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July 26, 2001

Mr. Jeffrey I. Neubert, C.E.O.
The New York Clearing House (NYCH) Association
100 Broad Street
New York, NY 10004

Mr. Robert McGovern, Chairman of the Operations Committee
The Boston Clearing House Association
600 Atlantic Avenue Boston, MA 02106

Ms. Carol P. Bright
Chairperson, *The Bank Depository User Group*
c/o Wachovia Bank, N.A.
301 North Church Street
Winston-Salem, NC 27150

Dear Jeffrey, Robert and Carol,

The Bond Market Association¹ (the "Association" or "TBMA") is pleased to respond in more detail to your letter dated April 12, 2001 regarding our dealer-to-customer good delivery guidelines for Fedwire securities published in the Association's Government Securities and Uniform Practices Manuals (collectively, the "Good Delivery Time Guideline" or the "Guideline"). You have requested that TBMA rescind the Good Delivery Time Guideline.

We stand ready to discuss this matter further with you if you continue to believe that would be worthwhile. However, this letter responds in detail to your concerns and, based upon our detailed review, we have no current intention of changing the Guideline.

The Association continues to believe that the Good Delivery Time Guideline represents a desirable and beneficial recommended market practice that plays an important role in the smooth and efficient functioning of the fixed income securities markets.² By allowing dealers to perform their crucial function as intermediaries between the sellers and the ultimate buyers of securities - customers -the Good Delivery Time Guideline contributes to the liquidity of these securities markets. The contribution to liquidity arises from the certainty that the Good Delivery Time Guideline adds to the process. All participants in the fixed income securities markets that settle through Fedwire benefit from the overall reduction in settlement fails that results from the Guideline.

¹ The Association represents securities firms and banks that underwrite, distribute and trade fixed income securities, both domestically and internationally. The Association's member firms collectively represent in excess of ninety-five percent of the initial distribution and secondary market trading of municipal bonds, corporate bonds, mortgage and other asset backed securities, as well as other fixed income securities. Further information regarding the Association and its members and activities can be obtained from our web site (www.bondmarkets.com).

² From Congress' statements in adopting Section 17A of the Securities Exchange Act of 1934 to the G-30 Report on securities settlements, every group that has analyzed securities settlements has stressed the need for certainty and timeliness of settlement.

In response to your letter, we have set out a detailed discussion of why the Good Delivery Time Guideline should not be eliminated and explain why we believe that the Good Delivery Time Guideline is consistent with the goals of participants in the relevant securities markets and Congress' stated purpose.

Market-Driven: The Association disagrees with your statement that the Good Delivery Time Guideline "no longer has any justification or place in today's highly automated book-entry environment." We believe that the delivery time structure is market-driven. The continued recognition and acceptance of the Good Delivery Time Guideline by the many different types of participants in these markets evidences the Guideline's utility in providing liquidity for Fedwire securities markets.

- The market for Fedwire securities, particularly Treasuries, is much more liquid than markets in certain other securities that settle on different platforms (such as the Depository Trust & Clearing Corporation) that do not utilize a delivery time structure like that recommended by the Good Delivery Time Guideline. The lower level of liquidity of such securities which settle on different platforms is yet another reason why advocating the elimination of the Good Delivery Time Guideline by comparisons to such platforms is not justified. Further, given the greater expectation of liquidity in Fedwire securities, dealers, in their role as financial intermediaries, often purchase large volumes of such securities for delivery. The delivery time structure is crucial in allowing dealers to deliver efficiently such securities, and in ensuring the continued liquidity of the Fedwire securities market.
- Contrary to your assertion, the Good Delivery Time Guideline correctly states the timeframe for dealer-only deliveries to be 2:45 to 3:15. We understand, however, that the market has independently developed a practice that moved the start of the cut-off for customer deliveries from 2:45 to 3:00, reducing the time period for dealer-only deliveries from a half-hour to fifteen minutes. The fact that so many dealers and their customers have independently agreed that customers should be able to make deliveries until 3:00 demonstrates that the cut-off time for customer deliveries is being determined by market forces, not by the Association. Indeed, the same market forces that halved dealer-only delivery time could have eliminated it altogether. However, that has not happened. Instead, dealers and their customers have demonstrated that dealer time continues to contribute to the efficiency of the Fedwire securities market. In other words, the market has shown that the advent of book-entry records for Fedwire securities has not eliminated the need for, or the utility of, dealer time.

Reduce Fails and Systemic Risk: Efficient and reliable delivery of securities is an integral part of a liquid securities market. As discussed in detail below, the elimination of the Good Delivery Time Guideline is likely to lead to an increase in the number and amount of failed delivery obligations ("fails"), with the natural consequence of reducing the liquidity in the relevant market. Given the fact that dealers often must receive securities in order to fulfill their delivery obligations, fails raise the potential for increased instances of defaults, and thereby increase the potential for widespread systemic risk.

- Unlike other settlement platforms, such as the DTCC, the Fedwire system does not currently enable counterparties to match their deliver and receive obligations with one another. As such, the elimination of a dealer-only delivery time at DTCC cannot justifiably be used to argue for the elimination of the Good Delivery Time Guideline for the delivery of Fedwire securities. Given that no trade matching exists through Fedwire, dealers use dealer delivery time to prevent fails by ensuring that delivery obligations are accurately fulfilled by the close of Fedwire.³

³ Note, however, even if Fedwire were to adopt a trade matching function, dealer time would continue to serve an integral role in the efficient clearance and settlement of Fedwire securities for the reasons detailed herein.

- Since counterparties are not able to confirm their trades through Fedwire, dealers may occasionally deliver securities to customers that do not perfectly conform to a customer's order. In such instances, securities are refused, or "DK'd", by customers. The Good Delivery Time Guideline gives dealers the necessary flexibility to correct their delivery obligations and re-deliver securities that have been DK'd. Without this time period, dealers would not be afforded the opportunity to re-deliver DK'd securities, leading to an increase in fails and systemic risk.
- With the elimination of dealer time, dealers will be in a position where they will continue to receive and deliver securities until the daily close of Fedwire, increasing the risk that they will be unable to meet their ultimate delivery obligations by 3:15 PM. This situation will also result in an increase of delivery fails and systemic risk. In order to prevent this situation, it is our understanding that many dealers independently choose not to accept deliveries from customers **or dealers** after 3:00 PM during dealer time.
- As one justification for the elimination of the Good Delivery Time Guideline, you state that a majority of all Fedwire book-entry (FBE) activity is completed by 2:00 PM each day. However, even if a majority of FBE activity occurs by 2:00 PM, dealer time still plays a crucial role in preventing larger "block" delivery fails. This is because dealers often accumulate securities throughout the day in order to deliver a block amount of \$50 million of such securities to customers. The Good Delivery Time Guideline allows a dealer to obtain any remaining securities from another source (e.g. a securities lender) after 3:00, and deliver the completed block to customers. Without this time period structure, even if a dealer were to obtain a majority of the \$50 million block amount by 2:00, it would not be able to complete the block amount and would likely fail on its delivery obligation for the entire \$50 million amount.

Roles of Dealer and Customer in Securities Markets: The securities market looks to dealers to receive and deliver securities as part of their role as financial intermediaries in executing, clearing and settling trades. Dealer time, as set forth in the Guideline, is necessary in that it allows dealers to fulfill the role that customers expect of them in an efficient manner, thereby providing greater certainty and liquidity to the securities market.⁴

- Unlike other financial market participants, dealers are recognized as financial intermediaries under a panoply of laws and regulations.⁵ Such laws, to which non-dealers are not subject, apply to dealers by virtue of their role as financial intermediaries in the securities market. The Good Delivery Time Guideline allows dealers to meet and manage legal obligations they have by virtue of being a registered dealer.
- The Good Delivery Time Guideline is neutral in its application. During the time period for deliveries out to customers, dealers do not accept deliveries from customers **or dealers**. The even application of the Guideline to both dealers and customers greatly facilitates the ability of dealers to fulfill their financial intermediary role. If the dealer time period were to be eliminated, dealers would continue to receive and deliver securities from both customers and dealers, making it much more difficult to finalize and meet their delivery obligations at the end of the day. This aspect of the Good Delivery Time Guideline facilitates the ability of dealers to meet such delivery obligations and fulfill their role as financial intermediaries, thereby helping to ensure a stable and liquid securities market.

⁴ We also note that your assertion that the "Fed no longer publishes a list of primary dealers" is untrue. A list of primary dealers is available at the following link on the Federal Reserve Bank of New York's website:
<http://www.ny.frb.org/pihome/news/opnmtops/2001/an010523.html>.

⁵ We note in this regard a registered dealer's obligations under SE'C Net Capital Rule 15c3-1 and Customer Protection Rule 15c3-3 as it relates to both reserve computations and buy-in obligations. In addition, a registered dealer is subject to margin rules of self-regulatory organizations such as NYSE Rule 431 and 432 and NASD Conduct Rule 2520, each of which regulate capital of registered dealers. Equivalent regulations apply to government securities dealers under 17 C.F.R. 402 and 403.

Benefit to Customers: The Good Delivery Time Guideline helps ensure that customers obtain needed securities in a timely and efficient manner. In addition, by reducing fails, the Guideline also greatly reduces fail-related costs that would otherwise be borne, at least in part, by customers.⁶

- The delivery time structure contemplated by the Good Delivery Time Guideline allows dealers the opportunity to meet their delivery obligations to customers in a reliable and orderly manner. This is particularly important given the lack of trade matching or confirmation on the Fedwire system. In addition, as noted above, the delivery time structure allows dealers to re-deliver securities to customers in the event that an initial delivery of securities was inaccurate and was therefore DK'd by a customer.
- Also, as discussed above, the elimination of the Good Delivery Time Guideline increases the risk that dealers will be unable to fulfill their delivery obligations to customers. In such instances, dealers will be forced to incur substantial overnight financing costs. While dealers may absorb some of these costs, it is probable that at least a portion of such costs will be passed on to customers.⁷
- The delivery time structure contemplated by the Good Delivery Time Guideline also allows dealers to prioritize their delivery obligations in order to benefit those customers who wish to purchase securities and deliver them prior to the start of dealer time. In addition, dealer time accommodates customers who purchase and hold securities by allowing dealers to deliver securities to such customers during dealer time, thereby facilitating earlier delivery to those customers who have same-day delivery obligations. Without this delivery time structure, dealers would not have the flexibility to prioritize deliveries to customers in such fashion, making it difficult or impossible to accommodate customers in such manner.

We again wish to emphasize that the Good Delivery Time Guideline is merely a *recommended* market practice. This is evidenced by the fact that, as noted above, although the Good Delivery Time Guideline sets dealer time at 2:45 to 3:15 PM, evolving market practice has reduced dealer time to a fifteen-minute window from 3:00 to 3:15 PM. Further, customers that wish to deliver securities to dealers during dealer time can pursue arrangements to do so. In fact, it is our understanding that many customers do take advantage of the very competitive dealer landscape and make arrangements for delivery during dealer time.

The Association appreciates the opportunity to respond to your letter. If you have any further questions or comments on this matter, please feel free to contact George Miller, Senior Vice President and Deputy General Counsel, at 212.440.9403 or gmill@bondmarkets.com, or Omer Oztan, Assistant General Counsel, at 212.440.9474 or ooztan@bondmarkets.com.

Sincerely,

Paul Saltzman
Executive Vice President and General Counsel

⁶ The Association also notes that, in addition to the costs described above, customers may also incur significant costs payable to custodian banks as a result of "contractual settlement" services certain banks offer to customers. In the event a dealer fails to deliver securities to a custodian bank on behalf of a customer, custodian banks that offer contractual settlement services obtain and provide such securities to the customer, charging the customer a fee for such service.

⁷ You estimate that compliance with the Good Delivery Time Guideline has caused certain customers to incur costs of \$17,150,000 on an annual basis. However, given the fact that many customers purchase and hold securities for the long term, it is by no means clear from your letter whether such costs were incurred by customers as a normal cost of holding long term positions in securities, or incurred as a direct result of compliance with the Guideline. Further, it is unclear whether such amount includes the fees charged by custodian banks for "contractual settlement" services (see footnote 6).

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cc: *Depository Trust and Clearing Corporation*
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