

BUREAU OF THE PUBLIC DEBT'S
AUCTION PROCESS

OIG-00-019

December 21, 1999



Office of Inspector General

United States Department of the Treasury

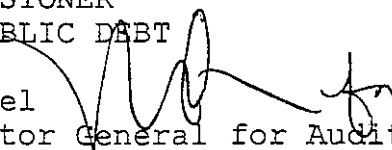


OFFICE OF
INSPECTOR GENERAL

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

December 21, 1999

MEMORANDUM FOR VAN ZECK, COMMISSIONER
BUREAU OF THE PUBLIC DEBT

FROM: Dennis S. Schindel 
Assistant Inspector General for Audit

SUBJECT: Bureau of the Public Debt's Auction Process

This memorandum transmits our final audit report titled *Bureau of the Public Debt's Auction Process*. We performed a follow-up review on the recommendations made in the Office of Inspector General (OIG) audit report titled *Improvements Needed in the Treasury Auction Process*, OIG-97-004, dated November 8, 1996. We also evaluated the automated bidding process.

We concluded that the Bureau of the Public Debt took appropriate actions on the recommendations contained in OIG-97-004 and implemented an effective and efficient automated bidding process. No significant reportable issues came to our attention. Therefore, we are making no recommendations at this time.

Our conclusions are summarized in the Overview section and explained in further detail in the Audit Results section of the report. Bureau of the Public Debt management concurred with our conclusions. The management comments are summarized in the Audit Results section of the report, and a complete text of the comments appears as Appendix 2.

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss this report, you may contact me at (202) 927-5400, or a member of your staff may contact Maria V. Carmona, Acting Director, Program Audits, at (202) 283-1591.

Attachment

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Overview

This report presents the results of our audit to determine whether the Bureau of the Public Debt (BPD) took adequate corrective actions to implement the recommendations in the Office of Inspector General (OIG) report titled *Improvements Needed in the Treasury Auction Process*, OIG-97-004, dated November 8, 1996. We also reviewed BPD's automated bidding process to ascertain whether: (1) the process was efficient and secure, and (2) effective contingency plans were in place. We conducted this audit from October through December 1998, as part of the OIG's *Office of Audit Annual Plan for Fiscal Year 1999*.

Our audit revealed that BPD took adequate corrective actions to address the deficiencies cited in the November 1996 OIG report, and the electronic auction process operated in a satisfactory manner. Therefore, no recommendations for corrective action are necessary at this time.

Background

The BPD Office of Financing is the organizational entity within the Department of the Treasury (Treasury) responsible for conducting marketable securities auctions. The Office of Financing facilitates the auction process by receiving bid data, determining awarded yield and prices, and disseminating auction results. Also, the Office of Financing ensures adherence to auction-related rules and regulations.

BPD accomplishes its mission of financing the operations of the Federal Government by issuing three types of marketable securities (bills, notes, and bonds) that are direct obligations of the United States Government. These securities are sold to the public to pay off maturing debt and raise the funds needed to operate the Federal Government. Treasury securities are sold through competitive and non-competitive bidding at more than 160 auctions held throughout the year. Buyers of these securities generally are large competitive dealers, as well as other dealers, financial institutions, institutional investors, foreign investors, and retail investors. During Fiscal Year 1998, over \$2 trillion in Treasury securities were issued.

Since 1962, Treasury has limited the maximum amount of securities awarded to a single bidder in a Treasury offering. The primary reasons for limitation are to ensure broad distribution of Treasury securities and to make it less likely that ownership of Treasury securities will be concentrated in a few hands as a result of an auction. In 1962, awards

to a single bidder in an auction of Treasury securities were limited to one quarter of the securities offered. The limitation was revised in September 1981, whereby no single bidder may be awarded more than 35 percent of the amount of a Treasury security offered to the public. For example, in a note auction with a \$10 billion public offering, a bidder with a reported net long position of \$1 billion would receive a maximum auction award of \$2.5 billion. Net long refers to the amount of the position in a specific security held by a bidder prior to the auction.

The application of the 35 percent limit to any bidder includes consideration of that bidder's net long position in the security being auctioned in three markets. The three markets are the following:

- Futures market - traded on exchanges and used to lock in purchase and sale prices in advance of delivery.
- Forward market - over-the-counter market used by dealers to lock in purchase and sale prices in advance of delivery.
- When-issued market - over-the-counter market used by dealers to lock in purchase and sale yields for securities announced but not issued.

Positions in the futures market are included in the bidders net long position only if the futures require delivery of the specific security being auctioned. In the case of a security that is being reopened, the net long position also includes holdings of the outstanding security. Further, the net long position includes the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) principal components, including when-issued trading positions of such principal components. STRIPS is the Treasury program under which eligible securities are authorized to be separated into principal and interest components, and transferred separately.

In 1993, BPD introduced an enhanced version of the automated bidding process that allows commercial bidders to enter security bids directly into personal computers and electronically transmit bids to the Federal Reserve. FedLine is a full-service software package that provides electronic access to Federal Reserve transaction and information services. BPD claims several benefits from electronic bidding, including capturing information at the source, instant transmissions of bid information, and early identification of errors.

Objectives, Scope, and Methodology

The overall objective of our audit was to determine whether BPD had taken adequate corrective actions to implement the recommendations in the OIG report titled *Improvements Needed in the Treasury Auction Process*, OIG-97-004, issued on November 8, 1996. We specifically determined whether: (1) BPD implemented each recommendation contained in the November 1996 audit report; (2) any recommendation was not implemented and the reason; and (3) the implemented changes were effective. We also reviewed BPD's automated bidding process to ascertain whether: (1) electronic submissions of tenders allow the auction results to be released more efficiently; (2) appropriate controls are in place to protect the electronic tender data being entered, transmitted, and stored; and (3) adequate contingency plans are in place.

Audit work was performed at the BPD Office of Financing in Washington, D.C., and at the Federal Reserve Banks (FRB) in New York and Chicago, from October through December 1998. We reviewed the current electronic bidding process and assessed the internal controls. We conducted interviews to obtain management information on what needed improvement and we observed the auction process at all three locations to assess performance and identify any potential problems. We reviewed the *Treasury Security Tender Submission Guide and Uniform Offering Circular* for adequacy, and examined transactions to determine compliance with departmental and BPD policies for the electronic bidding process.

This audit was conducted in accordance with the *Government Auditing Standards* issued by the Comptroller General of the United States, and included such tests as were deemed necessary.

Audit Results

The Treasury Auction Process Was Strengthened

In response to the November 1996 OIG recommendations, adequate corrective actions were taken to strengthen the Treasury auction process. BPD enhanced its procedures to identify potential errors in the reporting status of a bidder's net long position. Also, the BPD Office of Financing initiated an ongoing liaison relationship with the FRBs and bidders to educate the responsible individuals on the auction rules and stay abreast of emerging issues and problems. Furthermore, the FRB New York Markets Group improved the documented process for spot

checking customer bids after every auction. Details on these actions are presented below.

Independent Verification of Bidder's Net Long Position Was Enhanced

Action was taken to meet the intent of our recommendation to develop a mechanism to ensure a bidder's net long position can be adequately verified. Although our November 1996 report contained the recommendation that a rule be considered that would require auction participants to maintain documentation supporting their net long position, another action was taken. Subsequent to the completion of our work for the prior audit, Treasury issued final large position rules on September 12, 1996. These rules and the existing market controls provide enough information and mechanisms for market regulators, i.e., the combination of record keeping and reporting rules is more comprehensive than net long reporting rules which would focus only on concentrations at auction.

Additionally, the BPD Office of Financing implemented a net long position telephone verification procedure. Its purpose is to discover possible reporting errors or flawed procedures used by competitive auction bidders in the determination of reporting status with Treasury's auction rules and the calculation of a reported position. In an auction, the net long positions of certain bidders or customers are selected for verification. The net long positions which may be verified include:

- (1) a submitter or customer with a large reported net long position;
- (2) bids less than, but close to, the net long reporting requirement amount for that auction with no net long position reported; or
- (3) a reported net long position amount that looks different from the norm or is in any way peculiar.

Position verification may also occur when a large bidder, in combination with its major customers, has acquired a large proportion of the public offering. In this situation, the Office of Financing compares the results of the verification with what the firm reported in the auction. A telephone verification report is completed and filed for future reference.

We performed a walk-through of the verification procedure, and we determined that BPD's independent verification of bidders' net long positions is effective to uncover flawed procedures or misunderstandings of the net long position rules. In addition, the verification procedure could potentially uncover auction violations related to the net long position. During our walk-through, the BPD Office of Financing staff contacted a firm to perform a verification of the firm's net long position during that day's auction. We compared the firm's telephone

verification report with information maintained in the Treasury Automated Auction Processing System (TAAPS) on the 2-year note being auctioned. Since the firm's response confirmed the auction day bids and position reporting, there was no need for further action.

Training and Liaison Needs Were Addressed

BPD implemented our recommended actions to ensure that bidders are fully aware of the auction rules by initiating training and liaison programs. These programs enable auction participants to comply more fully with auction rules and possibly reduce the number of inquiries during the auctions.

BPD initiated a series of on-site visits by the Office of Financing staff with auction participants to observe and review, first hand, the processes and internal compliance procedures used by the participants. During the visits, auction participants describe their auction process through formal presentations and/or informal discussion with members of the Office of Financing staff. Auction participants also discuss competitive and noncompetitive processes and the calculation of the firm's net long position.

Furthermore, during 1998, staff in the Office of Financing conducted auction seminars, held training sessions, and participated in other seminars. BPD also offered extensive hands-on FedLine terminal training and reviews of a number of auction-related business topics. In our opinion, BPD's visits, along with continued work with dealers through compliance and training programs, will help to ensure adherence with Treasury's auction rules.

Spot Check Procedures Were Revised and Improved

Our recommendations were implemented to revise the procedures for spot checking customer bids and ensuring the spot checks are performed. Implementation of spot checks is important to deter bidders from exceeding purchase limits on Treasury securities.

The FRB New York Treasury Auction Group improved procedures for spot checking customer bids. Spot checks are performed immediately after every auction to ensure dealers are not submitting unauthorized bids on behalf of their customers in order to circumvent purchase limits on Treasury securities. In addition, by verifying the par amount of a

customer's bid and the rate at which the bid was submitted, assurance is provided that the submitting dealer correctly entered the customer's bidding instructions.

We reviewed implementation of the spot checking procedures after an auction. We found that implementation was clearly documented and readily available for examination. Also, FRB supervisors are directed by the procedures to continuously review and approve their staffs' assigned work, and BPD is directed to regularly review the FRB's performance of spot checks. Based on the actions taken by the FRB and BPD, we believe the current spot check program promotes reasonable assurance that bidders will not exceed purchase limits on Treasury securities.

The Electronic Bidding Process Was Effective and Efficient

BPD implemented an effective automated bidding process of electronic submission of tenders to serve its customers and release the auction results more efficiently. FedLine's Automated Auction software electronically routes the submitted tender to TAAPS for the purchase of Treasury securities at original issue to the FRB. Submitters can transmit tenders for their accounts, customers' accounts, and their current *TreasuryDirect*¹ customers. Bidders save time by bidding on Treasury securities via computer, instead of taking a paper tender to an FRB office. In addition, tenders are accepted until the auction closes, with prompt confirmation available.

BPD also provided other electronic bidding capabilities. In April 1998, the Office of Financing implemented a browser-based alternative to FedLine. At the beginning of our review, 31 submitters were offered the browser-based alternative, which offers enhanced submission, receipt, processing, and data storage of tenders. Additionally, in September 1998, the BPD Office of Securities and Accounting Services implemented a system which allows existing *TreasuryDirect* investors, with good Automated Clearing House information on file, to submit tenders electronically via the Internet. Finally, in October 1998, the Office of Securities and Accounting Services added an additional capability which allows investors to purchase securities via the telephone.

¹ *TreasuryDirect* is an automated system that provides an alternative to the commercial book-entry system for investors who wish to hold bills, notes, and bonds directly with Treasury.

Controls Over the Electronic Bidding Process Were Adequate

FedLine's built-in security features ensure that all tenders are fully encrypted, thereby protecting the electronic tender data being entered. The security features also generate a printout of a complete audit trail of all tenders submitted and accepted for auction. Using this printout, the Office of Financing will review and verify the accuracy of the auction results, and issue a press release announcing the range of accepted competitive bids, the proration at the stop-out yield or discount rate, and other pertinent auction information. The press release is then disseminated to the financial news services and automatically sent to each auction participant's Fedline computer terminal. In our opinion, based on our observation of auction activities at three locations, adequate controls exist over the electronic bidding process.

Adequate Auction Contingency Plans Were in Place

Based on our review of the TAAPS *Federal Reserve Bank Contingency Procedures Plan* and the recent results from implementing the plan, we determined that BPD has adequate assurance that the auction process will continue to operate in the event of a disaster at an FRB site. The plan is a strategy by which personnel from one FRB Review Site assists another if one or more banks are prevented from processing the auction in TAAPS. The plan also covers a disaster scenario wherein the BPD Office of Financing would continue to operate at an alternate location in Washington, D.C.

Evidence of the plan's adequacy was demonstrated in September 1998, at which time the TAAPS contingency plan was implemented when a fire broke out on the auction floor prior to the auction. According to the Office of Financing staff, everything needed to conduct an auction was in place at the contingency location, and the auction was carried out effectively. Additionally, the equipment at the contingency location is checked quarterly to ensure that it is working properly.

Conclusion

We concluded that BPD took appropriate actions to implement and document all previous recommendations to strengthen the auction process. In addition, we determined that the automated bidding process is adequate. The process operates in a manner that ensures tenders can be entered easily, and tenders and customer lists can be stored for transmission on auction day. Finally, because the FedLine Automated Auction system provides a direct link to the FRBs and the system's

software provides multi-level security, it is our opinion that BPD's auction process can be relied upon to provide accurate and reliable information.

Management Response and OIG Comment

BPD concurred with our conclusions that the audit resulted in no significant reportable issues. Furthermore, the Bureau feels it took appropriate actions on the recommendations contained in OIG-97-004, and implemented an effective automated bidding process.

The OIG considers the Bureau's response sufficient to close the audit.

ABBREVIATIONS

BPD	Bureau of the Public Debt
FRB	Federal Reserve Bank
OIG	Office of Inspector General
STRIPS	Separate Trading of Registered Interest and Principal of Securities
TAAPS	Treasury Automated Auction Processing System
Treasury	Department of the Treasury

MANAGEMENT RESPONSE



DEPARTMENT OF THE TREASURY
BUREAU OF THE PUBLIC DEBT
WASHINGTON, DC 20239-0001

September 27, 1999

MEMORANDUM FOR DENNIS S. SCHINDEL
ASSISTANT INSPECTOR GENERAL FOR AUDIT
OFFICE OF INSPECTOR GENERAL

From: Van Zeck, Commissioner *Ann Minter for*
Bureau of the Public Debt

Subject: Response to Draft Report on the Bureau of the
Public Debt's Auction Process

Thanks for the opportunity to respond to your Draft Report on the Bureau of the Public Debt's Auction Process. This audit was a follow-up review on the recommendations made in the Office of Inspector General (OIG) audit report titled *Improvements Needed in the Treasury Auction Process* (OIG-91-004) dated November 8, 1996. I concur with your findings that the audit resulted in no significant reportable issues. Furthermore, the Bureau of Public Debt (BPD) took appropriate actions on the recommendations contained in OIG-97-004, and implemented an effective automated bidding process. Also, the content of this report does not warrant protection under the Freedom of Information Act.

I would like to thank you and your staff for conducting the audit at the Office of Financing and the Federal Reserve Banks of New York and Chicago. The OIG audit team was knowledgeable and professional, which resulted in an efficient and less burdensome audit. We look forward to working with you in the future.

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