

October 2008

Fails Best Practices:

The market for U.S. Treasury securities represents the most liquid and deepest market in the world. SIFMA and its member firms commit to ensuring that nothing compromises the benchmark status enjoyed by this market.

SIFMA recognizes that large-scale, chronic settlement failures in the U.S. Treasury securities market, both the cash and repurchase markets, pose systemic and firm risks that are not in the best interests of this market and the U.S. taxpayer.

Recently, some concern has been expressed about potential increases in settlement fails, due either to a low interest rate environment or an increase in price volatility. It is in the interest of every SIFMA member firm participating in this market, as well as every other market participant, to:

- 1) implement practices that enhance the firm-wide monitoring of settlement fails in the U.S. Treasury market;
- 2) develop best practices to eliminate settlement fails before they become chronic;
- 3) mitigate the risks that settlement fails pose to the firm and the market; and
- 4) implement practices and procedures that require firm personnel to manage and reduce fails that have become aged and chronic in the market.

SIFMA Recommends that Member Firms Monitor, Manage and Mitigate Aged and Chronic Settlement Fails in U.S. Treasury Securities

Fails in the U.S. Treasury market, both cash and repo, occur daily and are generally resolved within a day or so. Fails in a normal trading environment occur for a number of reasons: operational issues cause the bulk of day-to-day fails; incorrect trade details result in mismatches, but these are typically resolved quickly by communications between the parties.

However, during periods of low interest rates, the incidence and age of fails increases as the economic incentives to deliver securities and to participate in the market as a lender of securities decrease significantly. Indeed, while large-scale, chronic and aged fails pose greater risks to both the market generally and to individual firms, SIFMA acknowledges that fails will increase in some trading environments, but that through proper monitoring and adherence to best practices, the systemic consequences of aged and chronic fails can be minimized and reduced.

In the day-to-day operation of its business, SIFMA recommends that each member firm adopt policies and procedures designed to (i) quickly identify increased levels of aged settlement fails; (ii) escalate to management and the compliance function any concerns about the level of fails the firm is facing and (iii) institute procedures to reduce chronic settlement fails. SIFMA recommends that firms consider the following in developing day-to-day fails management techniques in order to ensure that fails do not extend indefinitely and do not pose unnecessary risks to the institution and to the market:

- **Interest Rate Environment:** As real interest rates decline, firm personnel, including traders, management and compliance, should be alert to possible significant increases in settlement fails. Management and compliance personnel need to be integrated into, and understand, the activities of traders in a low rate environment. Traders and operations personnel should involve both management and compliance if the number or age of fails increases significantly.

- **Escalation to Management:** Firms should establish, describe and communicate to operations and trading personnel levels of fail activity that require management and compliance consultation. Firm policies should provide for escalation in a manner that permits management to facilitate early intermediation and discussion of the firm's fails position in the context of market-wide activity. Firm management should assess particular trading strategies that may serve to exacerbate a chronic fails situation and consider modifying such strategies if appropriate.

- **Time-lines and Risk Mitigation:** When fails of a significant size age beyond a few days, and in any event after 5 days, management, operations and compliance personnel should discuss the facts and circumstances giving rise to the fails and, consider implementing risk mitigation procedures appropriate to those facts and circumstances, such as margining of fails, limiting certain trading techniques, identifying pair-offs, facilitating or encouraging early cash-settlements, and attempting to source securities needed for delivery. Each firm will have to determine for itself when and how to implement these strategies, but SIFMA believes that early scrutiny will avert problem situations from developing.

- **Covering Short Positions:** SIFMA members support and urge all market participants to note the following paragraph from the Treasury Market Best Practices¹ concerning covering short positions:

"Market participants with large short positions should make deliveries in good faith. Market participants with a particularly large short position in an issue should ensure that they are making a good faith attempt to borrow needed securities in order to make timely delivery of securities. Market participants should avoid the practice of "strategic fails" -- that is, the practice of selling short a security in the repo market at or

¹ The Treasury Market Best Practices, published by the Treasury Market Practices Group, are available at http://www.newyorkfed.org/tmpg/TMPG_best_practices_021908.pdf.

near zero percent with little expectation of being able to obtain the security to make timely delivery."

- **Upgraded Operational Capability for Margin and Negative Rate Repo:**

Firms should consider the development of an operational and legal infrastructure that permits the calculation and payment of margin for open fails and that permits firms to engage in funding activity at repo rates below zero.² SIFMA will work with all market participants to further develop industry-wide negative repo rate and margining capability. SIFMA believes that the availability of negative repo trading during high fails period will allow market participants to source securities at a market determined price.

SIFMA is committed to working with the relevant constituencies within its membership to provide the necessary market-standard documentation and operational protocols that would permit wider acceptance of margin and negative-rate repo transactions.

- **SIFMA Buy-in Procedures:** All market participants should be aware of the regulatory obligations placed on dealers to take prompt steps to obtain possession and control of U.S. Treasury securities that are the subject of a customer sell order fail to receive position that has been outstanding for 30 days. Appropriate personnel should be familiar with SIFMA's Buy-in Procedures (available at <http://archives1.sifma.org/agrees/govsecbuyin.pdf>).

- **Master Repurchase Agreement: Mini-closeout provision:** SIFMA's Funding Division has endorsed the development of a "mini-closeout" provision that can be used with the Master Repurchase Agreement ("MRA"). This additional provision will allow market participants that are in a fail to receive position under a repo transaction governed by the MRA to close-out and settle only the failing transaction without closing-out all the transactions under the agreement. Market participants will retain the right to declare a full event of default if they wish.

SIFMA Treasury Fails Monitoring Committee

In addition, SIFMA, in recognition of the importance of implementing market-wide mitigation procedures and in order to promote awareness should settlement fails begin to escalate beyond levels reflecting normal market conditions, will establish a Treasury Fails Monitoring Committee. This Committee will consist of senior representatives from both the funding and cash markets who have day-to-day responsibility for managing the funding and cash activities of member firms and will function in much the same way as SIFMA's Calendar and Securities Market Emergency Committee. The Committee will include representatives from both the buy- and sell-sides as well as observing representatives from the Federal Reserve and the U.S. Treasury. The

² SIFMA published in 2006 a Repo Trading Practice (available at <http://archives1.sifma.org/assets/files/Final%20Negative%20rate%20guideline.pdf>) to facilitate negative repo transactions.

Committee will be able to meet by conference call on very short notice at the request of at least 2 of its members. This Committee's function will be to assess the level of settlement fails in the market on an ongoing basis and to alert the market, by public statement, when, in the Committee's judgment, market-wide mitigation, remediation and the attention of management is warranted. Annually, the Committee will develop metrics and objective standards that will aid in the Committee's determination that a particular event warrants industry-wide attention.

Upon any statement of the Committee with respect to high levels of fails, individual firms will be asked to review their current positions in the Treasury market, to monitor their failed settlements and, if necessary, to implement strategies and practices in an effort to reduce the gross level of failed settlements and mitigate the risks to the firm and the market as a whole created by such failed settlements. In addition, if the Committee believes that particular measures could address the specific circumstances surrounding a high-level of settlement fails, it will be authorized to recommend those measures to the SIFMA membership.

SIFMA also recommends that a member firm's representative to the SIFMA Fails Committee should be identified/communicated to firm personnel and provided with real-time information on the level of fails both at the firm and in the market so that the representative can determine if a market-wide event may be occurring and a meeting of the SIFMA Fails Committee is warranted.