

Eleven Steps for Addressing Treasury Fail Penalties

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Money managers trading U.S. Treasury securities need to take quick action to prepare for the May 1, 2009 effectiveness of the industrywide voluntary protocol under which parties will be assessed penalties for settlement fails in Treasuries. We outline eleven specific steps money managers should consider below.

Background

In November 2008, amidst a significant spike in fails in the U.S. Treasury market, the Treasury Market Practices Group (the TMPG),¹ a group composed of primary dealers, representatives of the Federal Reserve Bank of New York, and end-user market participants, recommended that all participants in the Treasury securities trading markets agree on a protocol to remediate settlement fails. The TMPG, together with the Securities Industry and Financial Markets Association (SIFMA), published a Trading Practice in early 2009 designed to provide compensation for nonfailing market participants in cash market trades, as well as repurchase transactions and securities lending, options, and forward transactions involving Treasury securities. The Trading Practice is expected to go into effect for those participants that elect to participate beginning May 1, 2009.² The Fixed Income Clearing Corporation (FICC) submitted a rule filing on March 12, 2009 to subject its members to similar fail charges relating to Treasury securities cleared and settled through FICC.³

The Trading Practice

Under the Trading Practice, a fail charge is subject to a *de minimis* threshold of \$500 per transaction (determined on an account-by-account basis for trades allocated across multiple principals), accrues daily on each business day during which the trade fails, and is calculated by the nonfailing party based on an agreed formula that caps the charge at 3% of the purchase price of the Treasury securities involved and reduces the charge by the target level for the federal funds rate most recently announced by the Federal Open Markets Committee (Target Fed Funds rate). Participating firms will not be required to pay a charge for any fail once the Target Fed Funds rate rises above 3%.

The charge is accrued monthly and due no later than the last business day of the month following the month in which the resolution of the fail occurs, so long as the nonfailing party provides notice of the amount due by the tenth business day of such month. Fail charges do not apply (i) where the defaulting party is otherwise excused

1. The TMPG is sponsored by the Federal Reserve Bank of New York and is composed of representatives from the following firms: Morgan Stanley & Co. Incorporated, Goldman, Sachs & Co., Barclays Capital Inc., Bank of New York Mellon, Fidelity Investments, Reserve Bank of Australia, Citadel Investments, ICAP North America, JP Morgan Chase, BlackRock, Inc., BTG, State Street Bank, and Depository Trust & Clearing Corporation.
2. A copy of the Trading Practice is available on the TMPG website at www.newyorkfed.org/tmpg/pr033109.pdf and on the SIFMA website at http://www.sifma.org/capital_markets/docs/Fails-Charge-Trading-Practice.pdf.
3. See <http://www.sec.gov/rules/sro/ficc/2009/34-59569.pdf>.

under the terms of the transaction (e.g., due to a repudiation by the other party) or (ii) where delivery is not against payment of cash (e.g., where a party is required to deliver Treasuries as margin).

The TMPG and SIFMA provided sample notice language for market participants to send and include on confirmations to notify clients and counterparties that they have opted into the Trading Practice. The language has the effect of a deemed consent under which the counterparty has agreed to follow the fail charge procedure outlined in the Trading Practice. Although the notice includes the possibility of a trading partner refusing to sign on to the Trading Practice, it suggests that any such “opt-out” would need to be expressly agreed to between the parties. As a practical matter, given the anticipated insertion of language in confirmations, it may be difficult for a dealer to recognize an opt-out by a trading partner, and our expectation is that dealers will be unwilling to do so.

Encouraged by the Federal Reserve Bank of New York, all of the primary dealers appear to have adopted the Trading Practice. For money managers and other institutional investors trading in Treasury securities, this may effectively require them, in many cases, also to adopt the Trading Practice.

In adopting the Trading Practice, money managers should consider taking the following steps:

1. Evaluate whether they have authority under applicable client agreements to use client assets to pay fail charges (we would anticipate that in typical cases, fail charges could be considered a term of a transaction that falls within a money manager’s trading authority).
2. Determine what notice they should provide to their clients, including mutual fund boards or primary fund advisers (if the managers are subadvisers) regarding the charge and the justifications for opting into the voluntary procedure (e.g., justification might include an analysis of recent fails and a determination that the fail charges would appropriately compensate clients, or might be based on a determination that participation in the Treasury trading market will, as a practical matter, require trading with dealers that have adopted the Trading Practice and that will require all trading partners to agree to pay fail charges).
3. Analyze whether there is a need, from a materiality perspective, to include disclosure relating to the change in a mutual fund’s statement of additional information (SAI) (we assume that the charges will not be sufficiently material in the typical case to warrant SAI disclosure).
4. Determine how to coordinate appropriately with client custodians to prevent fails, and clarify the process of accounting for and reconciling payments and receipts of fail charges.
5. Consider whether to engage in negotiations with dealers for the payment of the accrued amounts in advance of the date indicated in the Trading Practice or require payment of additional interest on the accrued charges.
6. Determine whether there are market counterparties available that have not adopted the Trading Practice and with whom the money manager can transact in Treasury securities without agreeing to the Trading Practice.
7. Establish appropriate procedures to track fails by trading counterparties that affect the manager’s clients and to collect the fail charges from the counterparties.
8. Understand the counterparties’ processes for providing notices regarding fails and accrued charges.
9. Evaluate how to account for fail charges payable to client accounts (including for purposes of calculating NAV).
10. Determine the framework for evaluating whether fails resulting from actions or omissions of the money manager or the custodian should be treated as compensable trade errors on their part.
11. Determine whether existing repurchase, securities lending, bond option, forward, and other counterparty agreements need to be amended to reflect the Trading Practice.

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