds but currently only provide news and analysis of convertible bonds with “indicative prices”.<sup>29</sup>

## **B. Practical Issues in Applying Treasury Regulation 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.

### **1. Need to update (f)(2)**

The International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited does not exist as a single exchange any longer. While the general view is that the London Stock Exchange qualifies under (f)(2), it is not clear if the Irish Stock Exchange qualifies under (f)(2). In addition, the governing rules of certain foreign exchanges, such as the Luxembourg Exchange, have gone through significant changes. (See the Appendix.) It may be time 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. The actual trading of listed bonds is generally carried out over the counter in the same way non-listed bonds, and there is no minimum trading volume requirement for bonds to be listed on any exchange.

---

<sup>29</sup> See the Appendix for more detailed description of trading of debt instruments in the market.

## **2. 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 either on a board of trade designated as a contract market by the Commodities Futures Trading Commission or 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. However, the IRS indicated in FSA 200025020<sup>30</sup> that it 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 FSA 200025020’s interpretation of interbank market is literally applied to debt instruments as well, almost all debt instruments might 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, FSA 200025020’s interpretation only requires that banks or investment banks be willing to transact, and does not require that any quotations be readily available. Accordingly, applying FSA 200025020’s interpretation of interbank market to debt instruments may make (f)(5) superfluous. We believe that that FSA 200025020’s interpretation of the meaning of “interbank market” should not apply to debt instruments.

## **3. What systems fall under (f)(4)?**

As discussed above, corporate debt instruments are rarely listed on an exchange designated in (f)(2), and seldom issued in exchange for market traded property (other than stock or securities). Thus, debt instruments would rarely be described in either (f)(2) or (f)(3). In addition, as discussed below, due to a broad exclusion provided therein, (f)(5) does not apply to most debt instruments. Accordingly, the question of public trading generally is focused on whether the debt instrument constitutes “property appearing on a quotation medium” as described in (f)(4).

---

<sup>30</sup> F.S.A 200025021 (June 23, 2000).

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. Some taxpayers defer the decision to underwriters or investment bankers involved in the deal and, in an attempt to provide some protection for their position, ask for a certificate from them stating that the bonds appear (or do not appear) on a quotation medium described in (f)(4). However, investment banks are only in a better position in determining how a bond trades and are not in any better position to determine whether a bond is in fact described in (f)(4), given the ambiguous language in (f)(4).

For example, 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.<sup>31</sup> In particular, some take the view that the Bloomberg website providing specific quotes by brokers and dealers that are only accessible by certain limited investors should fall under (f)(4). However, others argue that if only permitted customers can gain access to the quotes, it literally fails to meet the definition of “a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders)” and, at that point, the situation looks very similar to “readily quotable instrument” under (f)(5), where price quotations are readily available from dealers, brokers or traders.

As described in the Appendix, it has been reported that there are currently 77 electronic trading systems, currently ranging from auction systems to cross-matching systems, through which bonds trade, and their operations are diversified and complex. Some trading platforms provide fully executable quotations while others do not. Many web-based trading systems provide indicative quotes only. There is no consistent position among practitioners as to whether any of these systems would constitute a quotation medium under (f)(4).

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

---

<sup>31</sup> Without explaining the reasoning, the IRS once stated in a Field Service Advice that the Bloomberg is a quotation medium. See 1996 FSA Lexis 264 (“An example of a quotation medium is the Bloomberg System”).

memorandum and the offering memorandum provides the actual price of the bonds. However, such view is not supported by the wording of (f)(4) because offering memorandums are generally “confidential” and not generally circulated to the public, but rather are limited to investors who are offered the bonds pursuant to the offering memorandum. In addition, some 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).

#### 4. Firm v. soft quotes

Even if a particular system otherwise meets the definition of a “system of general circulation” under (f)(4), if the price provided is a “quote” rather than an actual price, a question often arises as to whether such quote qualifies as “recent price quotations” contemplated by (f)(4). The question is particularly vexing in the current market where most quotes are “soft” or “indicative”. Many practitioners generally believe that “soft” or “indicative quotes” should not constitute “recent price quotations” since such quotes are more akin to mere advertisement. However, it is our understanding that even when there is a “firm” or “executable” quotes, final prices are determined in negotiations, influenced by the lot size, and often differ from the quotes.

Literally applied, (f)(4) does not require the quotes to be “firm” but instead requires that the quotes provide a reasonable basis to determine fair market value.<sup>32</sup> As described in the Appendix, Bloomberg and MarketAxess generally provide access to indicative quotes, although executable quotes are sometimes available from certain sellers. In reality, a broker-dealer’s indicative quote generally does give a reasonable basis for determining fair market value, as such broker-dealer’s reputation would be tarnished by quotations that are misleading.<sup>33</sup> On the other hand, many view indicative quotes as serving an advertising function and/or that if quotations are not accessible to retail investors and require approvals for access, such system is not generally circulated.

---

<sup>32</sup> Compare Treas. Reg. Section 1.7704-1(b)(5) (“An interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.”) (emphasis added)

<sup>33</sup> It may be the case that indicative quotes in some systems are more reliable as a measure of value than in others. As described in the Appendix, Valubond penalizes brokers and dealers who provide indicative quotes when trades are not ultimately executed at such quotes.

## **5. Recent pricing information**

While (f)(4) requires that the price quotations as well as actual prices must be of “recent sale transactions,” it does not provide the definition of the term “recent”. It seems relatively clear, however, that 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”. Many of the price quotations or sales prices appearing on a quotation system do not indicate how recent the quotations and/or prices are. Thus, it may be impossible to ascertain that the requirement of the “recent” price or quotations is met.

## **6. Determinability of fair market value**

Even if it is established that a bond is listed on a “quotation medium” qualifying under (f)(4), unless there is an actual price available, it may be difficult to determine the precise fair market value. Literally applied, (f)(4) implies that the existence of quotations is not itself sufficient; rather, those quotations must provide a reasonable basis to determine fair market value. When there is only a bid price or an ask price, but not both, even if the quote is executable, it may be hard to determine the fair market value because spreads could be quite large for some bonds and thus (f)(4) would arguably not be met in those situations. One could also argue that even an executable quote without a known lot size should not fall under (f)(4) because, for example, there is often a large swing in the pricing due to a “volume discount” factor.

## **7. Safe harbors in (f)(5)**

Paragraph (f)(5) only asks whether quotations are readily available from dealers, traders and brokers. 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 exception provided under (f)(5)(ii) excludes most of the bonds from the scope of (f)(5).

Under (f)(5)(ii), if a bond is relative small in size (\$25 million or less), it is economically 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, the bond is automatically excluded from (f)(5). It appears that these three exclusions purport to exclude from public trading those bonds that are relatively

small in size or more equity-like than other publicly traded debt. However, other than the exclusion based on the size, no other exclusion provided for in the existing regulations seems to make much sense.

While (f)(5) is titled “Safe harbors,” unless the debt is less than \$25 million in size, (f)(5) does not make the analysis any easier since it requires taxpayers to decide whether any other debt instrument meets (f)(4). Some argue that since paragraph (ii) is titled “Safe harbors”, the exclusion is at the option of the taxpayer. However, given the language under paragraph (ii), it would be dangerous to ignore such exclusion.

## **8. Uncertainty in planning**

Even if an issuer comes to a conclusion that its debt instrument does not meet the public trading definitions under (f)(2) through (f)(5), if it wants to plan a transaction 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. The reverse is also true, especially in the context of reopenings or “tack-on” issuances. In general, bond trading is most active immediately after the issuance and tends to slow down afterwards. When an issuer wants to issue additional bonds after some time has passed and tries to qualify under the “qualified reopening” rules, the bonds may not be listed on any quotation medium within the meaning of (f)(4) to meet the “public trading” required under the qualified reopening rules. Although the bonds are expected to be actively traded again as soon as additional bonds are issued, there is no assurance that the bonds would be listed in any qualifying quotation medium within the 60 day period.

## **9. Accessibility of quotation medium**

Paragraph (f)(4) refers to “a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders),” but provides few clues as to whether it is necessary that the pool of the recipients of information must include brokers, dealers and traders. For example, if the system disseminates information only to subscribing qualified institutional buyers (“QIBs”) but not to competing brokers, dealers and traders, would the system not qualify? As explained in the Appendix, there are numerous websites sponsored by various brokers, dealers and market makers providing quotations but many are only accessible to QIBs,

which dominate the market for debt.<sup>34</sup> There is no reason to believe that prices and quotations available to QIBs should be any less reliable than those available to brokers, dealers or traders in general or to retail investors (in fact, given the market share of QIBs, sophistication and influence of QIBs, prices and quotations obtained by QIBs are arguably more reliable indicators of value than prices and quotations obtained by retail investors).<sup>35</sup>

The other issue relates to the requirement under (f)(4) that quotations be those of “identified brokers, dealers or traders”. Certain systems providing quotes often do not show the identity of the person providing the quotes, but QIBs could often determine the identity if they desire to execute the trade. If the system itself does not provide the identity but if an investor could find out, is the requirement that the quotes be from an “identified” person satisfied? What if the identity can be revealed to QIBs but not to other brokers, dealers or traders?

### **C. Policy and Recommendations**

#### **1. Policy issues**

Policies underlying Section 1273 indicate that the issue price of a debt instrument, which in turn determines, among other things, the amount of gain or loss, original issue discount and the cancellation of debt income, should be the fair market value of the debt instrument as long as such fair market value can be determined accurately and objectively. If the property is “traded on an established market,” it was believed that the information regarding the fair market value should be publicly available and ascertainable. Treasury Regulations under Section 1273 thus adopted, in (f)(4), the concept of a system of general circulation (a quotation medium) as a general minimum standard for when fair market value should be deemed publicly available and ascertainable.

Unfortunately, unlike in the equity market, even when bonds are trading most actively in the market, the price of such bonds are often not “listed” on any system that is accessible by

---

<sup>34</sup> One commentator estimates that individuals own only 9% of corporate bonds, while institutions own 91% of corporate bonds.

<sup>35</sup> Furthermore, the utility of allowing systems available to dealers to qualify as quotation mediums is questionable in the bond market, given that dealers in many instances keep quotations secret from other dealers for competitive reasons.

brokers, dealers or the general public. When notes are issued and actively marketed by one or more underwriters, it may be even harder to find the listing of the quotes or the actual pricing of such notes, since it would be known in the market that such dealer, broker or underwriter is making a market for such notes and thus it is expected that potential buyers and sellers would contact those underwriters directly or through their brokers. Accordingly, under such circumstances, there may be less need for active listing of the trades in the absence of a legal requirement. While TRACE may eventually cause all the transaction prices of bonds entered (other than those that are excluded from the reporting requirements) to be disseminated under its system, such complete listing is currently not available and may never become available. Further, there are certain categories of bonds, including foreign currency denominated bonds, that are excluded from TRACE. In addition, although bonds listed on a national securities exchange (such as NYSE and AMEX) are automatically deemed to be publicly traded, as explained above, such listing is not reflective of the degree or the volume of active trading in the market because even for such bonds, most of the trading takes place over-the-counter.

At the same time, there have been tremendous developments in valuation techniques in the financial market in general, making the valuation of financial instruments much easier compared with a decade ago. Among all different types of property other than cash, it is understood that debt instruments are generally the easiest to value. Bond dealers usually determine their quotations on an investment grade bond by comparing such bond with other bonds that have similar maturities, coupon rates and bond ratings, rather than by performing an analysis of issuer-specific factors.<sup>36</sup>

When a debt instrument falls outside the “public trading” definition, the issue price is generally determined under Section 1274: If the debt instrument provides for adequate stated interest, its issue price would generally be the face amount, and if it does not, the imputed principal amount. Neither the face amount nor the imputed principal amount would bear any meaningful relationship to the actual fair market value.

---

<sup>36</sup> See Schultz, ‘Corporate Bond Trading Costs: A Peek Behind the Curtain’, 56 *The Journal of Finance* 677, 678 (April 2001).

The question then becomes whether or not it is sensible to limit “public trading” to situations where the trading value is publicly available through a system of general circulation, leaving all the others that do not meet such definition to be governed by Section 1274. For reasons explained above, given the lack of systematic reporting of prices in the market and the development in valuation of debt instruments, restricting the definition of “public trading” in debt instruments to those where prices are transparent tends to lead to an unnecessarily narrow and arbitrary application of the definition. In addition, there is a great deal of confusion as to what system qualifies as a quotation medium under (f)(4). For bonds that are traded in the market and whose quotations are readily available from dealers and brokers, it appears that the practical and sensible answer is to determine its issue price based on the trading price rather than the face amount.

## 2. Recommendations

We believe that certain modifications to Treasury Regulations Section 1.1273-2(f) are needed in order to make the definition of public trading reflective of today’s market and also to eliminate certain ambiguities.

First, given the fact that almost all bonds are traded over the counter in privately negotiated transactions and prices are not reported in any systematic way, and that bond values are relatively easily determinable in the financial market, one possible solution would be to broaden the scope of (f)(5), which deals with readily quotable instruments . This could be accomplished by removing the exclusions in the safe harbor provision in (f)(5)(ii), except perhaps a minimum threshold size requirement, so that bonds are treated as publicly traded when quotes are readily available from brokers, dealers or traders, whether or not the same issuer has any other trading debt instruments.<sup>37</sup> We believe that the issuer’s determination as to whether its

---

<sup>37</sup> It appears that when the Treasury decided to insert (f)(5) in the final regulations in 1994, it acknowledge that public trading should be deemed to exist if quotations are readily available:

“One commentator suggested that the rule regarding readily available price quotations should be eliminated. The IRS and Treasury, however, believe that one principal way in which debt instruments are traded is through brokers and dealers from whom price quotations are readily available, that this market is liquid, and that instruments so traded are susceptible to ready valuation. In such a case, it is consistent with the purposes of the rules applicable to publicly traded property that the instruments be considered publicly traded”.

Preamble to the Final Regulations, T.D. 8517, 59 Fed. Reg. 4799 (February 2, 1994). 1994-1 C.B. 38, 41.

debt instrument is publicly traded should govern the tax positions of both the issuer and holders of the debt instrument on this point. The minimum threshold amount is \$25 million under the current regulations, but it may be useful to reexamine whether the amount should be increased.

One potential concern resulting from the broad definition suggested above would be that such definition may include debt instruments that are easily valued but have no meaningful trading (i.e., neither actual trading nor firm quotes involving a meaningful size). Such concern could be addressed if there is proper guidance as to when quotes are treated as “readily available from brokers, dealers or traders”. In our view, “readily available” quotations means that the quotes should be willingly and easily obtainable from a broker, dealer or trader and based on actual trading prices or firm (or executable) quotes with respect to the debt instrument at issue, without the need for investors or issuers to provide any particular financial information relating to the debt instrument. Readily available quotes should be distinguished from an appraisal. In this regard, we recommend that the Treasury and the IRS consider a rule under which quotations of a debt instrument are treated as “readily available from brokers, dealers or traders” for this purpose if the quotes are based on actual trading prices or firm (or executable) quotes or are provided by a broker, dealer or trader who is making a market in the relevant debt instrument.<sup>38</sup> In addition, the definition may require that when quotes are based on actual trading prices or firm quotes, such prices or quotes involve a minimum size that is appropriate in the context of the trading market for comparable debt instruments.<sup>39</sup>

If the definition is broadened to include any readily quotable debt instruments, it should be noted that loans may be viewed as “publicly traded” if their quotes are “readily available.” Due to unprecedented developments in the loan market, the differences between loan trading and bond trading have diminished. Thus, there appears to be no compelling reason to exclude loans

---

<sup>38</sup> In general, market makers would maintain and update daily bid and ask quotations that are generally executable.

<sup>39</sup> We note that there could be situations where quotes are available but relate to a small volume and thus may not be viewed as representative of the trading of the relevant debt instrument. However, we believe that such situations would be rare. Our understanding is that the representative trade size varies depending largely on the rating on the relevant debt instrument, and that it ranges from a minimum of \$1 –2 million per trade in a high yield debt instrument to a minimum of \$5-10 million per trade in an investment grade rated debt instrument.

from the scope of public trading under Section 1273 if their quotes are readily available from brokers or dealers (subject to a minimum size). On the other hand, compared with bonds, many loans are still truly illiquid and privately held. Thus, with respect to loans, it may be 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.<sup>40</sup>

We note that the proposed broader definition of public trading could adversely impact taxpayers in bankruptcy. For example, when a taxpayer in bankruptcy significantly modifies the terms of its outstanding debt obligation, the amount of cancellation of indebtedness income realized from such modification would be measured by the difference between the amount of the old debt discharged and the issue price of the deemed new debt. If the new debt is deemed publicly traded under the proposed definition, its issue price would be its fair market value, which would generally be lower than its face amount when the issuer-taxpayer is financially troubled, resulting in a larger amount of cancellation of indebtedness income.

Second, if the concept of quotation medium is retained, the Treasury and the IRS 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. For example, relevant factors may include the existence of actual pricing or “firm” quotes, accessibility by investors to the pricing or quotes, and the system or the platform being recognized as one for trading bonds (perhaps with certain minimum standards for the platform or the system itself). We are facing unprecedented developments in the bond market, such as the expected full dissemination of TRACE data and the constant evolution of internet systems, which provide a variety of different

---

<sup>40</sup> 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 (i.e., the 60 day period ending 30 days after the issue date of the debt instrument) 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 and how participations are treated for such purpose).

methods for trading bonds. In addition, issuers attempting to confirm that their bonds are not publicly traded face a truly daunting task of having to identify what systems exist that potentially would qualify as a quotation medium in this evolving market. A detailed guideline setting forth relevant factors in determining whether any system qualifies as a quotation medium would contribute significantly in eliminating some of the ambiguities existing under the current law. Publishing a list of systems and platforms constituting a quotation medium would likely be a futile exercise given that new trading systems and websites are being created constantly and changes in existing trading systems are made without notice.

In this regard, the Treasury and the IRS may consider a special rule under which bonds included in a bond index prepared by investment banks are presumed to be publicly traded if the composition and pricing information relating to the index is available to the public. A number of banks prepare different types of bond indices for government and corporate bonds to monitor the fluctuation in value in the bond market. Corporate bond indices include, among others, an investment grade bond index, a high yield market index and an emerging market index. Each bank has its own detailed and clear guidelines as to the characteristics of a good bench mark for each index. While the details may vary for each index, it is our understanding that in order to be included in any bond index, a bond must have certain minimum volume of trading and liquidity during the relevant period. Banks review and modify the composition of each index on a regular basis to ensure that each bond listed in the index meets the required standard. Once an index is compiled, the price of each bond included in the index would be updated periodically (at least monthly) based on actual prices. However, among the bonds that meet the requirements, including threshold liquidity and volume, only some would be selected for the inclusion in each index. As a result, the fact that a bond is not included in an index would not necessarily mean that it is not actively or publicly traded. It is our understanding that investors can generally find out whether a particular bond is included in a particular index, although there is no guarantee that investors can find out actual prices or firm quotes of a bond included in an index. Based on these facts, it appears that those bonds that are included in a bond index meet the indicia of public trading and may be presumed to be publicly traded for purposes of Section 1273, unless proven otherwise by either taxpayers or the IRS.

Third, we recommend that the per se public trading rule relating to bonds listed on certain designated stock exchanges 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 indicia of public trading.

If the per se rule relating to bonds listed on designated exchanges is retained, it should be clarified whether the Irish Stock Exchange qualifies under (f)(2) given that the “International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited” no longer exists as a single exchange. In addition, the governing rules of certain foreign exchanges, such as the Luxembourg Exchange, have recently changed. A re-examination of whether the Luxembourg Exchange or other foreign exchanges should qualify under (f)(2) may be appropriate.

Fourth, we recommend it 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.

Fifth, we recommend the Treasury and the IRS clarify that the determination of fair market value is an issue that is separate from public trading. That is, even if there is a quotation medium causing an instrument to qualify as publicly traded, there may be reasons why the quotes should not necessarily reflect the fair market value of such instrument.

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

Seventh, we recommend the Treasury and the IRS reconsider the requirement of “public trading” in a qualified reopening where additional bonds are sold for cash to unrelated parties. The definition of related party under Sections 267 and 707 may be used in this context. In our experience, the uncertainty as to the status of public trading in connection with issuance of additional bonds has led some issuers to avoid issuing bonds as a “tack-on” of existing bonds and instead to issue new debt as a separate issuance. Transaction costs of new offerings are higher

than the transaction costs of a tack-on offering, and the unnecessary transaction costs caused by the uncertainty may make the bond market less efficient.

Eighth, we recommend that the anti-abuse rule be broadened. 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 would be important.

Finally, once the definition of public trading in Section 1273 is clarified, it would be desirable to streamline the definition of public trading in other Sections as well. The definitions of public trading under other Sections also fail to reflect adequately the way bonds are traded in the current market.<sup>41</sup> We suspect that the definition adopted for purposes of Section 1273 may not make sense for all Sections. If so, some deviation may be made as long as the new or different definition is workable in the context of the market for bonds described above.

---

<sup>41</sup> We note however, that in many respects, the language used in the publicly traded partnership regulations provides a good basis for determining when bonds are publicly traded.

## Trading of Debt Instruments

There is limited written information with respect to the trading of debt instruments. The following description of the bond market and the trading of bonds is based in part on interviews with numerous traders and other market participants.

### A. Domestic Exchanges

The NYSE listed approximately 1,273 bonds at the end of 2003 (595 were issued by U.S. companies, 73 were issued by foreign companies, and the rest were issued by governments and international banks).<sup>42</sup> Currently, only 25 corporate bonds issued by 16 companies are listed on AMEX. To be listed on the NYSE, corporate bonds must (1) have a principal amount of \$5 million and (2) (a) be issued by companies whose equity is also listed on the NYSE or are affiliated to such listed companies, (b) be guaranteed by a company whose equity is listed on the NYSE, (c) be rated at least “B” by Standard & Poor’s or its equivalent by another nationally recognized securities rating organization (“NRSRO”) or (d) if not rated by an NRSRO, 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.<sup>43</sup>

The NYSE’s Automated Bond System (ABS®) provides the principal trading platform for bonds listed on the NYSE. Subscribing firms can enter and execute orders on bonds by entering the trade through computer terminals.<sup>44</sup> The entries are matched on a price and time basis and once matched, the trades are automatically submitted for clearing.<sup>45</sup> All NYSE listed bonds trade on the ABS, but not all trades in NYSE listed bonds take place on ABS or through NYSE (and in fact, most institutional-sized trades in NYSE listed bonds occur outside of NYSE).<sup>46</sup> Brokers working for ABS-subscribing firms are obligated to “explore” the ABS

---

<sup>42</sup> See New York Stock Exchange 2003 Factbook at [http://www.nyse.com/factbook/viewer\\_edition.asp?mode=table&key=1238&category=1](http://www.nyse.com/factbook/viewer_edition.asp?mode=table&key=1238&category=1). The value of NYSE’s company bonds is relatively small (approximately \$250 billion at the end of 2001) versus the total value of corporate bonds outstanding (approximately \$5.7 trillion). See Securities Industry Fact Book 2002 at 22.

<sup>43</sup> See New York Stock Exchange Listing Manual, Section 102.03 (Section 102.03 has changed since the 1991 report—listing on the NYSE no longer requires that “the company is in a position to cover interest charges on all debt issued by it...including the issue it is seeking to list”). The AMEX considers bonds “on a case by case basis, in light of the suitability of the issue for an exchange market”. The American Stock Exchange Company Guide, Section 101. The minimum specified requirements for bond listing are the same as that of the NYSE, except that with respect to requirements 2(a) and 2(b), the AMEX requirements also allow listing if the relevant company is listed on the NYSE, AMEX or NASDAQ. See *id.* Because the number of bonds listed on the AMEX is very small, the rest of this discussion on the domestic exchanges will focus on the NYSE.

<sup>44</sup> See Automated Bond System User Manual (the “ABS Manual”), Chapter 3.

<sup>45</sup> See *id.*

<sup>46</sup> See Hong and Warga, ‘An Empirical Study of Bond Market Transactions’, 56 *Financial Analysts Journal* 32, 34 (March/April 2000).

before transacting outside the NYSE for lot sizes of nine bonds or less (the so-called “nine bond” rule).<sup>47</sup> Subscribers can see executable quotes entered in the ABS.<sup>48</sup>

Although the NYSE has the most extensive listing of the exchanges, only a small number of corporate bonds actually trade on the NYSE—in the last quarter of 2002, the average daily volume of all bonds traded on the NYSE was approximately \$18 million,<sup>49</sup> compared to \$20.4 billion average daily volume of corporate bonds alone over the same period.<sup>50</sup> The number of trades conducted on the NYSE has generally declined between 1988 and 2002.<sup>51</sup> The average size of the lots traded on the NYSE is generally small, averaging only 23.6 bonds per trade, indicating that many trades on the NYSE are odd-lot trades.<sup>52</sup> In contrast, institutional dealers and brokers typically transact in lot sizes between 500 to 1000.<sup>53</sup> Compared with the number of odd-lot trades that occur generally, the number of odd-lot trades occurring through the NYSE is small.<sup>54</sup> The statistics are consistent 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. The prices obtained by investors purchasing in large lots can and often do differ from the prices obtained by investors purchasing small lots.<sup>55</sup>

## B. PORTAL

The NASD created PORTAL (also known as the PORTAL market) for designated foreign and domestic securities that are eligible for resale under SEC Rule 144A.<sup>56</sup> 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

---

<sup>47</sup> See *id.*

<sup>48</sup> See ABS Manual, Chapter 5.

<sup>49</sup> See New York Stock Exchange 2002 Factbook *at* [http://www.nysedata.com/factbook/viewer\\_edition.asp?mode=table&key=2&category=1](http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=2&category=1).

<sup>50</sup> See The Bond Market Association, Research Quarterly (February 2003).

<sup>51</sup> See New York Stock Exchange 2002 Factbook *at* [http://www.nysedata.com/factbook/viewer\\_edition.asp?mode=table&key=75&category=4](http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=75&category=4). In 1988, 522,173 trades were conducted over the NYSE, versus 154,212 in 2002.

<sup>52</sup> See New York Stock Exchange 2002 Factbook *at* [http://www.nysedata.com/factbook/viewer\\_edition.asp?mode=table&key=75&category=4](http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=75&category=4).

<sup>53</sup> See Hong and Warga, ‘An Empirical Study of Bond Market Transactions’, *supra* note 43, at 34.

<sup>54</sup> Approximately 65% of TRACE transactions are in quantities of less than 100 bonds, and it is estimated that there are approximately 28,000 trades in corporate bonds on a typical day. See Letter from Robert R. Glauber, Chairman and Chief Executive Officer, NASD, to the Honorable W.J. Tauzin, Chairman, Committee on Energy and Commerce and the Honorable John D. Dingall, Ranking Member, Committee on Energy and Commerce (December 31, 2003). If the TRACE sample is representative, then approximately 18,200 trades a day occur at lot sizes of less than 100 bonds. In contrast, the number of trades per day for all bonds traded on the NYSE, in contrast, was only 395. See New York Stock Exchange 2003 Factbook *at* [http://www.nysedata.com/factbook/viewer\\_edition.asp?mode=table&key=1596&category=1](http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=1596&category=1).

<sup>55</sup> See Hong and Warga, ‘An Empirical Study of Bond Market Transactions’, *supra* note 43, at 39-40.

<sup>56</sup> See Rule 5300 of the NASD Manual.

backed securities, collateralized mortgage obligations, money market instruments and municipal and municipal-derivative securities.<sup>57</sup> 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.

PORTAL designation allows a debt security that is rated below investment grade and that is issued under Rule 144A to receive a CUSIP number and the book-entry services of DTC. For U.S. federal income tax purposes, designation of a debt instrument as a PORTAL security has little significance, other than the fact that all secondary market transactions,<sup>58</sup> subject to certain exceptions, in PORTAL debt securities are required to be reported under the TRACE system (described below). The PORTAL market does not provide quotations for any of its securities<sup>59</sup> and does not record trades made on PORTAL securities (although trades in PORTAL debt securities are recorded in the TRACE system).

### C. TRACE

TRACE is a system that requires all NASD members to report specified trade details of any transaction in a “TRACE-eligible security”.<sup>60</sup> Rule 6210(a) of the NASD manual provides “[t]he term ‘TRACE-eligible security’ shall mean 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. The term ‘TRACE-eligible security’ excludes debt issued by government-sponsored entities, mortgage- or asset-backed securities, collateralized mortgage obligations, and money market instruments”. TRACE requires the following transaction information to be reported: (1) the CUSIP number or NASD symbol of the security, (2) the number of securities traded, (3) the price (or the elements necessary to calculate price) of the transaction, (4) the date and time of trade execution, (5) the counterparty’s identifier, (6) whether the trade executed as the principal or as the agent, (7) certain broker details, (8) the stated commission, (9) if required, the yield to call or yield to maturity and (10) “trade modifiers” as required by TRACE.<sup>61</sup>

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

---

<sup>57</sup> See Rule 5310(e) of the NASD Manual.

<sup>58</sup> 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.

<sup>59</sup> The 1991 Report’s description of PORTAL noted that PORTAL lists price quotations in the PORTAL computerized automated trading system. Since the 1991 Report, NASD has changed its policy and currently does not list any quotations on the PORTAL system.

<sup>60</sup> See Rule 6230(a) of the NASD Manual.

<sup>61</sup> See Rule 6230(c) of the NASD Manual.

is disseminated publicly, including transactions in convertible debt securities listed and quoted on NASDAQ, and (3) trades occurring at a price substantially unrelated to the current market price (e.g. gifts).<sup>62</sup> Trades are required to be entered into TRACE within 45 minutes, and the goal is to require trades to be reported within 15 minutes.<sup>63</sup>

TRACE currently does not cover bonds denominated in foreign currency or loans and TRACE does not collect or disseminate information on quotations.<sup>64</sup> Currently, TRACE only disseminates transaction information for securities that meet its criteria for dissemination. TRACE's stated objective is to expand its criteria to eventually disseminate all or almost all future transaction information entered into its system, which objective is expected to be met sometime in 2004.<sup>65</sup> Currently, only trades in the following TRACE-eligible securities are disseminated: (1) investment grade securities with an initial issue size of at least \$1 billion, (2) non-investment grade securities that are among the fifty most "actively traded", (3) securities rated by Moody's Investors Service, Inc. as "A3" or higher and Standard & Poor's as "A-1" or higher, and has an original issue size of at least \$100 million<sup>66</sup>, and (4) one hundred twenty TRACE-eligible securities that are rated "Baa/BBB" at the time of designation and meet certain other criteria.<sup>67</sup> It is estimated that transaction information on more than 4,200 securities representing approximately 75% of the dollar value of trading activity in investment grade bonds was disseminated by TRACE in 2003.<sup>68</sup>

Trade information not eligible for dissemination under TRACE is unavailable to persons outside of TRACE. Trade information eligible for dissemination under TRACE is disseminated in many ways. Various subscription services such as Bloomberg® and MarketAxess® provide near instantaneous access to trade information disseminated by TRACE, while NASD disseminates trade information free of charge on its website after a four hour delay.<sup>69</sup> TRACE's public website displays 90 days of transaction history and 90 days' daily high/low price.<sup>70</sup>

---

<sup>62</sup> See Rule 6230(e) of the NASD Manual.

<sup>63</sup> See Letter from the Honorable William H. Donaldson, Chairman, SEC, to the Honorable John D. Dingall, Ranking Member, Committee on Energy and Commerce (December 30, 2003).

<sup>64</sup> In our conversations with TRACE representatives, we confirmed that there are no current plans to add such information to the TRACE system.

<sup>65</sup> In our conversations with TRACE representatives, we confirmed that this is still the expectation; however, no firm date has been set yet.

<sup>66</sup> Trades in such securities will continue to be disseminated until such securities are downgraded below "Baa3/BBB-".

<sup>67</sup> See Rule 6250(a) of the NASD Manual.

<sup>68</sup> See Letter from the Honorable William H. Donaldson, Chairman, SEC, to the Honorable John D. Dingall, Ranking Member, Committee on Energy and Commerce (December 30, 2003).

<sup>69</sup> For municipal bonds, the Municipal Securities Rulemaking Board is in the process of implementing a real time reporting system that will require virtually all secondary market trades of municipals to be reported within 15 minutes of execution.

<sup>70</sup> Letter from Robert R. Glauber, Chairman and Chief Executive Officer, NASD, to the Honorable John D. Dingall, Ranking Member, Committee on Energy and Commerce (December 16, 2002).

#### **D. Bloomberg<sup>71</sup>**

Bloomberg is a financial data service that provides information to investors in a number of ways. Bloomberg subscribers can access information disseminated by TRACE almost instantaneously. The level of access as well as the types of information available vary greatly depending the status of the person seeking the information, and there appears to be no uniform guidelines as to exactly what level of information is available to particular categories of investors or traders. The general screen designated for a specific bond available to all subscribers would generally not provide actual prices or quotes from identified brokers or dealers, but may provide a list of willing buyers and sellers. It may also indicate whether such identified willing buyer or seller provides a quote that is “executable” or not. While the screen often provides a Bloomberg fair value, our understanding is that the Bloomberg fair value is neither based on quotations nor actual prices but merely reflects the valuation of bonds by Bloomberg analysts.<sup>72</sup>

In addition to the general screen, certain subscribers can get access to special Bloomberg screens on which broker-dealers provide bid and ask quotations on corporate bonds. For competitive reasons, a broker-dealer will generally not allow other broker-dealers access to its quotations and will provide access to investors and other persons with whom such broker-dealer has a relationship. Even with access to quotations, most quotations on Bloomberg are “indicative” quotations, meaning that the broker-dealer is merely giving an indication of what it believes the bonds might trade at. Many market participants regard indicative quotations as an invitation to transact in a particular bond, essentially serving an advertising function—much like mortgage rates published in newspapers. The actual prices at which a bond will sell at will depend on many factors, including the size of the sale. Because some quotes are not updated more than once a day, quotations may be stale by the time a subscriber calls the broker-dealer. Although broker-dealers generally broadcast indicative quotes that are close to what it is willing to buy or sell the quoted bonds at, the actual prices at which the broker-dealer will buy or sell quoted bonds can and often do differ from those quoted on Bloomberg. Thus, it is unclear how useful such indicative quotes are in determining the fair market value of a bond. In some instances, the quotations are “executable”, meaning that within certain lot sizes, a broker-dealer is agreeing to execute trades at the quoted prices. However, even if the quotes are “executable,” there is no guarantee that the actual price at which the bonds are sold would be the same as the quoted price because the actual price will depend on the actual size of the trade.

#### **E. ValuBond<sup>73</sup>**

ValuBond’s is an internet and workstation-based trading platform for certificates of deposits and debt issued by U.S. corporations,<sup>74</sup> municipalities, agencies, treasuries, and

---

<sup>71</sup> The following discussion is based on information provided on the website for Bloomberg and conversations with market participants.

<sup>72</sup> Some Bloomberg screens do show the trading prices as well as the bid and ask prices for a particular bond. Our understanding is that such prices are rarely available, and generally only prices for convertible bonds or investment grade bonds are available. In addition, access to such prices is often limited.

<sup>73</sup> The following discussion is based on information provided on the website for ValuBond and conversations with representatives of ValuBond.

collateralized mortgage obligations. ValuBond's trading platform operates in various of ways. Subscribers can view fully executable quotations for various bonds, and execute a trade on the system without contacting the person making the quotation.<sup>75</sup> Trade confirmation and other details are recorded on the ValuBond system. Unlike Bloomberg and MarketAxess (discussed below), a subscriber need not obtain approval to see quotations from a broker. ValuBond's trading platform is for retail trades rather than trades with QIBs, although individuals generally cannot gain access to ValuBond and only brokerage firms, insurance companies, banks and dealers may have access to the system.<sup>76</sup> Price quotations are generally very current. Most trades on ValuBond are less than \$200,000. The identity of the person making the quote is often, but not always, revealed.

In addition to providing persons access to fully executable quotations, ValuBond also provides indicative quotations. To avoid the posting of misleading indicative quotations, ValuBond requires that brokers posting indicative quotations fulfill at least 95% of their indicative quotations at the prices posted, or such broker will be temporarily suspended from use of ValuBond's system. ValuBond does not publish prices for trades executed on Valubond, although trades in corporate bonds are generally reported to the TRACE system.

#### **F. MarketAxess<sup>77</sup>**

MarketAxess Holdings Inc.'s website, MarketAxess.com ("MarketAxess"), is an 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 currently, the vast majority of corporate bonds traded on MarketAxess are investment grade bonds and high yield bonds that are near investment grade. Trades may be settled on MarketAxess's system, which provides an automated audit trail for each stage of the trading cycle. Trades occur only between QIBs and broker-dealers (i.e. QIBs cannot sell to other QIBs and broker-dealers cannot sell to other broker-dealers using MarketAxess's trading platform). Trade volume on MarketAxess is significantly higher than on the NYSE, growing from \$11.7 billion of total trade volume in 2001 to \$192.2 billion of total trade volume on MarketAxess in 2003.<sup>78</sup> Currently, 19 broker-dealers participate in providing liquidity in credit products to approximately 600 QIBs

---

<sup>74</sup> ValuBond may add Eurobonds to its system in the future.

<sup>75</sup> In contrast to some other systems, such as Bloomberg, that rarely provide executable quotations, a significant portion of the quotations listed on ValuBond are executable. Furthermore, subscribers know, without contacting the maker of the quotation, what lot sizes the quotations are good for. Some bonds will have multiple quotations, or tiered quotations, if the buyer or seller has different prices for different lot sizes for the same bond.

<sup>76</sup> Brokerage firms will trade on ValuBond on behalf of its individual customers.

<sup>77</sup> 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.

<sup>78</sup> Approximately 73% of trading volume in MarketAxess was in U.S. bonds and 16.5% of trading volume was in European corporate bonds. MarketAxess has already far surpassed the NYSE in trade volume in corporate bonds.

through MarketAxess.<sup>79</sup> Like Bloomberg, MarketAxess provides quotations from identified broker-dealers. 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. Like Bloomberg, access to quotations are provided after approval by broker-dealers, and such quotations are not available to other broker-dealers.

In addition to facilitating trades, MarketAxess's Corporate BondTicker® provides recent sale prices for trades disseminated by TRACE and 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, and is also available to Reuter's customers.

#### **G. ConvertBond.com<sup>80</sup>**

ConvertBond.com ("ConvertBond"), a website owned by Morgan Stanley & Co. Incorporated ("Morgan Stanley"), 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". Previously, ConvertBond provided indicative quotations for convertible bonds, but currently does not provide any quotations on bonds. ConvertBond attempts to provide information on all U.S. convertible bonds, and believes that almost all such bonds are listed on ConvertBond. The indicative prices are neither based on quotations nor actual sale prices and merely reflect the valuation of such bonds by Morgan Stanley's convertible bond trading desk.

#### **H. Other Electronic Systems**

The Bond Market Association reports that there are currently 77 electronic fixed-income trading systems operating in the U.S. and Europe, with 46 in the U.S. and 31 in Europe.<sup>81</sup> Thirty-five of the identified trading systems trade in U.S. and European corporate bonds.<sup>82</sup> The types of systems are classified as auction systems, cross-matching systems, interdealer systems, multi-dealer systems and single-dealer systems. Under an auction system, a seller or issuer usually posts the details of an offered security and the specific terms of the auction. Buyers submit bids and the best bids are accepted.<sup>83</sup> With cross-matching systems, buyers and sellers enter buy and sell orders on to the system, and such orders are automatically executed when

---

<sup>79</sup> Such broker-dealers accounted for approximately 98% of the underwriting of the U.S. corporate bonds traded on MarketAxess. MarketAxess believes that such broker-dealers also represent the principal source of secondary market liquidity in such securities.

<sup>80</sup> The following discussion is based on information provided on the website for ConvertBond and conversations with representatives of ConvertBond.

<sup>81</sup> See The Bond Market Association, *eCommerce in the Fixed-Income Markets: The 2003 Review of Electronic Transaction Systems* (November 2003).

<sup>82</sup> These platforms are available through many different means, including Bloomberg, Reuters, the internet, and over proprietary networks. See *id.*

<sup>83</sup> Auction systems for corporate bonds are provided by DealComposer Inc. See *id.*

matched.<sup>84</sup> Interdealer systems allow dealers to execute trades with other dealers.<sup>85</sup> Multi-dealer systems allow investors to execute trades based on quotations from multiple dealers.<sup>86</sup> Single-dealer systems allow investors to execute trades directly with a specific dealer.<sup>87</sup>

## 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 the 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, in order to qualify for an exemption from the imposition of the withholding tax on interest payment 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 is the Luxembourg Exchange. One major investment bank indicated that about 80-90% of European bonds they trade are listed on the Luxembourg Exchange. The Luxembourg Exchange has been used more often than any other exchange because, until recently, it had the least stringent disclosure requirements.<sup>88</sup> The Irish Stock Exchange also has comparatively less burdensome financial requirements and is becoming more popular for bond listings among European issuers. 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 listing, particularly for bonds issued by those whose equity is already listed on such exchanges. It is noted that while (f)(2) lists the Frankfurt Exchange, among others, as an exchange the listing of a debt on which automatically results in such debt being treated as publicly traded, the Luxembourg Exchange is not among the enumerated exchanges.<sup>89</sup> Thus the listing on the Luxembourg Exchange would not itself cause a bond to be treated as publicly traded.

---

<sup>84</sup> Cross-matching systems for corporate bonds are provided by the ABS; BondDeskGroup; BondHub.com; ValuBond, Inc.; and Xbond. See *id.*

<sup>85</sup> Interdealer systems for corporate bonds are provided by eSpeed, Inc.; EuroMOT; Garban-Intercapital plc; GFI; TheMuniCenter. Interdealer systems are more common with government securities. See *id.*

<sup>86</sup> Multi-dealer systems for corporate bonds are provided by Bondpage.com; Bondscape.net; Fixed Income Securities, Inc.; LoanX, Inc.; MarketAxess; Spear, Leeds & Kellogg; and SunGard Transaction Network; SWX Eurobonds. See *id.*

<sup>87</sup> Single dealer systems for corporate bonds are provided by Autobahn Electronic Trading; Bear Stearns & Co. Inc.; Citigroup Fixed Income Direct; Credit Suisse First Boston LLC; dbconvertibles.com; De@lDone; Goldman, Sachs & Co.; GovRate/Odd-Lot Machine; J.P. Morgan express; LehmanLive; Merrill Lynch Capital Markets; RetLots Caboto; SEB Merchant Banking; and TDAX Eurobonds. Almost all of the single dealer systems are accessed through the internet and/or Bloomberg.

<sup>88</sup> We understand that the Luxembourg exchange recently began to ask for more disclosure, e.g., guarantor financial statements, and therefore, issuers may look to other exchanges for the bond listing. Also, some audit opinion requirements under the accounting rules of the issuer’s country vary depending on where the bonds are listed.

<sup>89</sup> The Luxembourg Exchange was included in the 1992 proposed Treasury Regulations Section 1.1273-2(d)(2)(iii), but was removed from (f)(2) in the final regulations.

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. In this connection, Bloomberg is also used for trading in bonds issued by European entities.

## **J. Loans**

The market for trading in loans has developed significantly over the last decade, and buy/sell quotations for loans are commonly available from traders, dealers and brokers. Many traders, dealers and brokers circulate quotations to clients, and such quotations are often firm quotations. The manner in which loans trade is becoming more similar to the manner in which bonds trade in the actual market. However, not all loans have readily available quotations, especially loans small in size or subject to trading restrictions.

Currently, loans are not listed on any exchanges, nor are they generally considered eligible for PORTAL or TRACE reporting. However, Bloomberg often provides some limited information on loans.