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**Via Electronic Mail and Federal Express**



October 4, 1999

Ms. Lori Santamorena  
Director  
Government Securities Regulation Staff  
Bureau of the Public Debt  
Department of the Treasury  
999 E Street N.W., Room 515  
Washington, DC 20239-0001

Re: Proposed Rule Regarding Marketable Treasury  
Securities Operations

Dear Ms. Santamorena:

The Bond Market Association (the "Association")<sup>1</sup> appreciates the opportunity to comment on the proposed rule<sup>2</sup> (the "Proposed Rule") issued by the Department of the Treasury ("Treasury") relating to terms and conditions under which Treasury may redeem outstanding, unmatured marketable Treasury securities. The Association concurs with Treasury's view that instituting a buy-back program offers Treasury an important new means of managing the government's debt and responding to the government's improved fiscal condition. Moreover, the Association commends Treasury for actively investigating various avenues to preserve the liquidity of the Treasury market and by extension all the fixed-income markets.

Although the dealers are generally very supportive of Treasury's instituting a buy-back program, they have articulated some concerns and recommendations regarding this potential program. First, they strongly urge that the accounting policy that requires market premiums paid in connection with repurchasing Treasury securities to be expensed in the year incurred be changed to permit amortizing such premiums over the remaining life of

<sup>1</sup> The Bond Market Association is the bond market trade association, representing securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. Its members include all of the primary dealers recognized by the Federal Reserve Bank of New York, as well as other government securities dealers. More information about the Association can be found at its Internet website <http://www.bondmarkets.com>.

<sup>2</sup> 64 *Fed. Reg.* 42626 (August 5, 1999)



the securities repurchased. Even if the accounting policy is not changed, dealers believe that, under current market conditions and economic environment, the benefit of redeeming issues that trade at a premium still outweighs the disadvantage of expensing the premium in the year it is paid. Second, dealers request Treasury consider conducting buy-backs on a regularly scheduled basis at or about the time conventional auctions are conducted. Third, dealers recommend that, as Treasury determines the amount of a particular issue to redeem, it be mindful of the effect such repurchases may have on the liquidity of that issue remaining outstanding after the buy-back. To prevent investors and dealers from being unable to cover open short positions, dealers strongly recommend Treasury adopt a policy not to repurchase more than ten percent of the current amount outstanding of any particular issue at any given time. Fourth, dealers request the settlement date be at least two business days after the deadline for submissions of offers, rather than one business day. In addition, Association members strongly request Treasury consider making the length of time as short as possible between the close time of submissions and when the confirmations are provided to submitters, given dealers' potential exposure to market risk during such time. Fifth, dealers suggest the definition of "accrued interest" be clarified to prevent confusion among investors regarding the amount payable at settlement. Lastly, the dealer community believes there are no technical or operational issues resulting from using the Federal Reserve Bank of New York's ("FRBNY") electronic systems as proposed for conducting reverse-auctions. These points are discussed in further detail below in seriatim.

### **Accounting Policy Issues**

It is the Association's understanding that, under current Office of Management and Budget accounting policy, any market premium paid by Treasury in redeeming securities must be recorded as an interest expense in the fiscal year the buy-back is conducted. Conversely, if Treasury were to repurchase a security at a price below par, the discount would serve to reduce interest expense in the year the buy-back occurs. The projected amount of excess cash available for buy-backs could be substantial given the anticipated large incoming tax revenues and the current sizes of regularly scheduled issuances of Treasury securities. Therefore, Treasury's choice of the specific issues repurchased could materially affect the recorded interest expense<sup>3</sup> and, in turn, the size of the budget surplus.<sup>4</sup> Ideally, the accounting policy should be modified to better reflect economic reality by allowing any repurchase premium or discount to be amortized over the remaining life of the bond repurchased. Such a change will allow Treasury's repurchase objectives to be better aligned with the goal of lowering overall borrowing costs.

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<sup>3</sup> For example, the outstanding debt of approximately \$248 billion that is scheduled to mature between 2015 and 2021 has a current combined market value of \$308 billion. This translates to an average premium dollar price of \$124.

<sup>4</sup> The term "surplus" refers to the government's unified surplus, which includes Social Security trust funds.



Even if the accounting policy issues are not resolved, the dealer community believes the benefit of redeeming issues that trade at a premium outweighs the disadvantage of expensing the premium in the year it is paid for several reasons. First, any premium paid to buy back a bond will be offset by the avoidance of paying a higher-than-market coupon on the bond had it not been repurchased. Second, Treasury's willingness to repurchase a significant amount of securities that trade at a premium permits Treasury to better achieve one of its principal objectives: shortening the average maturity of the nation's debt. The dealers believe the more attractive candidates for achieving this goal are scheduled to mature after 2014. These securities, however, for the most part trade at a premium. Third, in some instances, Treasury can receive better value in purchasing seasoned Treasury securities—securities that have been outstanding for some time and which are no longer on-the-run. Seasoned securities trade “cheap,” meaning an investor earns a higher rate of return than for a newly issued security.<sup>5</sup> Because interest rates have generally declined over the last 20 years, many of these cheaper off-the-run securities trade at premiums.

If Treasury decides to implement the buy-back program without being willing to incur sizable premiums, we believe the value of the buy-back program will be substantially diminished. Given that most securities sell at a premium, the size of the buy-back program would have to be significantly curtailed. This could hinder Treasury's ability to sustain the liquidity of Treasury benchmark securities going forward, assuming the budget surplus continues to improve as projected. Moreover, conducting the buy-back program by primarily concentrating on redeeming securities that trade at or close to par, almost to the exclusion of all other issues, could be disruptive to the smooth-functioning of the Treasury market.

### **Announcing Reverse-Auctions**

Association members recommend the redemption operation announcement be issued approximately 3-5 business days prior to any reverse-auction date. This notice period is necessary for adequate price discovery, allowing dealers an opportunity to canvass their customers to determine the level of interest. Adequate time is needed given that dealers are faced with coordinating offers from numerous customers, including customers abroad, as investors can only submit offers through the primary dealers. The dealer community agrees that the redemption operation announcement should specify (1) the

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<sup>5</sup> Former on-the-run securities can trade cheaply for several reasons. First, as on-the-run issues age they lose their status as on-the-run issues primarily because they cease being actively traded and find their way into the portfolios of buy-and-hold investors. Consequently, their yields relative to similar issues rises slightly and their prices becomes cheaper. Second, certain securities with 15 years or longer to maturity are eligible for delivery against the Chicago Board of Trade's Treasury bond futures contract, a very active hedging and trading instrument. When these long-term bonds have less than 15 years to maturity and are no longer deliverable against the T-bond futures contract, they are priced less aggressively and carry a higher yield, i.e., they are cheaper. Third, off-the-run bonds with years-to-maturity shorter than 30 years, tend to trade more cheaply than securities whose years-to-maturity are closer to 30 years.



total redemption amount, (2) the eligible securities, (3) the total privately held amount of each eligible security, (4) the reverse-auction date and (5) the settlement date.

With regard to the term "eligible securities," the Association members believe Treasury is best served by identifying targeted sectors rather than the specific issues because the market price of those specific issues may increase as a result of the announcement. Dealers believe that any such announcement effect,<sup>6</sup> however, could be mitigated by disclosing the sectors of the yield curve from which securities will be redeemed rather than the specific issues. By limiting the scope of each reverse-auction to one or two sectors at a time, Treasury will make the logistics of dealers' participation in the buy-back program significantly easier. Dealers will be better able to canvass customers and obtain custody of the securities for delivery of the securities to Treasury by the reverse-auction settlement date. It will also simplify Treasury's task of deciding which offerings to accept in a timely manner. Thus, Treasury's limiting its reverse-auctions to a particular sector(s) rather than to various issues throughout the yield curve is beneficial for both Treasury and the participating primary dealers.

Association members recommend Treasury announce its anticipated buy-back plans for the following quarter at its regularly scheduled quarterly refunding press conference as it currently does for conventional auctions. It would be helpful if the pre-announcement included the number of reverse-auctions to be conducted within a specified time frame (e.g. two reverse-auctions within a particular calendar quarter).

### Scheduling Reverse-Auctions

Association member's request Treasury consider conducting buy-backs on a regularly scheduled basis.<sup>7</sup> A regular reverse-auction schedule would be consistent with Treasury's long-standing practice of predictable financing patterns. Dealers believe that a regular schedule could widen the breadth of investors who participate in the buy-backs, just as the quarterly refunding process for many years has attracted widespread involvement among investors and securities dealers alike. In addition, a regular schedule of reverse-auctions would minimize any negative market effect by spreading it over a period of time rather than concentrating it at one point in time.

Association members also encourage Treasury to consider scheduling the regular reverse-auctions so that the time between conventional auctions and reverse-auctions is minimized. If done in conjunction with refunding auctions, buy-backs and the refunding will likely attract even more attention. Doing so will minimize Treasury's exposure to inter-

<sup>6</sup> The announcement effect arises when the secondary-market price of a security increases when market participants become aware that there may be a large buyer in the market for that security.

<sup>7</sup> Treasury has expressed an interest in possibly using its buyback program as a cash management tool. Association members believe that implementing a regular schedule of reverse-auctions does not preclude Treasury from conducting buybacks on an ad hoc basis. For example, Treasury could still conduct buy-backs to absorb excess cash in periods when revenues greatly exceed immediate spending needs.



est rate fluctuations, allowing Treasury better assurance of savings in borrowing costs by repurchasing higher-yielding off-the-run issues with proceeds raised from lower-yielding new issues. Shortening the time between the two types of auctions would also create a more stable Treasury supply and would reduce the normal market concession associated with issuing and repurchasing debt. Moreover, investors benefit from being able to swap more easily from off-the-run issues into the new supply of on-the-run issues.<sup>8</sup> In addition, a shorter time frame will facilitate dealer-hedging activities done in conjunction with their purchases and sales of Treasuries.

### **Liquidity of the Remaining Securities Outstanding**

The preamble to the Proposed Rule expressly mentions the possibility that, following a buy-back, the privately held amount still outstanding of a particular security could be very small. Even though dealers recognize the overall Treasury market liquidity should be enhanced by adding liquidity in the form of larger benchmark issues, dealers are very concerned about the implications to the liquidity of particular issues after Treasury has repurchased large amounts<sup>9</sup> of such issues. In certain instances, the government's purchase could exacerbate the technical nature of certain issues, which may already trade tightly in the financing markets. An investor that has sold short an issue may find it more difficult, or perhaps even impossible, to cover that short position if Treasury repurchases the issue. To prevent this problem, Association members strongly urge Treasury to reconsider its position that it will not set any limits on the amount or percentage of the outstanding amount of a security that could be redeemed. The dealers believe that, for the smooth-functioning of the markets, Treasury should adopt a policy not to repurchase more than ten percent of the current amount outstanding of any particular issue at any given time. Association members believe that such a policy will enable dealers to sell short the issue, which is important since short sales add to the issue's overall liquidity, without fear of substantial risk. Finally, instituting such a policy will also enable Treasury to receive the best price when conducting a buy-back, particularly with respect to technical issues which are likely to be trading richer than other similar issues.

### **Time Periods**

As currently written, the preamble to the Proposed Rule provides that settlement will occur one business day after the deadline for submission of offers. Dealers unanimously agree that this allotted time period is too short. Dealers have reasoned that additional time is needed for them to inform their customers that their offers have been accepted and to obtain custody of the redeemed securities. Since all tenders must be submitted through the primary dealers, the dealers are potentially faced with accommodating many tenders.

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<sup>8</sup> Investors can roll the proceeds received from the buy-back to purchase new issues even if the auction of the new issues is scheduled before the buy-back auction, as long as settlement of the buy-back occurs prior to the settlement of the new issues.

<sup>9</sup> Although the critical level of the remaining floating supply may vary from issue to issue, every issue has a threshold level below which its liquidity could become severely jeopardized.



The preamble explains that a next-day delivery time was chosen because it follows current market convention for other Treasury securities transactions. Association members would like to note that this is not the case for conventional auctions, where the settlement period can be several days. More importantly, Treasury transactions in the secondary market are not subject to a sales penalty such as the one provided in Section 375.31 of the Proposed Rule. Lastly, a longer settlement time is needed for a reverse-auction than for a coupon pass because dealers primarily satisfy their deliveries to the FRBNY using securities from their own proprietary accounts. Whereas, in a reverse-auction, where all submitters must sell their securities through the primary dealers, additional time is required for the primary dealers to receive these securities in a timely manner in order to prevent a delivery default to Treasury. For these reasons, the Association strongly urges Treasury to consider allowing at least two business days between the deadline for submission of offers and the settlement date.

As currently written, the Proposed Rule is silent on the length of time between the closing time for submissions and the time the confirmations will be provided to submitters. It is very important to the dealer community that this time period be as short as possible given dealers' potential exposure to market risk. When the FRBNY conducts a coupon pass using the Trading Room Automated Processing System ("TRAPS"), submitting dealers are notified within ten to twelve minutes. Association members strongly request that Treasury consider making the response time for its redemption operations comparable to the one for coupon passes, given that TRAPS will also be utilized.

#### **Definition of Accrued Interest**

To avoid confusion, Treasury may want to clarify the definition of the term "accrued interest" in the Proposed Rule so that it better conforms to the description provided in the preamble. We recommend that the term "accrued interest" be redefined "as an amount payable by the Treasury as part of the settlement amount for the interest income earned between the last interest payment date *up to and including* the settlement date." [recommended text change is italicized] The Association believes that this change will cause less confusion among investors regarding the amount payable at settlement.

#### **No Technical or Operational Issues Foreseen**

The Proposed Rule suggests the buy-back program be implemented using TRAPS, which is currently utilized by the FRBNY to engage in open market transactions and facilitate transfers of securities to Treasury at settlement. Given the high demand on resources of systems departments for projects such as preparing computers to accommodate the Year 2000 date change, the dealer community is pleased that little to no material system changes will be needed for the dealers to participate in Treasury's buy-back program. Moreover, our members believe there are no operational limitations or problems at the dealer level involved with using TRAPS.

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The Association appreciates the opportunity to comment on the Proposed Rule and looks forward to continuing the exchange of ideas between Treasury and market participants. Any questions regarding this letter may be directed to the undersigned (Susan Estes at 212.761.2316 or Charles Parkhurst at 212.723.6178) or Paula H. Simpkins, Vice President and Associate General Counsel, of the Association's staff (212.440.9431).

Sincerely,

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cc: Gary Gensler, Under Secretary, Office of Finance, *Department of the Treasury*  
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