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VIA FEDERAL EXPRESS & EMAIL

September 10, 2001

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

Re: Proposed Rulemaking on Modifications to the Calculation of the Net Long Position and the 35 Percent Award Limit in Marketable Treasury Securities Auctions.

Dear Ladies and Gentlemen:

The Bond Market Association[1] ("Association ") and its Primary Dealers Committee[2] welcome this opportunity to comment on the Treasury Department's ("Treasury") Advance Notice of Proposed Rulemaking with regard to the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds; Calculation of Net Long Position and 35 Percent Limit, 31 CFR Part 356, July 19, 2001 (the "Proposed Rulemaking"). The Association is delighted that Treasury is revisiting what both the Association and the Treasury Borrowing Advisory Committee[3] view as an unnecessary impediment to broad participation in reopenings under the current auction rules.

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[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] The Treasury Borrowing Advisory Committee of The Bond Market Association ("Borrowing Committee") is an advisory committee established by federal statute that meets quarterly at the Treasury Department. The Borrowing Committee's membership is comprised of senior representatives from "buy-side" institutions and from a number of the major commercial and investment banks. The Borrowing Committee makes observations to the Treasury Department on the overall strength of the U.S. economy

A. Introduction

The Association fully supports the Treasury's modification of the net long position ("NLP") reporting and 35 percent limit requirements (the "35 Percent Rule") as applied to reopenings. Treasury's decision last year to conduct regular reopenings of its longer-dated securities[4] in order to preserve their liquidity has meant that some potential bidders may be unable to fully participate in reopenings under the existing 35 Percent Rule. The recent introduction of a new four-week bill as a reopened security has further underscored the need to modify the existing 35 Percent Rule so that the policy goals underlying the auction rules can continue to be met.

B. Executive Summary

- The Association supports Alternative 1 as a reasonable means of ensuring broad auction participation in the context of more frequent reopenings. Creating a partial exclusion in the NLP calculation for a bidder's current holdings in the auctioned security would allow for broader participation in reopenings than under the current rules while still preventing the potential for undue concentrations of ownership in "on the run" Treasury securities immediately after an auction.

- The Association also finds merit in Alternative 4, as this approach would likewise ensure broader participation in reopenings with little danger of undue concentrations. Alternative 4 also has the added benefit of being easy to implement which is important given the cost associated with modifying each dealer's existing NLP reporting system.

C. Policies Underlying the 35 Percent Limit

There are two general public policy objectives underlying the current auction rules and NLP reporting requirements. First, the auction rules in general, the NLP reporting requirement, and the 35 Percent Rule are all designed to ensure that Treasury auctions are fair and open with broad participation by a significant number of competitive bidders.[5] Obviously, if one or more potentially large bidders is excluded from fully participating in an auction, the pricing received by Treasury can be materially impacted. Thus, it is important that the NLP reporting requirements and 35 Percent Rule are crafted in a manner that allows Treasury to receive the most competitive rates possible when its securities are priced.

Second, Treasury's auction rules and related reporting requirements are intended to make sure that the ownership of Treasury securities immediately

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as well as providing recommendations on a variety of technical debt management issues. The Bond Market Association does not participate in the deliberations of the Borrowing Committee.

[4] See Treasury Press Release (Feb. 2, 2000).

[5] See Advanced Notice of Proposed Rulemaking at 3.

after an auction remains broadly dispersed and not subject to undue concentration of ownership. There are a number of obvious benefits that Treasury derives from ensuring that its securities are broadly distributed. However, it is just as important to the dealer community that a deep and liquid supply of any new "on the run" Treasury security is available as repo collateral and for purchase in the secondary market immediately after the auction.[6] Fortunately, the existing 35 Percent Rule and NLP reporting requirement are designed to provide such comfort to all bidders because they ensure that the ownership of newly issued Treasury securities is broadly dispersed. While these two equally important policy goals can sometimes conflict, it is important that any changes to the existing 35 Percent Rule minimize the likelihood that a dealer will have difficulty obtaining auctioned securities in the secondary market immediately following an auction.

The Association applauds Treasury for recognizing that the existing 35 Percent Rule has the potential to unnecessarily limit the ability of certain larger bidders to participate in an auction involving a reopened Treasury security, thereby undermining a fundamental policy objective of the auction rules. As indicated in the Proposed Rulemaking, Treasury should attempt to strike the best possible balance between the twin goals of fostering broad participation in its auction and limiting the potential for excessive concentration of ownership of its securities. For the reasons expressed below, the Association would encourage Treasury to amend the current 35 Percent Rule by implementing either Alternative 1 or Alternative 4 as described in the Proposed Rulemaking.

D. <u>Discussion of the Alternatives in the Proposed Rulemaking</u>

Alternative 1

The Association fully supports Alternative 1 as an amendment that would facilitate broader participation in auctions while still limiting the potential for undue concentration of ownership of Treasury securities immediately after an auction. Alternative 1 will enable larger bidders to participate more fully in a reopening. Creating a partial exclusion in the NLP calculation for a bidder's current holdings in the auctioned security strikes an appropriate balance between the goals of fostering broad participation in auctions and preventing undue concentrations of ownership of Treasury securities. Alternative 1 correctly takes into account the reduced number of primary dealers, the increasing size of the balance sheets of certain dealers and their affiliated holding companies, and the

[6] For instance, one of the responsibilities of a primary dealer is to participate actively in Treasury auctions. While dealers take on substantial market risk when they choose to participate in a Treasury auction, dealers are able to bid aggressively and participate actively in an upcoming auction, in part, because of the existence of a healthy "when issued" market that allows the dealer and its customers to come to an agreement before an auction on the yield at which the customer will receive the auctioned securities on the auction settlement date. One by-product of the active "when issued" market in Treasury securities, however, is that dealers frequently enter into an auction substantially short the auctioned security. Dealers, therefore, need to know that they can obtain the securities they need to deliver to their customers either in the auction itself or immediately thereafter in the secondary market.

shrinking average issuance size. Given the characteristics of today's Treasury market, large dealers and their affiliates should not be penalized for holding a sizable amount of the already outstanding Treasury security so long as such holdings do not exceed 35 percent of the combined prior offering amounts of the security.

We understand that Treasury may be concerned that some dealers may have difficulty modifying their own internal NLP calculation and reporting systems in order to be able to take advantage of the option of excluding a certain amount of their current holdings when calculating their NLP. Obviously, if the NLP information received by a dealer from its affiliates does not specifically break down the type of holdings an affiliate has in the outstanding securities, the dealer will have difficulty taking advantage of the proposed exclusion. However, the Association does not believe that such system modifications will be unduly difficult or expensive for dealers to accomplish.

Alternative 4

The Association also finds merit with Alternative 4. Of the options presented in the rule proposal, Alternative 4 is perhaps the easiest to implement from a training and compliance system standpoint. Some market participants believe that Alternative 4 would allow for broader participation in reopenings than Alternative 1 without creating any additional danger of undue concentrations because Treasury has other effective tools at its disposal to prevent manipulations such as short squeezes. These tools include the Treasury's general anti-manipulation authority under the Government Securities Act, the Federal Reserve's market surveillance function, the weekly FR2004 reporting requirements imposed on the primary dealers and the Treasury's own broad authority to impose large position reporting requirements on all market participants.

Under Alternative 4, a bidder would still be prohibited from being awarded more than 35 percent of the securities issued in a reopening. Moreover, taking into account a bidder's existing position in the outstanding security just before an auction is arguably unnecessary to ensure a fair auction since the auction rules were only designed to ensure broad distribution of securities in the primary market and in the first few hours or days following an auction.[7]

Establishing a limit on auction awards that does not take into consideration a bidder's positions in an outstanding issue could potentially result in a single bidder acquiring an aggregate position in the auctioned security large enough to impair the liquidity of the issue in the secondary market.

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7 For instance, there is nothing in the current auction rules that specifically prohibits a bidder or other market participant form acquiring more than 35 percent of the auctioned securities via the secondary market in the hours immediately following the auction.

Nevertheless, the Association believes that Alternative 4 does not have the potential to inhibit liquid and orderly secondary market trading in that issue for two reasons. First, this approach would still limit the total amount awarded to a single bidder to 35 percent of the new issuance. As a result, the new issuance will be broadly dispersed among market participants and the "street supply" of the new issue will be more than sufficient to support an orderly and liquid secondary market. Second, under Alternative 4, a successful bidder would still have its award reduced to the extent the bidder was long the security in the "when issued" market.

E. Discussion of the Other Alternatives in the Proposed Rulemaking

The Association and its Primary Dealers Committee also considered the various other alternatives described in the Proposed Rulemaking. However, the Association does not favor any of these other approaches.

Alternative 2

With respect to Alternative 2, the Association believes this solution would fail to strike the appropriate balance between robust auction participation and market integrity. Under this approach, the NLP reporting requirement would be eliminated altogether, and Treasury would reduce the 35 percent limit to 25 percent (or some other amount below 35 percent). The appeal of this approach lies in its simplicity – namely that it eliminates much of the current compliance burden faced by bidders. However, the dealer community has already borne the expense of developing and implementing the systems necessary to comply with the current NLP reporting requirements. Given that today's Treasury auctions benefit from being fairer and more transparent due to the NLP reporting obligations and award limits, the Association sees no reason why Treasury should now abandon altogether its NLP reporting requirements.

Alternative 3

Similarly, the Association does not support Alternative 3. Under this approach, the current NLP calculation rules would remain the same. However, the 35 percent limit would be based on the public offering amount plus any previous offerings of the same security. The problem with this approach is that it does not adequately support the policy of ensuring that ownership of Treasury securities remain broadly dispersed. This approach could theoretically allow a single bidder to be awarded 100 percent of the securities being auctioned. Thus, under this approach, if Treasury had offered $10 billion of a Treasury security in a previous auction, and then subsequently offered an additional $5 billion in a reopening, a bidder with no NLP could be awarded the entire reopening amount ($15 billion x .35= $5.25 billion). In contrast, under this example Alternative 4 would only allow a single bidder to be awarded $1.75 billion - 35 percent of the new issuance.

Alternative 5

The Association also believes that Alternative 5 would be undesirable. Under this approach, the NLP calculation rules would remain the same, but the 35 Percent Rule would be adjusted upwards for both initial issuances and reopenings in order to give large holders a greater ability to come within the overall limit. The Association thinks that 35 percent is an appropriate percentage level for the auction limit and does not believe that Treasury's decision to conduct reopenings more routinely necessitates that the percentage used to limit auction awards should be modified. Moreover, in situations where an auction is not a reopening, Alternative 5 unnecessarily creates a greater opportunity for a single firm to take a larger percentage of an initial issuance than is appropriate given the policy objectives underlying the current rules.

Alternative 6

The Association believes that Alternative 6, which would retain the current rules in their existing form, is also not a viable alternative. As indicated earlier, the Association believes that Treasury needs to modify the existing 35 Percent Rule in light of the Treasury's decision last year to conduct regular reopenings of its longer-dated securities and the introduction of the new 4-week bill. Because the current rules require a bidder to include their existing holdings in the outstanding securities when calculating its NLP, larger market participants can sometimes be unnecessarily precluded from fully participating in auctions of reopened securities.

The Association greatly appreciates this opportunity to comment on the various policy options being considered by Treasury as it seeks to improve the current NLP reporting requirements and the 35 Percent Rule currently contained in the Treasury auction rules.

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: *The Bond Market Association*
Primary Dealers Executive Committee
Primary Dealers Committee
Government Operations Committee
Government Legal Advisory Committee
Legal & Professional Staff

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