sifma

Invested in America

June 10, 2011

Submitted via Email to: tmpg@ny.frb.org

Re: Comments on Draft Recommended Agency Mortgage-Backed Securities and Agency Debt Securities Fails Charge Trading Practices

The Securities Industry and Financial Markets Association (SIFMA)[1] supports the efforts of the Treasury Market Practices Group (TMPG) to address fails in the Agency Debenture (Debt) and Agency Mortgage-Backed Securities (MBS) markets. SIFMA members share the concerns of TMPG members and the Federal Reserve Bank of New York (FRBNY) regarding elevated levels of settlement fails in MBS markets. SIFMA members agree that such fails create counterparty, market, other risks, and therefore share TMPG's view that every effort should be made to minimize fails, including through the implementation of an effective fails charge.

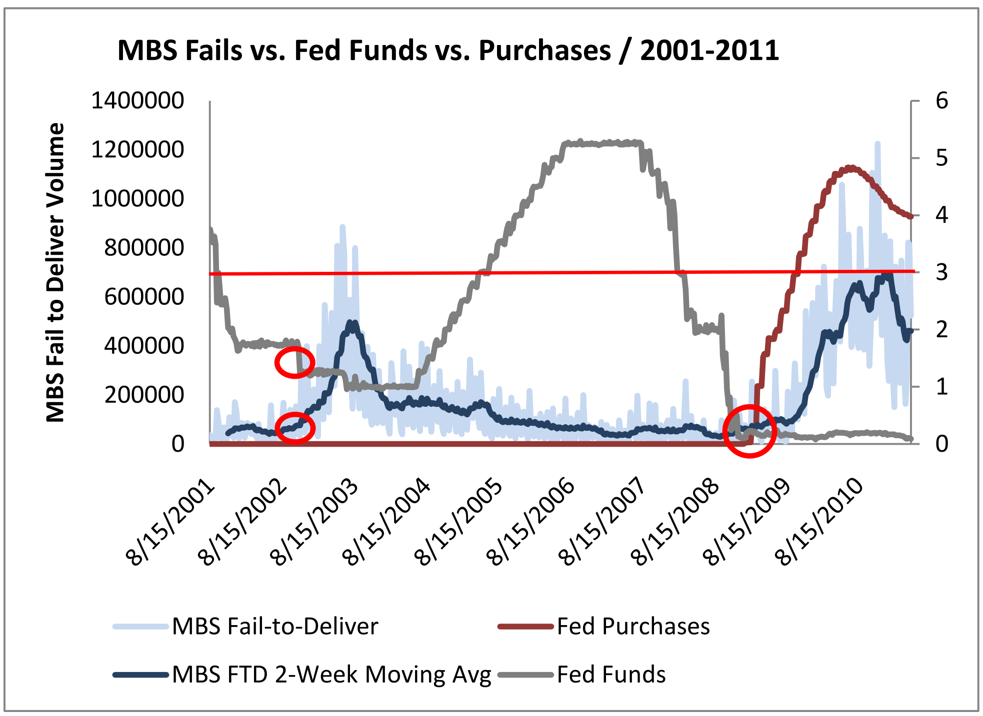
The working group that developed this commentary is composed of SIFMA's buy- and sell-side members, including front office and operations personnel, as well as members who serve as custodians, in the MBS and Debt markets. The majority of our comments are focused on the fails charge as it relates to the MBS market, as the Debt market is, in many ways, similar to the Treasury market and the Debt charge is largely identical to the Treasury fails charge. MBS markets are quite complex, and SIFMA has a long history of involvement in them. SIFMA appreciates this opportunity to provide comments as well as the great efforts of the TMPG that underlie this proposed trading practice. SIFMA supports the implementation of a fail charge, and a number of constructive considerations related to its design and implementation follow.

Our letter is generally divided into market considerations (Sections 1-4) and implementation considerations (Section 5-7). Key among the market considerations is that the penalty rate is set at the appropriate level to reduce fail incentives but maintain liquidity. Key among the implementation considerations are broad participation, and the minimization of the operational burden in MBS market, through automation or other initiatives. We note that certain of the topics discussed in this letter are not directly related to the activities of the TMPG or the proposed fails charge trading practice. However, they are connected in the sense that the fails charge will be implemented into a multifaceted market with many moving parts, where topics such as central counterparties or automation of collection should be considered along with the fails charges in a holistic manner.

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, please visit www.sifma.org.

1. **Fails Charge Rate:** The TMPG has proposed for comment a fails charge rate for MBS of 300 BP. SIFMA members have reviewed the proposal and have also examined and discussed available data on MBS fails. Based on this review and discussion, members generally agree that the proposed 300 BP penalty rate is likely to achieve the goal of minimizing fails. Less clear is what the impact of that proposed rate on liquidity of the MBS markets would be. A majority of SIFMA members desire that TMPG further explore a somewhat lower penalty rate which may also achieve the same goals of reducing fails, with a lesser impact to liquidity. . We acknowledge a range of views on this subject and believe it indicates that TMPG and SIFMA should work together to continue to analyze data, and expected market impacts, to determine an appropriate an effective fails charge level.

    1.1. **Data Review:** We understand that the 300 BP level was chosen for Treasury products due to analysis[2] indicating that below a Fed Funds target level of 300 bps chronic fails become more likely. Below is a presentation that appears to support a conclusion that significant increases in MBS fails are correlated with a Fed Funds level lower than 300 BP. In one instance, Fed Funds breached 150 BP, in another, Fed Funds were near zero before fails spiked, and the MBS fail increase also appears correlated with other factors. Therefore, a lower fails charge should still provide a significant financial disincentive to fail, and this should be considered in deliberations of the final MBS fails charge rate.



Source: Federal Reserve Bank of New York

    1.2. **Other Industry Initiatives:** SIFMA members highlight two significant industry initiatives that are expected to have a significant impact on incidences of fails in MBS markets. We recognize that these are not directly tied to the TMPG proposal, but they will impact the overall level of fails meaningfully and therefore should be considered along with the fails charge, as they are

[2] http://www.newyorkfed.org/research/epr/10v16n2/1010garb.pdf

related.

The first is the implementation of MBS central counterparty by DTCC (CCP). We discuss the importance of this further below, but the bottom line is that CCP is expected to significantly reduce trade settlements. By some estimates, settlement reduction could exceed 60%. CCP will net out DTC-participant trade loops; according to our members the significant majority of fails are matched and in the future we expect that CCP will sharply decrease fail volumes regardless of the interest rate environment. While this settlement reduction will primarily impact dealer-to-dealer trades, its size speaks for itself, and should significantly further the goal of eliminating non-intentional fails.

The second initiative is the expansion of an electronic method for assigning trades away from the buy side counterparties of dealers. This process allows electronic assignment and resolution of offsetting fails without requiring physical delivery or paper trade assignments, and allows resolution through FICC netting. SIFMA members expect participation in this process to be significantly enhanced in coming months. This process helps to drive transactions into the DTC-participant community, which will be benefitted by CCP as discussed above, and makes it easier to identify and resolve round robin loops of fails by reducing the number of participants in a chain of trades.

1.3. **Review of Penalty Rate:** The effectiveness of this initial rate should be reviewed periodically to determine its effectiveness. The final trading practice should reflect this institution of periodic review. If levels of fails do not decline as desired, the penalty rate may be stepped up to a higher level.

2. **Supply Dynamics:** While liquidity concerns were largely discounted in the discussion of the Treasury fail charge, we believe that liquidity issues are significant in the MBS context. There are specific supply and float concerns in MBS markets due in part to the Federal Reserve's Large Scale Asset Purchase Program which removed a significant quantity of MBS from the tradable float. This issue was not present in Treasury markets. MBS markets are also segmented among the various issuers and coupons, and involve more than one million CUSIPs. Therefore while overall liquidity in MBS markets is very high, it is less so when one drills down to a particular TBA coupon. As expected, coupons where fails are most prevalent and most enduring are coupons where freely tradable supply is very low, relative to total outstanding. While large increases in the supply of Treasury securities helped to eliminate fails in those markets in 2008, we do not believe the same thing will occur for MBS in the near term. While these supply issues may work themselves out over time, we do not believe they will be solved in the near term through organic growth, given current origination volumes and mortgage rate levels.

   As a general matter, this lack of supply creates a number of issues for the liquidity of MBS. We believe that a fails charge that is set at too high a levelcould exacerbate liquidity issues, by deterring market makers from taking on trades with anything exceeding minimal settlement risk. While traders should be confident in their ability to source bonds before confirming any trade, some level of fails is a general course of business in market making. Dissuading trading in less liquid coupons would further decrease liquidity in those coupons. We also note that fails in MBS tend to have a longer duration than in other markets, given the monthly settlement cycle and patterns of liquidity. Thus a fail of a given size would tend to attract a higher charge in the MBS context compared to a fail of Treasury or Agency securities of the same size. This ties in to the level of the penalty rate, as discussed above.

While the Federal Reserve currently maintains a significant portfolio of MBS, those securities are not lent into the market as they are in Treasury markets. Similar to the discussion of supervision below, this is another key difference between Treasury and MBS markets, and another reason why MBS fail penalties should be constructed uniquely to reflect the variations in the markets. A lending program could be an appropriate facility to smooth volatility and promote liquidity in MBS. We understand the larger goals of monetary policy, however, and how that may impact the management of the MBS portfolio. Nonetheless we would encourage the Federal Reserve to explore lending programs that would satisfy market dynamics in a manner similar to the SOMA program for Treasuries in a manner that does not impede monetary and economic policy objectives. We are aware that this is not a policy that the TMPG controls; rather we present it for consideration to illustrate the overall scope of issues that surround the MBS markets.

3. **Incentive Effects of Fails Charges:** A fails charge may tend to dissuade parties from failing, but at the same time increases incentive to be failed to. In other words, financial compensation for parties who are failed to could create incentives for those parties to squeeze or otherwise manipulate markets in order to create fails so that they can receive fails charge compensation. If these incentives cannot be mitigated a fails charge may not reach its maximum effectiveness.

   These incentives and risks also exist in the markets for Treasury securities, which are subject to fails charges; however, the policing of market behavior (generally) and squeezes (in particular) are visible and stringent in those markets. Regulators monitor Treasury markets on a continuous basis. In order to mitigate the negative incentives and risks a fails charge may create, consideration should be given to adapting the Treasury markets monitoring mechanisms or to creating new mechanisms for MBS markets. While numerous rules and regulations (as promulgated by the SEC, FINRA, Treasury and other regulatory bodies) apply to the MBS markets as well as Treasuries, ongoing daily market oversight is a component unique to Treasury markets for a variety of reasons.

   SIFMA members believe that the majority of the benefit of surveillance stems simply from the knowledge that it exists. Direct comparisons to Treasury markets are not practical given that Treasury markets have benefitted from surveillance for years; however SIFMA notes the apparent success of this oversight in Treasury markets as evidence of its worth. We also recognize that existing TMPG Best Practices address market manipulation and similar concerns but believe that a more active ongoing engagement would provide added benefits. This engagement would be consistent with the spirit of the TMPG Best Practices, and would promote the liquidity of MBS markets.

4. **Treatment of Existing Fails:** SIFMA members have discussed whether existing fails should be grandfathered, or whether existing fails at the time of implementation should accrue fails charges. SIFMA believes that the fail charges should apply to all failed transactions outstanding as of the day of implementation – with the accrual on such fails being calculated prospectively as of the date of implementation. This will incent the resolution of outstanding fails incurred before the effective date of the fails charge.

5. **Steps Needed to Ensure Broad Participation:** Perhaps the most important factor in the success of the implementation of MBS fail charge post-implementation will be the broad uptake and acceptance of the trading practice by all market participants. As the TMPG knows, SIFMA maintains guidelines for penalties assessed on MBS fails over factor dates (so-called 'CPR claims'). Given the high volume of fails over the last two years, SIFMA members have learned a number of important lessons. The most important lesson is that for a fails charge to be effective, participation must be as broad as possible. If market participants step out of the process, the ultimate failing party in multiple chains of fails may not be charged a penalty as the claim payment process may halt, as significant compliance issues may arise when firms are unable to receive a claim payment from one of their counter sides. The burden of compliance can create these participation issues. Our members believe there are a number of steps that can be taken to ensure the broadest participation and resulting reduction in fails:

    5.1. **The TMPG, FRBNY, and Market Participants Should Continue to Strongly Encourage Involvement of All Participants:** The TMPG and the FRBNY should continue to encourage, as explicitly as possible the importance of the inclusion of all market participants in the fail charge process when the Trading Practice is finalized. SIFMA recognizes that the TMPG and the FRBNY do not have the ability to mandate participation, but do have significant power to influence behavior, and were instrumental in the adoption of the Treasury fails charge. It is of critical importance that all broker-dealers, custodians, domestic and international banks, investment managers, and other market participants large and small accept this process. In order to facilitate broad compliance, the TMPG and the FRBNY should encourage all custodian banks to develop accurate fail reporting. Market participants should also stress the importance of adherence to these guidelines to their counterparties. SIFMA, for its part, will strongly encourage its members and all other market participants to participate.

    5.2. **Automation on Fedwire**: SIFMA notes above and below support for the implementation of CCP for MBS, not only as a critical step forward for the efficiency and robustness of MBS markets, but also as a process that will ease the burden of TMPG claim compliance. There is a greater step forward possible, however, because CCP will mainly impact DTCC participants, who tend to be broker-dealers. Fedwire/ACAPS, however, facilitates the payment processing and/or settlement on all Debt and MBS securities. We recognize as well that automation would present operational and implementation challenges to all market participants. Additionally, details such as dispute resolution mechanisms may need to be arranged. However, the most significant benefit of automation on Fedwire would be to ensure significantly broad compliance and therefore fairness of application, and tremendously reduce the overall, long-term operational burden on the market.

    SIFMA members feel strongly that TMPG and FRBNY should prioritize and continue to explore and ultimately adopt automation of the TMPG claim process on Fedwire, and we would be pleased to support such efforts in any way. To the extent that this automation cannot be implemented before the MBS and Debt fails charges are made effective, SIFMA believes that other points made in this letter regarding CCP and minimization of the operational burden become more important. It bears repeating that the number of CUSIPs, and therefore the operational effort, is far higher in markets for Agency MBS than Agency Debt or Treasuries.

5.3. **TMPG Should Explore Penalty Calculation Based on Current Balance To Ensure Broad Participation:** It is important that parties who are flat, and who essentially pass through claim amounts, are able to comply with the fails charge trading practice as easily as possible. With the proposed TMPG trading practice, as well as the current CPR claim trading practice, trade price is a factor in calculations, creating situations where offsetting buy and sell trades have different claim amounts due to differing buy and sell trade prices. This requires the counterparty to allocate the gain or loss somewhere. Certain of our members have indicated that they are unable to book losses to their accounts due to claims, for various legal or other reasons. This has impacted participation in SIFMA's CPR claims guideline, and resulted in a need for negotiation of claim amounts to a level where there is no loss, or simply the inability to participate in the CPR claim trading practice. Because of this, SIFMA members are beginning work to amend the CPR claim guidelines to explore if a single trade price can be determined on a monthly basis for the purpose of CPR claims.

SIFMA members suggest that there be a parallel consideration for TMPG fails charges. If fail charges were calculated based on current balance, the economic incentive effect would be little changed (if at all), but the compliance burden would be greatly reduced and participation made much easier for market participants. The complication for this approach will be whether custodians will be able to report fails to asset managers based on current face amount. The total complexity of such a calculation methodology is unclear at this time; therefore we encourage TMPG to continue to explore this mechanism to ensure broad participation in the MBS fails charge trading practice.

5.4. **Free Deliveries**: The proposed trading practices for MBS and Debt exempt free deliveries. Free deliveries are also exempted for Treasury securities. We believe that all free deliveries, such as returns of collateral, should be included in the fails charge process. As the TMPG knows, fails may occur because collateral held in a participant's account has been loaned or otherwise made unavailable and not returned in time for settlement of a trade. This may occur in securities lending, swaps, and futures contexts. Any fails charge guidance should specifically include these situations, and permit a party who fails to receive collateral back in time for another delivery to assess the failing party with a penalty. We understand that concerns have been expressed about valuation of claims related to free deliveries. If the suggestion noted above regarding the usage of current face for claim calculations is taken, this should eliminate the valuation issue. Additionally, to the extent that a free delivery was only a portion of a total fail amount, only the amount of the fails charge proportional to the size of the free delivery should be passed on.

6. **Application of Fail Charges**

6.1. **Resolution Period:** SIFMA strongly supports the concept of a resolution period to aid in the cleanup of frictional fails. Given the complicated nature of MBS settlements, and the large number of CUSIPs in the market, some level of unintentional failing due to confusion on delivery instructions or security identification is unavoidable.

While the trading practice would allow for a two day resolution, SIFMA members believe a three day resolution period should be considered to allow for the clean-up of pool fails by market participants who are acting within the spirit of the guidelines. To illustrate this view, we note that it is very common for market participants to have matched buy and sell trades for a given settlement date. Assuming pools have been allocated, it is not known with certainty that a fail has occurred on one side of this trade until Fedwire closes at 3:00 PM on settlement date and no further deliveries are possible. Following the 48-hour rule, if pool changes were executed after 12:15 on settlement day in light of this fail (or in expectation of a fail in the case of a change done between 12:15 and 3:00PM), the new pools *could not be delivered according to market practice* until the third day following contractual settlement, and the seller would face a 3-day fails charge claim, even though the fail was remediated by settlement day +1. Any other resolution would require market participants to settle outside of widely accepted and long standing MBS market practices. The alternative would be for this party to wait, and hope that the originally allocated pools come in on day one, or day two, and then deliver them on to their counterside. This means that a firm that executes a pool change on day one in order to close out their fail-to-deliver with certainty could be penalized, where a firm that did nothing, but happened to receive the needed pools on day two, would not be penalized. This outcome seems contrary to the spirit of the Trading Practice.

It is also true that the party who was failed to could process a penalty claim against its seller and theoretically be made whole on the charge they would owe. Any further pool changes after settlement + 1, of course, should generate a fails charge if they delay settlement. We also acknowledge this could reduce the incentive to clean up fails on settlement day. However, given the amount of fail clean up on the day after settlement day, we believe the operational burden this creates could exceed the benefit gained and should be further considered by TMPG .

6.2. **Application to Deliveries Versus Payment:** SIFMA members believe that fail penalties should only apply in instances where securities are delivered versus payment, as proposed in the draft trading practice (except for free deliveries, as discussed above). In other words, trades that do not settle versus payment should not be eligible for Fails Charges. An example of this non-DVP settlement includes round-robin settlements. A round robin is a closed loop of trades, where the initial seller is also the ultimate buyer. In these situations, if a fail charge were applied, no party would be a net payer or receiver of claim (assuming calculation based on current face). However, every party in that chain would need to receive, investigate, and process a claim. Given that round robins involve no net short, do not involve intentional fails, and do not confer a financial gain or loss on any party (again assuming current face as the calculation methodology), the benefit to the market of including them in the fails charge process is unclear. Round robin resolution is handled in accordance with SIFMA guidelines, and generally involves trades with identical contractual settlement dates, where dummy pool numbers are used to clear open trades. Actual securities do not change hands. Resolution of these round robin fail chains may take a number of days, given the burden of identifying counterparties to the trades, but generally take place in the same month as contractual settlement. We also note, finally, that DTC-participant to DTC-participant round robins will be netted out when CCP is implemented.

6.3. **Retransmittal Mechanism:** The CPR claims process includes the ability of a participant to retransmit a claim forward to its counterparties, with a minimum size threshold below that of a new claim. SIFMA members believe that such a mechanism should be included in the TMPG guideline for MBS given the more granular nature of that market compared to Treasuries and Agency Debt. A retransmittal would be required to evidence the receipt of the initial claim received by a counterparty involving those pools. The minimum dollar threshold for a retransmittal would be $100. A situation where a retransmittal would be needed is a situation where one counterparty has sold a failing security to another party, and originally bought that security from multiple parties who also failed to deliver, and the monthly claim total for those transactions back to the original sellers are below $500 each. The retransmittal would allow the party in the middle to recover the amount of the claim that they are faced with on their sell side. While the dollar amounts involved here are small, they are not immaterial.

7. **Implementation**: TMPG has proposed a first quarter 2012 implementation objective for both MBS and Debt trading practices. What follows are considerations for the implementation of the trading practices. At the highest level, many of our members have noted difficulty in scoping out timing needed for MBS penalty implementation due to a number of uncertainties as to the final form of the rule. For example, a move to calculation based on current face would be a significant exercise for custodians but confer many benefits on the market. Clarity on the specific meaning of legal counterparty could drive development in one direction or another, with different resource requirements for each. Therefore, we encourage TMPG to determine the implementation time based on feedback from market participants after the guideline is made final. We believe implementation of the Debt trading practice is less challenging and therefore may be executed sooner than that for MBS; similarly, we believe that some participants may desire to report Agency Debt and Treasury charges on the same claim letter, and report MBS charges separately.

7.1. **Central Counterparty and Timing of MBS Fails Charge Implementation:** The implementation of the MBS fails charge trading practice should be implemented in parallel with DTCC's central counterparty for MBS (CCP) if reasonably possible, as the implementation of CCP would allow for DTCC to automate the collection of claim amounts on a significant portion of fails for DTCC participants, who make up a significant proportion of MBS trading and fail volumes, and more importantly significantly reduce the number of settlements that may fail in the first place. The presumed timing of action on a penalty and DTCC's proposed implementation of central counterparty should to be aligned as much as is practical. We understand that DTCC's rule filing requesting regulatory approval to act as a CCP for MBS has been amended a number of times and currently awaits regulatory approval. SIFMA strongly supports the implementation of CCP and hopes that regulators approve this critical enhancement to the MBS markets as soon as possible.

7.2. **Custodians Must Have Time To Develop Reporting:** It is of critical importance that the ability of custodians to manage and process the expected number of fails charge claims must be examined carefully and contemplated in establishing a schedule for implementation. Implementation of the Treasury penalty proved difficult for many buy side market participants, and the implementation of a penalty for MBS will be most efficient and effective if any issues with custodians are surfaced and addressed prior to implementation. Custodians must be able to accurately report fails to their buy side counterparts to enable them to participate in the claims process. SIFMA notes that the monthly aggregation of claims creates a more complex claim calculation process for custodians than a one-to-one fail/penalty relationship, and this must be factored in to the implementation schedule. As noted above, the exact time required is not known at this time, and should be readdressed when the form of the trading practice is final.

7.3. **Need to Clarify "Legal Counterparty":** SIFMA members have discussed the usage of the words "legal counterparties" in the draft trading practice. We note additional language that "if an investment manager trades on behalf of a client, the pertinent party is the client". It is unclear if the "legal counterparty" is the legal entity of a counterparty, or the client of the counterparty if that counterparty is an investment manager. Our investment manager members note that (if the TMPG intends the fail charge to be applied at the legal entity level) in some cases the same legal entity can trade for multiple "clients" (i.e., accounts). It is therefore unclear to our members whether or not the trading practice is intended to be applied at the legal counterparty or the account level. It will be important for the TMPG to clarify exactly to whom the trading practice applies in the final guidance, and SIFMA members suggest that the trading practice be applied at the account level.

In conclusion, SIFMA supports the goals of TMPG to reduce settlement fails by implementing an effective fails charge. We hope the comments provided today are constructive and help achieve this shared goal. We would be pleased to provide further feedback as needed. Please contact Chris Killian with any questions or comments at 212-313-1126 or ckillian@sifma.org.

Sincerely,

Richard A. Dorfman
Managing Director
Head of Securitization

Christopher B. Killian
Vice President