40 Broad Street
New York, NY 10004-2373
Telephone 212.440.9400
Fax 212.440.5260
www.bondmarkets.com

1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456

St. Michael's House
1 George Yard
London EC3V 9DH England
Telephone 44.20.77 43 93 00
Fax 44.20.77 43 93 01

THE BOND MARKET ASSOCIATION

VIA FEDERAL EXPRESS & EMAIL

June 27, 2002

Government Securities Regulations Staff
Bureau of the Public Debt
999 E Street, N.W.
Room 315
Washington D.C. 20239

Re: Potential Modifications to the 35 Percent Award Limit and the Timing of the Calculation & Reporting of Net Long Positions

Dear Sirs:

The Bond Market Association[1] ("Association") and its Primary Dealers Committee[2] appreciate the opportunity to comment to the Bureau of Public Debt ("Bureau") on the Advanced Notice of Proposed Rulemaking ("Rule Proposal")[3] recently issued by the Treasury Department ("Treasury") in which Treasury proposes, among other things, certain changes to the timing and reporting of net long positions ("NLP") by bidders in its auctions.

A. Executive Summary

The Association strongly supports the Treasury's decision to consider updating its auction rules. As we explained in our previous letter,[4] the Association recommends that Treasury make three changes to the current NLP rules. First, we believe that Treasury should require bidders to calculate their NLP as of 12:40 p.m. rather than 12:30 p.m. in order to enhance the integrity of the auction

---

1 The Association represents securities firms and banks that underwrite, distribute and trade in fixed income securities, both domestically and internationally, including all primary dealers recognized by the Federal Reserve Bank of New York. Our members are also actively involved in the funding markets for such securities, including the repurchase and securities lending markets. Further information regarding the Association, its members, and activities, can be obtained from our public website http://www.bondmarkets.com/.

2 The Primary Dealers Committee is made up of senior representatives from the primary dealers in United States government securities whose name appears on the "List of the Government Securities Dealers Reporting to the Market Reports Division of the Federal Reserve Bank of New York" and inter-dealer brokers who serve as conduits between Primary Dealers in the Treasury and federal agency securities markets.

3 67 Fed. Reg. 20,934 (April 29, 2002).

4 See Letter from Eric L. Foster, Vice President and Assistant General Counsel, The Bond Market Association, to Brian C. Roseboro, Assistant Secretary for Financial Markets, dated March 13, 2002. (copy attached)

process. 12:40 p.m. is the optimal determination time because it takes full advantage of technological advances at the dealers while still ensuring the optimal accuracy of submitted bids and NLPs. However, we do not support the other more radical approaches to improving the NLP calculation and reporting regime that are outlined in the Rule Proposal.

Second, we strongly support Treasury's proposal to modify the current NLP reporting thresholds for its bill and note auctions so that the thresholds are always 35 percent of the issuance amount. Third, we recommend that Treasury give a reportable bidder that is short or flat the auctioned security a choice of either reporting a zero NLP or leaving the NLP field blank. We also believe that these later two changes should be made regardless of whether Treasury decides to modify the current NLP calculation and reporting rules.

B. Discussion

Modifying the Pre-Auction Calculation Time for NLPs is the Correct Approach

Of the several alternatives outlined in the Rule Proposal, we feel strongly that the simple step of reducing the interval between the NLP as-of time and the competitive bidding deadline is by far the best approach. Since the objective is to enhance auction integrity with minimal new compliance costs on bidders and no overall increase in Treasury's funding costs, shortening the period between the determination time and the reporting time for NLPs is the wisest approach. When coupled together with the other two rule changes proposed by Treasury, this approach offers the most advantages and is the easiest to implement.

Advantages of this Approach

To begin with, modifying the NLP determination time is the simplest and most immediate method of providing bidders and investors with greater confidence that no single bidder will be holding an inappropriate amount of the new issue immediately after the auction. There remains no real empirical evidence that indicates that there is an auction integrity problem stemming from the current 30-minute gap between the NLP determination time and the close of the auction. Nevertheless, Treasury should take advantage of this opportunity to take an incremental step to further enhance the integrity of the auction process.

Second, although calculating a bidder's overall NLP remains a difficult process that often requires some manual intervention, moving the NLP calculation time would be relatively easy for the Treasury and the dealers to implement. Technological improvements over the last several years in the dealers' intra-affiliate reporting system have enabled even those dealers that are affiliated with a larger global financial services firm to more easily capture their firm's total NLP position. These systems can be modified so as to help capture a 12:40 p.m. snap-shot of the bidder's NLP. While this process is still subject to human error, staff at many dealers now have substantial experience with calculating and reporting NLP and are more cognizant of the sorts of break-downs that can lead to submission errors. This has enabled dealers to improve the process of calculating, rechecking, verifying and reporting their NLP.

Third, we feel that this approach is the most appropriate because it avoids certain "transition costs" including time and expense associated with implementing a more fundamental rule change including alternatives 2 and 3 of the Rule Proposal.

Finally, while there are some disadvantages to moving to a later determination time, these disadvantages are minor. One disadvantage with this approach is certainly that it could lead to a temporary increase in NLP and bid submission errors. Because auction support staff will have less time to work with, there is certainly the possibility that Treasury may initially see a small spike in the number of NLP submission errors. Another disadvantage is that giving the dealers less time to calculate and report their NLP makes it more difficult for them to fully ensure that they are not over the 35 percent limit. Nevertheless, we feel that any overall increase in NLP or bid submission errors would be temporary. We also feel that a later determination time still leaves compliance staff with adequate time to inform the trading desk exactly how much room they have under the 35 percent limit. Our members are thus in agreement that moving to a slightly earlier determination time would be in the best interest of both Treasury and bidders.

12:40 p.m. is the Optimal Determination Time

We are convinced that 12:40 p.m. is the optimal NLP determination time. First, having bidders calculate their NLP 20 minutes before the close of the auction ensures that Treasury's auctions are viewed as completely fair while still allowing for sufficient accuracy of the NLP reports being submitted. Second, any advantages derived from moving closer to 1 p.m. are simply outweighed by the costs that a short turn-around time would impose on both Treasury and bidders. Moving the determination time any closer to 1 p.m. would also materially increase the compliance costs for bidders without necessarily reducing Treasury's overall funding costs.

Third, dealers may be less inclined to bid aggressively if their auction staff is still doing "double duty" calculating and rechecking an NLP number at 12:50 or 12:55 p.m. and thus unavailable to help submit a bid on the auction terminal that is generally located some distance from the trading desk. As mentioned earlier, larger dealers that routinely submit bids that are close to the 35 percent limit for a particular security need to know in advance of the auction's close exactly how much room they have left to bid without exceeding the limit. While a 12:40 p.m. calculation time may pose some problems, having a determination time that was even closer to 1 p.m. is much more likely to have a chilling impact on the bidding behavior of the largest bidders.

Fourth, under current Treasury policy, bidders must notify Treasury by 12:50 p.m. if they are experiencing FedLine connectivity problems that may require them to submit their bids via telephone.[5] This new policy makes it even more critical that bidders finalize their NLP numbers well in advance of this 12:50 p.m. notification deadline, especially since auction staff need to be available by 12:50 p.m. to help call in bids, if necessary.

Finally and most importantly, giving bidders less than 20 minutes to calculate, recheck and report their NLP will simply cause too many NLP calculation and submission errors. The likelihood of a submission error increases dramatically once a bidder has less than 20 minutes to calculate and submit its NLPs. During the last 30 minutes of a Treasury auction, professional auction staff at the dealers should be asked to focus on one task at a time not two. Forcing bidders to rush the process and have their staff perform double duty is likely to lead to a long term increase in errors – errors which may result in the auction awards having to be modified. This, in turn, might increase Treasury's funding costs as bidders seek to compensate for the possible delay in the announcement of auction results.

Disadvantages of a Later NLP Determination Time

There are also a number of disadvantages to providing bidders with less than 20 minutes to determine, verify and report their NLP. To begin with, moving the time up further would put substantial strain on existing personnel. Second, while NLP calculations can sometimes be finalized and submitted by a bidder rather quickly (i.e. within 10 minutes) due to improvements in internal systems, this is not always the case, especially when the auction involves a reopening of an active issue. Moreover, while some dealers have few affiliates whose positions commonly need to be incorporated into the reported NLP, others have numerous domestic and foreign affiliates that actively invest in "on the run" Treasury securities and trade them outside their respective time zones. As a result, larger dealers sometimes face challenges in finalizing their NLP even with the 30 minutes currently allotted. In short, while there will always some theoretical benefit in moving the NLP calculation time even closer to 1 p.m., having a determination time that is less than 20 minutes before close of the competitive auction is simply counterproductive.

Other Proposed Modification to the NLP Rules

The Rule Proposal asks for comments on two other possible approaches to improving the NLP calculation and reporting rules. One approach would be to require bidders to calculate their NLP as of 1 p.m. and report their position sometime after the auction results are announced. The other alternative would eliminate the pre-auction NLP reporting requirements altogether and rely instead on Treasury's existing authority under its Large Position Reporting rules to

---

[5] See Remarks by Peter R. Fisher, Under Secretary of the Treasury for Domestic Finance before The Bond Market Association's Legal and Compliance Conference (January 8, 2002).

monitor and address potential concentrations of ownership immediately following the auction.

We do not support either of these two approaches. We particularly feel that the post-auction reporting proposal would be counterproductive. As we explained in our earlier letter, we believe a post-auction reporting regime would discourage aggressive bidding. Under Alternative 2, larger bidders would have to allow themselves a substantial "margin for error" with respect to the 35 percent rule. It would also undermine the finality of the auction results since large bidders may, on occasion, have to be cut back by Treasury after the auction results were announced. Thus, it potentially undermines one of Treasury's key policy objectives – lowering its borrowing costs.

Secondly, a post-auction reporting regime would make it much more difficult to get timely and accurate NLP reports from customers that bid through one or more dealers. As you may know, it is currently common practice at dealers to decline to submit a customer's bid unless it is accompanied by adequate information regarding the customer's NLP. Unfortunately, this ability to ensure that an NLP is appropriately reported to Treasury is undermined in a post-auction reporting regime. Dealers would have little leverage over their customers to encourage compliance once the auction has concluded, and customer would have less incentive to properly calculate and report their NLP, especially if they were unsuccessful in the auction. Finally, if a customer is bidding through more than one dealer, situations may more commonly arise where each dealer assumes that the other is facilitating the reporting of that customer's NLP. In short, we feel this approach is unworkable, and we urge Treasury to focus its attention on the other possible solutions.

Increasing the NLP Reporting Threshold

The Rule Proposal also requests comments on the idea of changing the applicable threshold amounts for NLP reporting. The Association supports an increase in the current NLP reporting thresholds to better capture only those bidders that are most likely to exceed the 35 percent limit. The current $1 billion reporting threshold for bills and $2 billion reporting threshold for notes are both unnecessarily low. Any benefit Treasury derives from maintaining a low reporting threshold is outweighed by the additional bidder submission errors that result. Our members are perfectly capable of modifying their internal systems to use the issuance amount to calculate the threshold amount over which they should be submitting an NLP report for a particular auction. Treasury is, therefore, correct in reevaluating its current thresholds; and we would support a move to a reporting threshold that was 35 percent of the relevant issuance amount.

Allow Bidders to Report Their Short or Flat NLP as either a Zero or a Blank

Finally, we continue to believe that Treasury should not *require* a bidder to report a zero NLP when such bidder is above the applicable reporting threshold but has either no net long position or a net short position. However, instead of requiring a bidder to leave the field blank in such circumstances, we would urge Treasury to give bidders a choice of either reporting a zero NLP or leaving the field blank. It makes no sense to *require* bidders to leave the NLP field blank in these circumstances since such a rule would continue to lead to the occasional non-material bid submission error by bidders who reported their position as zero. Treasury can also continue to rely on internal audits to identify those cases where the bidder was above the threshold but forgot to calculate and/or report a positive NLP number. While requiring bidders to report their negative NLP as zero does theoretically act as check that a bidder realized that it was over the threshold, our understanding is that the existing rule has on occasion delayed the prompt announcement of an auction's results. Moreover, even the most experienced dealers do, on rare occasion, inadvertently leave the field blank when they have a negative reportable NLP. This has resulted in the receipt by a number of our members of serious violation letters in circumstances where the bidder engaged in a technical violation of the auction rules that in no way could have impacted the results of the auction. Modification of this rule is long overdue.

If you have any questions regarding this letter, please feel free to contact the undersigned at 212.440.9448 or efoster@bondmarkets.com.

Sincerely,

Eric L. Foster
Vice President
Assistant General Counsel

cc: *U.S. Treasury Department*
Timothy Bitsberger, Deputy Assistant Secretary for Federal Finance
Federal Reserve Bank of New York
Debbie Perelmuter, Senior Vice President
The Bond Market Association
Primary Dealers Executive Committee
Primary Dealers Committee
Government Operations Committee
Government Legal Advisory Committee
Legal & Professional Staff

U:\FosterEric\Treasury Auction Rules\NLP Comment II Letter June final.doc