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January 18, 2005

Ms. Lori Santamarena
Executive Director
Bureau of the Public Debt
Government Securities Regulations Staff
799 9th Street NW
Washington, DC 20239-0001

Re: Buy-Ins of Customer Sell-Order Fails in Government Securities

Dear Ms. Santamarena:

The Bond Market Association (the "Association" or "TBMA")¹ is writing to provide the staff of the U.S. Treasury Department ("Treasury") with our initial conceptual recommendations regarding potential modifications to the buy-in requirements applicable to customer sales of U.S. government securities under 17 C.F.R. § 403.4(m) (the "Buy-In Rule" or "Rule").² We very much appreciate this opportunity to share our views on this important topic with you.

We would also welcome the opportunity to meet in person with you, representatives from the Securities and Exchange Commission (the "SEC"), and other regulators regarding the preliminary ideas outlined in this letter.

As you are aware, over the last year the Association and its members have been focusing significant attention on fails in the U.S. Treasury and agency mortgage-backed securities ("MBS") markets and the application of the Buy-In Rule to such fails. This review was precipitated by the occurrence of an unusual level of fails – both in terms of volume and duration – in certain Treasury notes and MBS during the summer and fall of 2003. In conjunction with the industry's efforts in 2003 to reduce the level of fails in these specific securities, the Association formed a working group (the "Unsettled Transactions Working Group" or "Working Group") of trading, operational and legal

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 We note that this letter only addresses the "buy-in" requirements under 17 C.F.R. § 403.4 relating to "fails to receive" of customers fully paid or excess margin securities, and thus does not attempt to address the possession and control requirements contained in 17 C.F.R. § 403.5.

professionals from the cash and funding areas at various government securities dealers. The Working Group was tasked with studying why fails occur and developing recommendations on: (i) reducing fails generally, (ii) steps to resolve fails once they arise, and (iii) potential modifications to the Rule and to the TBMA buy-in procedures that were developed contemporaneously with the adoption of the Rule. The work of this Group benefited greatly from informal meetings with you and your Treasury colleagues as well as staff of the SEC, the New York Stock Exchange, Inc. and the National Association of Securities Dealers, Inc.

Although the efforts of the Working Group continue, we thought it would be useful to report on our efforts to date to reduce the likelihood that another endemic fail situation will occur in the U.S. Treasury and MBS securities markets and to share our preliminary views regarding potential improvements to the Buy-In Rule. We have significant questions about the efficacy of the Buy-In Rule in achieving its stated objectives during a period of endemic fails in a particular security. We, therefore, urge Treasury to consider modifications to the Rule to better address such endemic fail situations and to make certain other technical amendments to the Rule.

By way of background, in Part I of this letter we provide a brief executive summary of our findings and recommendations. Part II briefly summarizes the Buy-In Rule and the policy objectives for the Rule articulated at the time of its adoption. In Part III we discuss more fully some questions and concerns regarding the extent to which the Rule achieves its stated objectives, and in Part IV we propose several potential modifications to the Rule.

I. Executive Summary/Central Observations

The Association believes that:

- The Buy-In Rule, as currently written, is sometimes counterproductive as it can hamper the prompt and orderly clean-up of unsettled transactions in U.S. Treasury and MBS securities. This is especially true when failed transactions in a particular security have become endemic due to the absence of an adequate settlement supply.
- Strict enforcement of the Rule in endemic fail situations could result in a cascade of buy-ins occurring all at once and at a time when there is likely to be a greatly reduced willingness on the part of market participants to enter into new cash transactions because they are concerned that such transactions might likewise fail.
- The Buy-In Rule should, therefore, be suspended for all broker-dealers for securities experiencing an endemic fail situation since attempts to buy-in a failing counterparty under such conditions will only exacerbate the problem. More than adequate economic incentives exist to clean up aged fails under the capital rules and market conventions that grant the buyer the accrued interest from the original settlement date. Dealers also have robust risk management systems in place to monitor and limit their credit exposures arising from any unsettled transactions.

- Alternatively, if Treasury concludes that more is required upon suspension of the buy-in requirement, it could condition such suspension on a broker-dealer satisfying certain reporting or risk management requirements, as long as the broker-dealer has the flexibility to take whatever mitigating actions it deems appropriate under the circumstances to address fails – including, for example, obtaining collateral from the customer, limiting new transactions with the failing customer, or even buying-in the customer.
- In order to be able to suspend the Buy-In Rule due to an endemic fail situation, Treasury needs clear criteria for determining that an endemic fail situation is occurring in a particular security. There are various methods by which Treasury could objectively determine that an endemic fail situation has arisen. For instance, Treasury might consider encouraging the Federal Reserve to modify its FR2004 to better monitor the overall level of fails in a particular government security. The Association stands ready to discuss the various alternatives and provide additional suggestions at a follow-up meeting, if Treasury is interested in pursuing this approach.
- Treasury might also study the feasibility of adopting an additional special regime that requires in extraordinary situations the sharing of information regarding all of the outstanding unsettled transactions in a particular security to a neutral third-party. Such reporting should only be required upon Treasury's own determination, in consultation with other regulators, that there is an endemic fail situation. Such a reporting regime could allow dealers to quickly identify and resolve "round-robin" fails and thus help facilitate the timely clean-up of endemic fail situations.
- The Buy-In Rule, as currently written, is particularly burdensome for participants in the MBS market that face aged fails involving an agency MBS sold on a TBA basis. Therefore, the aging period after which buy-ins are required for such MBS should be extended from the current 60 calendar days to 100 calendar days.
- Treasury should clarify the intended scope of the Buy-In Rule and its relationship to the Association's Buy-In Procedures.

Before discussing the Buy-In Rule in more detail, we would emphasize that the Association continues to fully support the development and implementation of a broader strategy – beyond amendments to the Rule – to improve the settlement process and reduce fails in the U.S. Treasury and MBS securities markets. Indeed, we have been working on various initiatives to achieve this result. For example, the Association recently published new Repo Trading Practice Guidelines on "prompt delivery" trading that are intended, among other things, to incentivize firms holding a particular security to make that security available to other market participants who need it to make delivery to a third-party. The Association's "prompt delivery" trading practice rests on an assumption that fails may be better addressed through the elimination of any artificial barriers to negative rate trading. Also, as you are aware, during the fails of 2003, the Association played an active role in organizing "round robins" and other efforts to reduce

fails. In addition, the Association also has been preparing amendments to its buy-in procedures for MBS to ensure those procedures are workable.

II. Overview and Background Regarding the Buy-in Rule.

The Buy-In Rule requires a government securities broker-dealer that executes a customer sell-order in government securities (other than one identified by the customer as a short sale) and that for any reason has not obtained possession of the securities within 30 calendar days (or 60 calendar days, in the case of MBS) after the settlement date to “immediately thereafter close the transaction with the customer by purchasing, or otherwise obtaining, securities of like kind and quantity.”³ The buy-in requirement therefore applies only when the broker-dealer fails to receive a security sold long by a customer. It does not apply when the party failing to deliver the security is another broker-dealer. Nor does it require a broker-dealer to close-out a transaction in which it is failing to deliver securities to another party (whether a customer or another broker-dealer).⁴

Several different policy rationales for the Rule have been articulated over the years. In fact, questions about the feasibility and appropriateness of requiring buy-ins of government securities were first raised even before the adoption of the Rule in connection with the SEC’s 1973 adoption of a buy-in requirement under Rule 15c3-3(m). The SEC noted that its buy-in rule was, among other purposes, intended to allow “the broker-dealer to be able to promptly redeliver to other broker-dealers to whom deliveries are owed” and to “improve securities processing mechanisms employed by the securities industry by increasing the availability of securities to make deliveries and to accomplish timely settlements and thereby reduce fails in the settlement process.”⁵ Shortly before Rule 15c3-3(m) became effective, however, the SEC temporarily suspended the rule for exempted securities because of concerns that the rule would create “operational” problems in connection with such securities.⁶ The SEC noted that it did not “intend that a provision designed to improve the financial responsibility and related practices of broker-

³ Treasury Rule 403.4(m), 17 C.F.R. § 403.4(m) (2004).

⁴ We note that the definition of “customer” for these purposes refers to a person “from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of that person.” SEC Rule 15c3-3(a)(1). Most trading in the government securities market, however, occurs on a DVP/RVP basis, rather than with persons on whose behalf the broker-dealer receives, acquires or holds funds or securities. Substantial ambiguity therefore exists as to whether such DVP/RVP counterparties are “customers” whose fails are subject to the Buy-In Rule. While we have assumed for purposes of this letter that Treasury would take the position that transactions with such DVP/RVP counterparties are subject to the buy-in requirement, we recommend that Treasury clarify this issue in any future amendment to the Rule.

⁵ SEC Release No. 34-9974 (Jan. 30, 1973).

⁶ Id.

dealers cause operational hardships.”⁷ This suspension was subsequently extended indefinitely.⁸

The issue of buy-ins of government securities arose again beginning in 1987 with Treasury’s rulemakings to implement the Government Securities Act of 1986 (the “GSA”). Treasury initially proposed to terminate the suspension of the SEC’s buy-in rule with respect to government securities,⁹ but then opted to continue that suspension, noting its belief that

the actual impact of [the Buy-In Rule] in protecting customers against fails is uncertain in the government securities market. The [Treasury] also notes that the capital rules . . . contain certain incentives for clearing up fails on transactions. Given these considerations and the potential for disruption,¹⁰ the final regulations exclude the provision making [the Buy-In Rule] applicable to government securities.¹¹

In 1991, Treasury renewed its proposal to apply a buy-in requirement to government securities,¹² and eventually adopted the Buy-in Rule in 1994.¹³ In response to Treasury’s proposal, commentators had argued that the Buy-in Rule would have minimal customer protection benefits because the actual incidence of fails had diminished due to improvements in the settlement process and because there were

⁷ Id.

⁸ SEC Release No. 34-10093 (Apr. 10, 1973). With respect to municipal securities, the SEC noted “The Commission has been advised that primarily because of the very thin floating supply and numerous serial maturities of municipal obligations such securities may be difficult to buy-in and very often contracts to purchase such obligations may remain failing for long periods of time.”

⁹ Government Securities Act of 1986; Implementing Regulations, 52 Fed. Reg. 5660, 5674 & 5705 (Feb. 25, 1987) (the “1987 Proposing Release”).

¹⁰ Commentators had objected to the buy-in requirement with respect to MBS because of the frequent difficulties of buying in such securities, maintained that the buy-in requirement would cause difficulties for STRIPS and “off the run” Treasury issues or even with straight Treasury issues which normally trade in a deep market but are occasionally in short supply, and suggested that “onerous buy-in requirements could have an impact on the willingness of market participants to trade in certain issues throughout the Government securities market.” Implementing Regulations for the Government Securities Act of 1986, 52 Fed. Reg. 27910, 27921 (July 24, 1987) (the “1987 Final Rule Release”).

¹¹ 1987 Final Rule Release, 52 Fed. Reg. at 27921-22. Between the 1987 Proposing Release and the 1987 Final Rule Release, Treasury adopted a temporary rule that applied the SEC’s buy-in rule to government securities, except that buy-ins of MBS were not required until they were failed to receive for 30 days (rather than 10 days as provided by the SEC’s buy-in rule). Implementation of Regulations; Temporary Issuance with Request for Comments; Government Securities Act of 1986, 52 Fed. Reg. 19642, 19704 (May 26, 1987) (the “1987 Temporary Rule Release”).

¹² Implementing Regulations for the Government Securities Act of 1986, 56 Fed. Reg. 15529 (Apr. 17, 1991) (the “1991 Proposing Release”).

¹³ Implementing Regulations for the Government Securities Act of 1986; 59 Fed. Reg. 9403 (Feb. 28, 1994) (the “1994 Final Rule Release”).

adequate business incentives for broker-dealers to clean-up fails to limit their market exposure. Treasury stated its belief that

buy-in rules for customer sell orders are needed to strengthen customer protection because a customer's failure to deliver a security to an executing broker or dealer could result in that broker's or dealer's failure to deliver to another counterparty. Further, these rules will prevent customers from taking advantage of market fluctuations by refusing to deliver a security to a broker or dealer when the price rises after a sell order has been executed.¹⁴

Treasury did modify certain features of the SEC's buy-in rule to adapt it to the government securities markets.¹⁵ First, it lengthened the time period after which a sell-order fail must be closed out from 10 business days to 30 calendar days (or 60 calendar days for MBS) after the settlement date.¹⁶ In the case of MBS, the extended period was intended to accommodate the length of the settlement cycle applicable to MBS and the difficulty of buying in MBS (because of the complexities of the instruments, the particularities of the settlement process, and the scarcity in the market of specified pools).¹⁷ Second, the Buy-in Rule requires a broker-dealer to "close the transaction with the customer by purchasing *or otherwise obtaining*, securities of like kind and quantity" (rather than "close the transaction with the customer by purchasing securities of like kind and quantity," as provided by Rule 15c3-3(m)). This modification was made "to permit the use of alternatives other than purchasing securities (e.g., securities may be borrowed, substituted or bought back) in closing out orders."¹⁸

Although the Rule did not provide any further guidance as to how a broker-dealer could close out a fail, when proposing and adopting the Rule, Treasury noted that the Association (then the Public Securities Association) would be preparing recommended procedures for market participants.¹⁹ Such procedures (the "TBMA Procedures" or "Procedures") were published in October 1994 after a months-long, open process that included input from business, operations and legal personnel from TBMA member firms. Although the TBMA Procedures were never specifically approved by

¹⁴ 1994 Final Rule Release, 59 Fed. Reg. at 9405.

¹⁵ 1994 Final Rule Release, 59 Fed. Reg. at 9404-05.

¹⁶ 1994 Final Rule Release, 59 Fed. Reg. at 9405.

¹⁷ Treasury also noted that any buy-in would be allowed to settle on the next regularly scheduled settlement date for the particular class or pool of MBS. 1991 Proposing Release, 56 Fed. Reg. at 15530. The 1991 Proposing Release proposed these timeframes for buy-ins for fails to receive and the 1994 Final Rule Release adopted them for customer sell-order fails.

¹⁸ 1994 Final Rule Release, 59 Fed. Reg. at 9405. It is not clear how the borrowing of securities would in fact terminate the relevant transaction.

¹⁹ For example, in adopting the Rule, Treasury noted that it "understands [TBMA] will implement buy-in procedures for mortgage-backed securities similar to those in place for other government securities." 1994 Final Rule Release, 59 Fed. Reg. at 9405.

Treasury, various drafts were shared with Treasury and comments were received thereon.²⁰

III. Questions and Concerns Regarding the Current Buy-in Rule.

In the course of our considerations of the Buy-In Rule, a number of questions and concerns regarding the continuing efficacy of the Rule have been raised. We summarize these questions and concerns below.

A. Endemic Fail Situations.

There is a general consensus among our member firms that the Buy-In Rule is counterproductive in an endemic fail situation such as that which arose in the summer and fall of 2003. Under circumstances such as these – when securities “totally stopped clearing”²¹ – the execution of a buy-in will most likely result in another transaction that fails to settle. To the extent that the Rule is intended to allow a broker-dealer to obtain securities it can redeliver, or to protect the broker-dealer against counterparty failures, these policy objectives are not served by causing the broker-dealer to simply replace one fail to receive with another fail to receive.

More generally, since endemic fails are likely to result from unusual economic circumstances affecting the deliverable supply of a particular CUSIP generally, buy-ins are unlikely to reduce the overall net level of fails amongst all active market participants.²² In 2003, for example, a number of factors contributed to the shortage of supply and a sustained spike in fails in the “on-the-run” ten-year Treasury note. These factors included: (i) an extraordinary increase in trading volume associated with a sudden change in expectations regarding the direction of interest rates, (ii) a sudden increase in hedging activity by mortgage portfolio managers, (iii) an extremely low general collateral

²⁰ These Procedures state that a broker-dealer can close out a sell-order fail pursuant to the Rule by: (i) accepting delivery of “comparable securities;” (ii) selling the securities back to the customer (a “pair-off”) such that the customer pays an amount that includes accrued interest and bears the burden of any change in market value; (iii) conducting a buy-in; or (iv) to the extent the customer’s failure to deliver is caused by a failure to receive, accepting an assignment of the customer’s fail to receive transaction and effecting a cash settlement of the difference between the amounts owed on the two transactions. In addition, the Procedures specify detailed requirements for effecting a buy-in, including various notice requirements that are consistent with those established for buy-ins in other markets. In the case of MBS, the TBMA Procedures provide for the settlement of the buy-in on the next regularly scheduled settlement date following the execution of the buy-in, as was expressly contemplated by Treasury. See 1994 Final Rule Release, 59 Fed. Reg. at 9404. TBMA is presently in the final stages of publishing a revised set of procedures for MBS buy-ins to address some ambiguities that were uncovered during the recent endemic fail situation.

²¹ Michael J. Fleming and Kenneth D. Garbade, Repurchase Agreements with Negative Interest Rates, Current Issues in Econ. and Fin. vol.10 no.5 at 3 (April 2004) (available at http://www.newyorkfed.org/research/current_issues/ci10-5/ci10-5.html).

²² Any buy-in of a customer sell order fail would most likely be executed by a dealer’s cash desk which would enter into a new transaction via the inter-dealer market. However, to the extent that the inter-dealer market lacks an adequate supply of the particular security being bought in, such transactions may simply result in the creation of a new unsettled transaction.

repo rate, and (iv) a reluctance of holders of the issue to repo it out in the specials market when they could not be certain that it would be returned to them.²³ Endemic fails in the MBS market also may result from the fact that MBS issuance generally lags trading by two or three months and the supply that ultimately is issued in an environment of rising rates may be insufficient in relation to the trading volume. In short, the Buy-in Rule is unlikely to have any significant positive effect on the overall net level of fails arising due to these sorts of considerations.

The Association feels strongly that market practices designed to encourage the ultimate holders of a security to temporarily lend it out to dealers and other market participants are much more likely to be effective than rigorous enforcement of a buy-in rule. A security that continuously trades very “special” in the repo market for several days may never experience an endemic fail situation so long as there exists a clear set of market practices that encourage repo market participants to trade through a repo rate of zero. As noted, the Association’s recently developed “prompt delivery” trading practice is designed to ensure repo sellers are adequately incentivized to help the market avoid endemic fail situations in the future.²⁴

The Association also has significant concern that strict application of the Buy-In Rule in an endemic fail situation may have unintended but detrimental effects on the smooth functioning of relevant markets in times of market stress. To begin with, the threat of mandatory buy-ins may reduce the willingness of market participants to enter into new transactions that they are concerned might fail.²⁵ This could result in reduced liquidity in times of already high volatility – just when liquidity is most important – and significant uncertainty in the government securities market. Secondly, it is not clear that a successful buy-in is actually achievable under certain economic or market conditions. Adding to the problem is the fact that the Buy-In Rule prescribes certain conduct by dealers but does not, by its terms, expressly require customers to accept such buy-ins. Moreover, the consequences of an unsuccessful buy-in remain somewhat unclear under the Rule.

While recognizing that a large amount of unsettled transactions can present some level of risk to the broker-dealer community in general, the Association

²³ Thus, the May 2013 10-Year Treasury Note (which was the current on-the-run 10-Year Note, and thus a popular instrument for hedging interest risk) experienced a spike in demand to borrow the security and reduction in the amount of the security available to borrow via the repo or securities lending markets. The fact that the Federal Reserve Bank of New York could make no more than \$167 million in supply of the May 2013 10-Year Treasury Note available to dealers via its securities lending program was also viewed by some as a contributing factor.

²⁴ The Association also continues to investigate other trading practices that would create the proper economic incentives for market participants to make supply available and thus avoid any systemic problems associated with a limited supply.

²⁵ See 1987 Final Rule Release, 52 Fed. Reg. at 27921 (“One commenter also suggested that onerous buy-in requirements could have an impact on the willingness of market participants to trade in certain issues throughout the Government securities market. Another commenter predicted that a buy-in requirement could be competitively disadvantageous for primary dealers, which are required to make markets in Government securities”).

believes that the risks posed by unsettled transactions can be better addressed by encouraging dealers to engage in other risk mitigating efforts – such as encouraging firms to mark-to-market and margin their exposures to a failing counter party after a certain number of days. The Association also believes that strict enforcement of the Buy-In Rule must be weighed against the risks for the dealers and investors presented by such regulatory requirements, such as reduced liquidity in the cash markets, and confusion resulting from numerous unsuccessful buy-ins.

Under SEC Rule 15c3-3(n), broker-dealers are able to seek from their SROs individual, ad hoc, extensions of the time period before a buy-in is required.²⁶ This extension procedure provides a very useful mechanism for addressing, on a case-by-case basis, special situations arising in connection with a particular firm that warrant an exception from the buy-in requirement. In the Association's view, however, this procedure is not adequate to deal with an endemic fail situation. In an endemic fail, if buy-ins are not workable for one broker-dealer, they generally are unworkable for all broker-dealers. In addition, as demonstrated by our collective experiences in the fall of 2003, this approach is cumbersome and resource-intensive for both broker-dealers and regulators. We therefore recommend, as explained infra, that Treasury consider making it clear in advance that it will automatically suspend certain requirements of its Buy-in Rule with respect to transactions involving a particular security that is experiencing an extreme and sustained endemic fail situation.²⁷

B. Non-Endemic Fails.

Even outside an endemic fail scenario, legitimate questions have been raised about the extent to which the Buy-in Rule clearly advances its purposes, and whether those purposes themselves justify the costs imposed by the Rule. As noted above, one purpose of the Buy-in Rule is “to strengthen customer protection because a customer's failure to deliver a security to an executing broker or dealer could result in that broker's or dealer's failure to deliver to another counterparty.”²⁸ The Buy-in Rule, however, applies without regard to whether the broker-dealer has an offsetting delivery

²⁶ Under Rule 15c3-3(n), upon application by a broker-dealer, an SRO is permitted to extend the time before which the broker-dealer is required to take action to buy-in a security when the SRO “is satisfied that a broker or dealer is acting in good faith in making the application and that exceptional circumstances warrant such action.” The applicability of this authority to the government securities market was affirmed by Treasury in the 1991 Proposing Release: “In addition, if more than ten days are needed, the appropriate regulatory authorities have the authority to extend the buy-in period.” 56 Fed. Reg. at 15531.

²⁷ This automatic suspension of certain requirements of the Buy-in Rule should occur regardless of whether the endemic fail situation arises from a sustained reduction in the “street supply” or “float” of a particular security or a sustained increase in demand for a particular security in the repo markets due to new hedging or short selling activity in the marketplace.

²⁸ 1994 Final Rule Release, 59 Fed. Reg. at 9405.

obligation to a customer (or, indeed, to any other person). The Buy-in Rule therefore requires buy-ins when there is no customer protection issue.²⁹

Another rationale articulated for the Buy-in Rule is to “prevent customers from taking advantage of market fluctuations by refusing to deliver a security to a broker or dealer when the price rises after a sell order has been executed.”³⁰ The Buy-in Rule, however, applies without regard to whether prices have risen or fallen since the sell order has been executed. Moreover, broker-dealers have numerous remedies available to them when a customer defaults on its obligation to deliver securities to protect themselves against attempts to take advantage of market fluctuations. For example, a broker-dealer could require a customer to post margin after a certain number of days to cover any market-to-market exposure the dealer has to the customer arising from unsettled transactions. It is not clear why the customer or the broker-dealer is protected by requiring the broker-dealer to close out the transaction at a particular time, rather than allowing the broker-dealer to select among these various remedies.

More generally, there is some concern that the Rule rests on incorrect assumptions. For example, the Rule appears to assume that fails arise due to inappropriate actions or trading activity. In fact, some level of fails can arise in the normal course of trading in the U.S. Treasury market, especially given the demand for certain U.S. Treasury securities as a result of their use in establishing an interest rate benchmark off of which other securities can be traded on a spread basis and their use as a hedging instrument.³¹ In the MBS market, sell-order fails may also be the normal result of the scarcity of specific pools, the complexity of MBS and their extended settlement cycle.³²

In addition, the Rule appears to be based on the perception that the parties lack sufficient incentives to resolve fails. To the contrary, since the seller remains obligated to deliver the securities it sold, together with any distributions paid thereon prior to settlement, but the purchase price does not accrue any interest while the fail is outstanding, the seller loses the time value of the purchase price (i.e., the opportunity to reinvest the proceeds from the sale of the security) while the fail is outstanding.³³ Similarly, significant incentives are created for broker-dealers to close out failing

²⁹ As noted below, moreover, the methods of closing out a fail described under the TBMA Procedures would not necessarily result in the broker-dealer receiving delivery of the relevant securities.

³⁰ 1994 Final Rule Release, 59 Fed. Reg. at 9405.

³¹ See John Kambhu, “Trading Risks and Volatility in Interest Rate Swap Spreads,” Federal Reserve Bank of New York Staff Reports (Staff Rep. 178, Feb. 2004) (available at http://www.newyorkfed.org/research/staff_reports/sr178.pdf).

³² See 1991 Proposing Release, 56 Fed. Reg. at 15530.

³³ See Michael J. Fleming and Kenneth D. Garbade, Repurchase Agreements with Negative Interest Rates, Current Issues in Econ. and Fin. vol.10 no.5 (available at http://www.newyorkfed.org/research/current_issues/ci10-5/ci10-5.html) for a more complete discussion.

transactions by the net capital and reserve formula charges applicable to aged fails to receive as well as fails to deliver.³⁴

IV. Potential Modifications to the Buy-in Rule.

In light of the questions and concerns identified above regarding the efficacy of the Buy-In Rule, consideration might reasonably be given to eliminating the Rule entirely.³⁵ Although the Association would be unlikely to object to such an approach, for purposes of this letter we have assumed that Treasury would prefer to retain the Rule in some form if practicable, and we therefore have focused instead on identifying more limited modifications to the Rule. We describe several such modifications below.

The following recommendations are preliminary in nature. We would welcome the opportunity to work with Treasury staff and other regulatory agencies to implement any of our suggestions and help identify other initiatives that will reduce the circumstances in which fails routinely and consistently occur in a particular U.S. Treasury or MBS security for an extended period of time.

A. Suspend the Buy-In Requirement in an Endemic Fail Situation.

We urge Treasury in consultation with other regulators to consider suspending the buy-in requirement when fails in a particular security reach an “endemic” level. Several factors support such a suspension.

First, for the reasons described above, in the “endemic” fail situation the Buy-In Rule simply does not work. If buy-ins are required when securities are not available, those buy-ins will result in new fails – an outcome that does not achieve any regulatory objective. The risk to the broker-dealer will not have been reduced, nor will the broker-dealer have obtained securities to deliver to any customers to whom it may be failing. Worse yet, in the endemic situation the buy-in requirement may well adversely affect liquidity and confidence in the government securities markets, since dealers will be more reluctant to execute trades if supplies are limited and they expect that buy-ins may be required. Whatever circumstances have caused the shortage in supply will only be exacerbated by additional disincentives to trade.

Second, although endemic fails may present potential risks to the markets and market intermediaries, current net capital requirements under SEC Rule 15c3-1 and reserve formula requirements under SEC Rule 15c3-3 provide more than adequate protection for broker-dealers – and for their customers – against any insolvency of such broker-dealers or their counterparties. These rules not only protect broker-dealers (and thus their customers) from any exposures to failing counterparties, but also impose what are in effect economic penalties on broker-dealers with aged fails, thereby creating

³⁴ See SEC Rules 15c3-1 and 15c3-3.

³⁵ The Association notes that, when the Buy-In Rule was proposed TBMA (then PSA) objected to its adoption for both policy and operational reasons.

significant incentives for those broker-dealers to resolve such fails. Indeed, we believe that in an endemic fail situation the “penalty” feature of these capital charges – which we note place burdens only on the broker-dealer and not on the customers that are failing to deliver to such broker-dealers – may be excessive. During the fails of 2003, for example, the capital charges applicable to large broker-dealers as a result of such fails became extremely onerous and led to discussions with the SEC staff regarding relief from such charges. For this reason, we believe it would also be appropriate for Treasury and the SEC to modify both the net capital requirements to reduce charges for fails and modify the aggregate debit calculation under Rule 15c3-1 to exclude such fails.

If, notwithstanding the current capital treatment of fails and the economic incentives that exist for cleaning-up aged fails, Treasury continues to have concerns about the counterparty risks posed by an endemic fail situation, the Association recommends addressing these concerns through means other than a buy-in requirement. For example, the suspension of the Rule could be conditioned on the broker-dealer engaging in risk mitigations steps, such as margining and providing a third-party with specific information about the amount and status of its existing fails. Such a reporting requirement was imposed on some broker-dealers during the fails of 2003 as a condition to receiving temporary relief from the Buy-In Rule and provided SROs with substantial information regarding the extent and nature of the broker-dealer’s fails.

Alternatively, the suspension of the Buy-In Rule in an endemic fail situation could be conditioned on the broker-dealer having established adequate risk management mechanisms to monitor and limit its credit exposures under any aged fails. Such risk monitoring and management systems would provide flexibility for the broker-dealer to take whatever actions it deemed appropriate under the circumstances to address fails – including, for example, obtaining collateral from the customer, limiting new transactions with the failing customer, or even buying-in the customer. Reliance on broker-dealers’ own risk management practices in this manner would be consistent with several other recent regulatory initiatives aimed at managing broker-dealers’ risk exposures. For example, under recently-adopted amendments to the margin requirements of NYSE Rule 431, in certain circumstances a broker-dealer’s margin and capital requirements depend on the existence of adequate risk monitoring and management procedures.³⁶ In addition, the SEC’s recent rulemakings regarding “consolidated supervised entities” provided greater flexibility to broker-dealers in calculating capital requirements – and likely reduced capital charges – for broker-dealers that have in place appropriate risk management procedures (among other requirements).³⁷

If Treasury determines to pursue the approach of suspending the Buy-In Rule in an endemic fail situation, obviously a number of additional issues would need to be addressed. The Association stands ready to assist Treasury in this effort by fleshing out these concepts and proposing more specific recommendations. For example, it would be necessary to develop a mechanism for determining what constitutes an endemic level

³⁶ See NYSE Information Memo 03-42 (Sept. 29, 2003).

³⁷ Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Release No. 34-49830, 69 Fed. Reg. 34428 (June 21, 2004).

of fails, including a means to measure the actual level of fails to determine whether the designated threshold has been reached. In addition, when the fail ceases to be widespread, broker-dealers should be provided an additional grace period before a buy-in is required – in order to avoid potential market disruption caused by extensive buy-ins being conducted at or about the same time.

B. Possible Solutions for Resolving Endemic Fail Situations.

The Association recommends that Treasury explore the possibility of facilitating the creation of a regime whereby, in extraordinary circumstances, broker-dealers are required to report information to a neutral third-party regarding their outstanding fails in government securities. The mandatory sharing of specific trade details regarding unsettled transactions should only be triggered once Treasury determines that a significant level of fails is occurring in a particular government security and such fails are likely to stay extremely high for the foreseeable future. The reporting of timely information regarding fails would serve a number of purposes. For instance, a neutral third-party could use such information to facilitate the clean-up of “round robin” fails and otherwise help the parties involved reduce their net level of fails via net settlement for money differences.

We recognize that Treasury would probably need clear and reasonable criteria for determining when to activate any extraordinary fails reporting requirements. The Association would be pleased to offer its assistance in helping Treasury evaluate some of the possible policy options. Among the various options we have identified are: (i) utilizing the FR2004 data the Federal Reserve currently collects from the primary dealer community on a weekly basis regarding the overall level of fails in the government securities market; (ii) encouraging the Federal Reserve to modify its FR2004 so that it can request that all primary dealers submit data on their outstanding fails on a particular security; and (iii) utilizing fail data that already exists within the dealer community.

We also recognize that Treasury would probably need to think about the appropriate third-party recipient and nature of the specific information collected already regarding outstanding fails in a particular security and when such reporting requirements should terminate. Here again, the Association would be pleased to offer its assistance in helping Treasury evaluate some of the possible policy options. Among the various possible recipients we discussed were: (i) submission to a regulatory agency or self-regulatory organization; (ii) submission to a central utility; and (iii) submission of the details to the Federal Reserve.³⁸

Finally, we recognize that the reporting of specific trade details to a third-party might also be done on a voluntary basis, but we believe that there may be some added benefits to making it mandatory. For example, mandatory reporting would ensure consistency in the nature and amount of the information that is being provided. In addition, a mandatory reporting regime would help address concerns expressed in the

³⁸ As noted above, the Federal Reserve currently collects some general data from the primary dealer community on the overall level of fails in the government securities market as part of its FR2004 reporting regime.

past regarding dealers' legal right to disclose trade details or financial information about their customers and counterparties to third parties, even when the purpose of such disclosure is merely to facilitate the settlement of trades with such counterparties.³⁹

C. Extend the Aging Period After Which Buy-Ins are Required for MBS.

The Association recommends that the "aging" period after which buy-ins are mandatory for government MBS sold on a TBA basis be extended from the current 60 calendar days to 100 calendar days.

The settlement of TBA transactions in MBS, and the resolution of any such transactions that fail to settle as scheduled, present a number of unique issues. In particular, in order to adequately process the settlement of these trades – including the allocation of the relevant "pools" of securities, the calculation of the amortization and pre-payment amounts, etc. – such settlement normally occurs on standardized dates on a monthly basis. Although the adoption of standardized settlement dates has greatly reduced the incidence of fails,⁴⁰ an additional consequence is that, if a transaction fails to settle on the originally scheduled date, the next relevant standard settlement date will be in the subsequent month. Resolution of the fail prior to that date often will not be practicable.⁴¹ Indeed, Treasury has recognized this issue by allowing buy-ins to settle on the next regularly scheduled settlement date "in order to avoid the additional expenses associated with abnormal settlements."⁴² In addition, in a changing rate environment the new issue supply of mortgage pools may be insufficient to settle the current month's demand. Supply may lag two to three months.

Because of the timing of the standard settlement dates (and the existence of months with 31 days), however, the current 60 calendar day "grace" period in the Rule may in fact provide only one opportunity to resolve an MBS fail. TBMA believes that the buy-in requirement should be imposed only after market participants have had adequate opportunity to resolve the fail. Extending this period to 100 days generally would provide at least three opportunities for the parties to effect settlement of the failing trade.

³⁹ Of course, additional steps may be necessary to address potential confidentiality issues in connection with any potential disclosure of the reported information to third parties – e.g., to resolve "round robins".

⁴⁰ See 1991 Proposing Release, 56 Fed. Reg. at 15530.

⁴¹ For example, it generally is not practicable to acquire the relevant securities through the secondary market, where the securities often trade in smaller size and there is no "special" repo market that would facilitate delivery. In addition, the creation of the pools of mortgages that must be aggregated and delivered to close out the failed transaction generally also follows this monthly cycle; a party that fails to deliver the MBS therefore generally will not be able to locate alternative pools to settle a transaction until the subsequent standardized settlement date. Even if the party that fails to deliver is able to locate alternative pools, it will have to pay a premium to obtain delivery of them on a date other than a standard settlement date.

⁴² 1991 Proposing Release, 56 Fed. Reg. at 15530. See also 1994 Adopting Release, 59 Fed. Reg. at 9404.

D. Clarify That TBMA Procedures Satisfy Requirements of the Rule.

The Association recommends that Treasury clarify, either through an amendment to the Rule or via an interpretation, that: (i) the methods of closing out a sell-order fail described in the TBMA Procedures are consistent with the requirements of the Rule, and (ii) the timeframes for effecting a buy-in under the Procedures satisfy the requirements of the Rule.

Because certain of the close-out mechanisms described in the TBMA Procedures do not result in the broker-dealer receiving actual delivery of securities,⁴³ questions may arise as to whether the Procedures are consistent with the requirements of the Rule. As noted above, there is some ambiguity in the Rule as to how a broker-dealer should “close the transaction with the customer” – the Rule refers to “obtaining” the securities, but Treasury clearly contemplated a range of close-out techniques, including some which would not necessarily result in the actual receipt of securities by the broker-dealer.⁴⁴

In our view, the Procedures should be interpreted as being fully consistent with the requirements of the Rule. Treasury explicitly noted in its 1994 Final Rule Release that the manner in which transactions could be closed out would be addressed in greater detail in the TBMA Procedures, which were reviewed informally by Treasury staff prior to their adoption.⁴⁵ We note further that having the options described in the Procedures available provides a broker-dealer with important flexibility to close out a transaction in a manner that is most appropriate under the circumstances. Any one of these mechanisms serves to protect the broker-dealer against a customer who is “playing the market,” and none of them preclude a broker-dealer that has another delivery obligation from “otherwise obtaining” the security to make that delivery – e.g., by purchasing it, borrowing it or entering into a reverse repurchase agreement on it.

The timeframes established under the Procedures for effecting a buy-in also should satisfy the requirement in the Rule that the broker-dealer “immediately” close out the transaction. Any effective buy-in procedure must require that adequate notice be given to the seller before the buy-in. Indeed, other regulatory buy-in regimes also establish notice requirements.⁴⁶ Requiring such notices to be sent immediately upon the expiration of the applicable time periods under the Rule constitutes an “immediate” step towards closing out the transaction. Moreover, the only alternative approach would be to require notices to be sent *before* the expiration of the applicable timeframes established in

⁴³ For example, if securities are sold back to the customer, or if the broker-dealer takes an assignment from the customer of a fail to receive from another party, the broker-dealer does not actually receive delivery of the relevant securities.

⁴⁴ For example, according to the 1994 Final Rule Release, the transaction could be closed-out when the broker-dealer “bought back” the customer transaction (which presumably refers to a “pair off”). 59 Fed. Reg. at 9405.

⁴⁵ See, supra note 19.

⁴⁶ See, e.g., NASD Uniform Practice Code 11810.

the Rule. This approach, however, would in effect shorten those time frames, create significant operational burdens for the parties, and serve to distract them from using the time allotted under the Rule to resolve the existing fail. Therefore, Treasury should make it clear that good faith efforts to buy-in securities pursuant to the Procedures satisfy the technical requirements of the Rule.

* * *

The Association very much appreciates this opportunity to offer our views on the Buy-In Rule to Treasury staff. We would welcome further dialogue with you on this matter. If you have any questions regarding this letter, please feel free to contact the undersigned at 646.637.9222, Robert Toomey at 646.637.9224 or Nadine Cancell at 646.637.9228.

Sincerely,

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