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THE BOND MARKET ASSOCIATION

VIA FEDERAL EXPRESS & EMAIL

March 13, 2002

The Honorable Brian C. Roseboro
Assistant Secretary for Financial Markets
United States Treasury Department
1500 Pennsylvania Avenue, N.W.
Washington D.C. 20220-0002

Re: Request For Comments on How the Current Net Long Position Rule Can be Modified to Facilitate More Efficient Auctions

Dear Sir:

The Bond Market Association[1] ("Association") and its Primary Dealers Committee[2] welcome this opportunity to offer some suggestions on how the Treasury Department ("Treasury") can best achieve the policy objectives underlying its net long position ("NLP") rule while also speeding up the turnaround time for calculating and announcing auction results. The Association is pleased that Treasury is interested in exploring this important issue.

A. Introduction

In evaluating possible modifications to the current NLP reporting regime, it is important to first identify the public policy objectives Treasury seeks to achieve. With respect to the NLP rule and the 35 percent award limit (the "35 Percent Rule"), there are a number of different policy objectives to be served. One objective is to make sure that Treasury's auctions are as fair and open as possible. By requiring large bidders to report their relevant positions in the when issued, forward and futures markets, Treasury seeks to ensure that its auctions are not subject to direct or indirect manipulation through a bidder's activities in

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.

these other markets. Second, establishing a maximum award of 35 percent of an issuance, less the bidder's NLP, encourages broad participation in auctions by prohibiting any single bidder from controlling a disproportionate percentage of a new issuance immediately after the auction. A competing objective, however, is to ensure that bidders are not discouraged from fully participating in an auction. Since the interest rate paid by Treasury can be materially impacted by the exclusion of the largest and most competitive bidders, NLP reporting requirements and the 35 Percent Rule must strike a balance that allows Treasury to achieve its policy objectives while obtaining competitive rates when its securities are priced. Although these policy objectives may, at times, conflict, it is important that any future changes to the NLP reporting regime neither increase Treasury's overall cost of financing nor discourage the Primary Dealers and other large bidders from aggressively and consistently bidding in Treasury auctions.

B. <u>Executive Summary</u>

The Association recommends that Treasury refrain at this time from making any major modifications to its current NLP reporting requirements given the pending rollout of Treasury's new Primary Dealer interface - *TAAPSLink* v2.0. While the Association also supports the adoption of the three minor rule changes described below, we believe that the current NLP rules are only partially responsible for the existing delays in the calculation and announcement of the auction results. By effectively preventing a single bidder from controlling an unduly large percentage of newly auctioned Treasury securities, the current NLP rule is also an invaluable tool that gives the Primary Dealers and other large bidders confidence that they can participate meaningfully and successfully in each Treasury auction.

The Association is, therefore, first and foremost recommending that Treasury take certain internal steps to promote more efficient processing of submitted bids thereby reducing its overall funding costs. While heightened attention by dealers to minimizing their submission errors would unquestionably contribute to faster auction turnaround times, we believe the most efficient method of addressing this problem is for Treasury to pursue certain system enhancements. Specifically, Treasury should accelerate the rollout this year of *TAAPSLink* v2.0. As explained below, usage of the new *TAAPSLink v2.0* platform by the Primary Dealers will undoubtedly facilitate faster auction turnaround times.

In the absence of a prompt rollout this year of *TAAPSLink v2.0,* Treasury should also consider immediately developing and implementing improvements to the current FedLine system that will help bidders identify and prevent typographical errors and potential rule violations before their bids are submitted. Third, some of the questionable bids and technical rule violations that delay the calculation of auction results stem from customer bids submitted indirectly through a Primary Dealers or other submitter. The Association, therefore, recommends that Treasury strongly consider taking greater responsibility for educating indirect bidders on proper compliance with auction rules. The Association would be happy to assist Treasury in this effort.

The Association also recommends that Treasury make the following three changes to its current NLP rules. First, Treasury should start requiring bidders to calculate their NLP as of 12:40 p.m. rather than 12:30 p.m. in order to further enhance the integrity of the auction process. Second, Treasury should increase the current NLP reporting thresholds and thereby capture only those bidders that are most likely to exceed the 35 Percent Rule. This change will have the added benefit of reducing the number of questionable bids that must be manually reviewed. Finally, Treasury should change its NLP rules to eliminate the obligation that a bidder short or flat the auctioned security report a zero NLP.

C. Recommendations

1. Improving Auction Hardware & Software

The Association is firmly convinced that Treasury will achieve the most immediate and substantial improvements in reducing its auction results turn around time by improving the system edits in FedLine and rolling out TAAPSLink v2.0 as soon as possible. As the Borrowing Committee recently noted: "improving the electronic capabilities of the auction platform could both improve Treasury auction turnaround and increase investor participation in the auction."

First, Treasury should accelerate the rollout of *TAAPSLink v2.0* which is a much more user-friendly and stable interface than the current FedLine system. Replacing FedLine is, in itself, likely to substantially reduce the volume and frequency of customer and dealer bidding errors thereby improving turnaround time generally. Deploying, as soon as possible, a more user-friendly computer interface between the Primary Dealers and Treasury is therefore essential to achieving the policy objectives articulated in January by Treasury Undersecretary Peter R. Fisher. For instance, allowing the Primary Dealers to utilize an interface which has the customer's proper legal name and associated bidder identification number ("BIN") already pre-loaded on Treasury's system would materially reduce the number of questionable bids that are subject to manual review.[3] For example, delays resulting from bid submissions that contain a correct BIN but a technically incorrect spelling of a bidder name need not occur if Treasury's auction software had all bidder names and their associated BINs pre-loaded into the system.

Secondly, Treasury and its Bureau of Public Debt ("BPD") should consider redoubling their efforts to help eliminate, through software improvements (i.e., better system edits) certain specific types of bidding errors that are currently treated by FedLine as "questionable bids" and thus requiring manual intervention.

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[3] For instance, in this regard, our members view the auction processing software for Freddie Mac's Reference Note auctions as being very effective at minimizing bidder submission errors.

Making these edits will be particularly important if the rollout of *TAAPSLink v2.0* is delayed past this summer. We remain concerned that the review and processing of these questionable bids is unnecessarily contributing to delays in determining which bids are accepted. In short, preventable bid submission errors are delaying the release of auction results. These errors can best be minimized through the use of better system edits that prompt the submitter to correct their errors on a real time basis.

Accordingly, Treasury should consider modifying the FedLine system to more actively assist the bidder and thus minimize the risk that receipt of a questionable bid will delay the determination of an auction's results. For instance, bidders that fail to submit a required NLP (or submit multiple NLP numbers) increase auction turnaround time. FedLine could be modified, however, so that bids over the relevant NLP reporting threshold automatically trigger a screen reminding the bidder that their bid requires an NLP to be calculated and possibly reported. Likewise, as is the case with the *TAAPSLink 1.0* software currently used by some non-dealers, the FedLine system could automatically generate a reminder when a bidder in a Treasury Bill auction inputs an incorrect final digit or bid increment.

2. <u>Improving Compliance by Indirect Bidders with the Auction Rules</u>

The Association also urges Treasury to take a greater role in assisting the Primary Dealers in educating their customers regarding compliance with the Treasury auction rules. In our view, too many indirect bidders remain unfamiliar with certain more technical aspects of Treasury auction rules. The absence of adequate explanatory materials and other authoritative written guidance on Treasury's auction rules needs to be addressed as more and more customers become interested in bidding competitively in Treasury's auctions.

One solution to this problem is for Treasury and the Association to develop a simple user-friendly guide to the auction rules that was specifically designed to address the sorts of questions commonly raised by customers that bid through a dealer. Such a guide, which could be made available on Treasury's and the Association's websites, would help minimize customer bidding errors (especially involving NLP calculations) and would be useful especially given the reluctance of dealers to interpret technical aspects of the auction rules for their customers. Lastly, Treasury should continue to participate in and co-host compliance seminars on their auction rules, and the Association would be happy to assist in these efforts.

3. <u>Modifying Certain Auction Rules</u>

The Association is concerned that any major changes to the NLP rules will cause more bidder errors and make Treasury's efforts to achieve a significantly reduced auction turnaround time in 2002 more difficult. In this regard we agree with the Treasury Borrowing Advisory Committee's recent comment that "it [is] unclear whether the change in NLP reporting would lead to fewer or more violations of the 35 percent rule."

Nevertheless, the Association suggests that Treasury consider the following three rule changes: (i) increasing the current NLP reporting threshold to 35 percent of the issuance amount; (ii) requiring bidders to calculate their NLP as of 12:40 p.m. rather than 12:30 p.m.; and (iii) instructing bidders not to report any NLP when they are above the applicable reporting threshold but their NLP is either zero or a negative number.

Increasing the NLP Reporting Threshold

We recommended that Treasury increase the current NLP reporting thresholds to better capture only those bidders that are most likely to exceed the 35 percent limit. As you know, the current NLP reporting threshold is $1 billion for bills and $2 billion for notes and bonds unless otherwise stated in the offering announcement. As Mr. Fisher noted in January in his remarks before the Association's Seventh Annual Legal & Compliance Conference, "[m]ost NLP reporting errors tend to be procedural rather than substantive <u>and almost all submitting firms would not be in violation of the 35 percent rule even if they received 100 percent of what they bid for</u>." (emphasis added.) Given that the existing reporting thresholds generate too many questionable bids requiring manual review, Treasury should reevaluate the current thresholds and determine whether a higher threshold (like consistently using 35 percent of the issuance amount) may be more appropriate.[4]

Modifying the Pre-Auction Calculation Time for NLPs

The Association would encourage Treasury to consider moving the calculation time for net long positions to 12:40 p.m. The determination, summation, verification and reporting of a large global firm's NLP, including the position of the bidder's sometimes numerous affiliates, within a very short time period remains a considerable systems and administrative challenge for the Primary Dealers and other large bidders. Nevertheless, as a result of recent systems improvements, the Primary Dealers are all generally capable of calculating and reporting their NLP positions as of 12:40 p.m.

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[4] In 1997, Treasury reduced the NLP reporting threshold amount for all Treasury bill auctions from $2 billion to $1 billion, while maintaining the $2 billion threshold amount for Treasury note and bond auctions. See 62 Fed. Reg. 43,091 et. seq. (Aug. 12, 1997). The Association supported this change and continues to believe that consistently applying the same threshold to all bill and note auctions, rather than changing the threshold depending on the public offering amount, will likely result in a better overall understanding of, and compliance with, the auction rules. <u>See</u> letter from Stephanie S. Wolf, Vice President and Associate General Counsel of PSA, the Bond Market Trade Association to Kenneth R. Papaj, Director, Government Securities Regulations Staff (June 4, 1997).

However, the Association would oppose moving the calculation time any closer to 1:00 p.m. than 12:40 p.m. One reason is that some firms rely on the same individuals for preparing and reviewing both the submitted bids and the reported NLP for accuracy. Second, our members feel strongly that they need at least fifteen to twenty minutes to fully and accurately complete their NLP calculation, verify the numbers and input the results correctly on a consistent basis. Given that much of the operational risk associated with the submission of dealer and customer bids has effectively been shifted to the dealers under Treasury's "Your Bid is Your Bid" policy, the need to check and recheck submissions for accuracy has never been greater. Finally, the new policy of requiring bidders to notify Treasury at least ten minutes before an auction if they are experiencing connectivity problems and Treasury's efforts to curtail reliance on back-up telephone bid submission has made it essential for bidders to finalize and input their (and their customers') NLP number into the FedLine terminals by 12:45 p.m. For all these reasons, the Association would urge Treasury not to move the calculation time for the NLP any closer to 1 p.m. than 12:40 p.m.

Eliminate the Obligation to Report a Zero NLP

Finally, Treasury should consider not requiring a bidder to report a zero NLP when they are above the applicable reporting threshold but have either no net long position or a net short position.[5] It is unclear what benefit there is in Treasury receiving a zero NLP number from a bidder. It is clear, however, that the improper submission by a bidder of a blank NLP can delay the prompt calculation of an auction's results. Therefore, Treasury should explore the benefits of modifying this aspect of its NLP rule.

D. <u>Other Approaches</u>

In preparing this letter the Association considered a variety of different modifications to the current NLP rules including the following:

1. requiring bidders to calculate their NLP as of 1:00 p.m. and report such position to Treasury sometime after the auction results are announced; and
2. abandoning the pre-auction NLP reporting requirements altogether and relying instead on occasional post-auction audits by Treasury of 1:00 p.m. NLP positions or greater use of the large position reporting requirements.

The Association urges Treasury not to pursue either of these two approaches. We are not convinced that such modifications will lead to fairer and more operationally efficient auctions and ensure broad distribution of newly issued Treasury securities. Below is a brief description of what we see as the problems associated with these approaches.

[5] <u>See</u> 31 C.F.R. 356.13 (2002).

1. Post Auction Reporting of the NLP

The Association does not support the idea of requiring bidders to calculate their NLP as of 1:00 p.m. and reporting such position sometime later. The Association views this approach as both unworkable and possibly counter-productive. Moving the NLP calculation time from 12:30 p.m. to 1:00 p.m. is operationally feasible for the dealers since it simply requires a bidder to changes the time at which their NLP is calculated. Needless to say, however, it would be impossible for a bidder to report their 1:00 p.m. NLP before the auction results are released.

The problem with this approach is twofold. First, a post-auction NLP reporting regime would inappropriately shift ultimate responsibility for ensuring compliance with the 35 Percent Rule from Treasury to the largest bidders. In essence, larger bidders would be forced at times to cut back on the overall size of their bids in order to allow themselves a “margin for error” with respect to the 35 Percent Rule. Thus, a move to post-auction reporting of a bidder’s NLP would create a self-policing regime that could discourage exactly the sort of aggressive bidding Treasury should be rewarding. Second, under a post-auction reporting regime, instances in which a bidder was inadvertently awarded more than 35 percent of the issuance would undoubtedly increase. Since such bidders would have to be cut back by Treasury after the auction results were announced, the finality of auction results would be undermined thereby potentially contributing to an overall increase in Treasury’s funding costs. In short, this approach fails to support one of Treasury’s key policy objectives – lowering its borrowing costs. As a result, the Association does not favor this approach.

2. Abandon NLP Reporting & Rely on Indirect Surveillance

The Association also does not support the idea of abandoning the pre-auction NLP reporting regime in favor of an indirect monitoring system. Under such a regime, Treasury would seek indirectly to ensure that a fair auction took place and that there was broad ownership of Treasury securities immediately following an auction. It is certainly possible to envision a system by which Treasury occasionally conducted unannounced post-auction audits of the largest bidders’ 1:00 p.m. NLP positions. However, we are skeptical that such a monitoring system would be effective at ensuring that a bidder is never awarded more than 35 percent of an issuance. More importantly, however, as we indicated at the outset, we are not convinced that the current NLP rules are the principal barrier to improved turnaround time in Treasury auctions. As a result, we do not view the efficiencies derived from abandoning the current NLP reporting regime as outweighing the benefits of having a more precise and effective pre-auction system for preventing concentrations of ownership in newly issued Treasury securities.

In closing, the Association greatly appreciates this opportunity to comment on the various policy options being considered by Treasury as it seeks to improve auction turnaround time.

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
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