



Recommended Closing Time Practices for Delivering U.S. Treasury Securities

April 28, 2009

In lieu of the existing Securities Industry and Financial Markets Association (SIFMA) guidelines and current industry practice (see Appendices A and B, respectively), the Treasury Market Practices Group (TMPG) and SIFMA recommend that market participants adopt the following revised practice guidance for closing times for delivering U.S. Treasury securities by June 1, 2009:

- Any market participant can originate a delivery prior to 3:00 p.m.¹
- A participant can choose one of the following two options:²
 - Option A: It can (i) decline to originate any deliveries after 3:00 p.m., *and* (ii) decline to accept any deliveries originated after 3:00 p.m.
 - or*
 - Option B: It can (i) originate deliveries between 3:00 p.m. and 3:15 p.m. upon the *specific, prior approval* of the buyer, *and* (ii) accept deliveries between 3:00 p.m. and 3:15 p.m. following, in each case, its *specific, prior approval*.³

¹ All times referred to in this recommendation are premised on a 3:30 p.m. Fedwire Securities Service close. In the event of an extension, all referenced times within this recommendation would adjust accordingly, relative to the actual Fedwire Securities Service close on a given day.

² It is recommended that a participant can change its elected option from time to time, with advance notice of at least 5 business days to counterparties.

³ Some participants that choose Option B may decide to have standing instructions to always accept deliveries (from one or multiple counterparties) between 3:00 pm and 3:15 p.m. Such standing instructions would not be inconsistent with this practice recommendation.

- The interval between 3:15 p.m. and 3:30 p.m. is reserved for reversals only.⁴

Adherence to the recommended closing time practices would not require any change in either (1) current Fedwire closing times (see Appendix C), or (2) the current Fixed Income Clearing Corporation (FICC) practice of closing its delivery system for U.S. Treasury securities at 3:00 p.m.

The TMPG also recommends an approach for incorporating the fails charge recommendation into this revised closing time practice. The recommendation, described in greater detail beginning on page 5, reflects the principle that a seller who chooses Option B (“an Option B seller”) should attempt to effectuate deliveries by 3:00 p.m., since deliveries between 3:00 p.m. and 3:15 p.m. can only be made *if mutually agreed upon* with the buyer. As such, if a buyer who chooses Option B (“an Option B buyer”) declines to accept Treasury securities offered by an Option B seller between 3:00 p.m. and 3:15 p.m. the buyer would be entitled to charge the seller for failing to deliver the securities on that day.

Background

The proposed closing time practices came out of discussions among TMPG members and other market participants during the course of finalizing implementation details associated with the TMPG recommendation regarding charges for settlement fails.⁵ Some buy-side members and market participants expressed dissatisfaction with the existing market convention under which dealers can deliver Treasury securities to customers until 3:15 p.m., but customers can usually only deliver securities to dealers

⁴ A reversal is a return of securities previously delivered in cases where the original delivery was, or is believed to have been, in error. The restriction of the 3:15 p.m. to 3:30 p.m. period to reversals arises from Federal Reserve System policies (see Appendix C).

⁵ The TMPG recommendation and related material appears at www.newyorkfed.org/tmpg/.

until 3:00 p.m.⁶ This convention can sometimes leave a customer who had, at 3:00 p.m., an uncompleted obligation to receive securities and a matching uncompleted obligation to deliver the same securities in the position of taking in the securities after 3:00 p.m. without being able to turn the securities around and redeliver them on the same day. Instead of a pair of matched fails, the customer is left with an unmatched fail to deliver, resulting in higher interest expenses and/or an overdraft charge. Some buy-side members and market participants expressed the view that closing times should treat all market participants the same, regardless of whether they are real-money investors, leveraged investors, or dealers.

Discussion

The proposed closing time practices would allow all participants to originate deliveries until 3:00 p.m. each day. This follows current industry practice.

The proposed closing time practices would further allow, *but would not require*, participants to originate and receive deliveries on a *mutually agreeable basis* during the 15 minute interval between 3:00 and 3:15 p.m. This provision recognizes that some, but not all, participants have sophisticated inventory control systems and that those participants (as well as the market as a whole) can benefit from an end-of-day interval during which they can attempt to clear unfulfilled delivery obligations while retaining control of what comes into their clearing and custodial accounts.

Each market participant can elect one of two options with respect to the 3:00 to 3:15 p.m. interval:

- Option A provides that a participant can, as a matter of course, abstain from originating deliveries after 3:00 p.m., and decline to accept deliveries originated after 3:00 p.m. Knowing that a participant choosing Option A will not originate deliveries after 3:00 p.m. and that it will not accept deliveries

⁶ Some dealers make exceptions in some cases and allow some customers on some occasions to deliver securities between 3:00 and 3:15 p.m.

originated after 3:00 p.m. will allow the counterparties of that participant to better schedule their own deliveries and anticipate their own receipts.⁷

- Option B provides that a participant, be it dealer or non-dealer, can continue to receive and deliver securities between 3:00 and 3:15 p.m. on a *mutually agreeable basis* with its counterparties. A participant electing Option B can not originate a delivery between 3:00 and 3:15 p.m. except upon the specific, prior approval of the buyer, and it can reject a delivery originated between 3:00 and 3:15 p.m. in the absence of its specific, prior approval. Thus, a participant electing Option B has full control of its box between 3:00 and 3:15 p.m.

It should be noted that, regardless of whether a participant chooses Option A or Option B, neither its gross nor its net settlement fails can increase after 3:00 p.m. without its consent.

Finally, the proposed closing time practices provide that the interval between 3:15 and 3:30 p.m. is reserved for reversals only. This is in accord with current industry practice, with the current SIFMA delivery guidelines, and with Fedwire rules.

What's Different from Current Industry Practice?

The proposed closing time practices differ from current industry practice because all markets participants are treated the same – there is no distinction between dealers and others. Every participant can choose, i.e., *self-select*, whether it wants to close its window at 3:00 p.m. or whether it wants to participate in the 3:00 to 3:15 p.m. interval of mutually agreeable deliveries. If a participant chooses to participate in the 3:00 to 3:15 p.m. interval of mutually agreeable deliveries, it can further choose whether to accept, or decline to accept, any particular delivery proffered by another during that interval – but it

⁷ It would be perfectly feasible for a participant to elect Option B with the intention of declining to originate any deliveries after 3:00 p.m. and declining to accept all deliveries originated after 3:00 p.m. Option A allows a participant to make an *ex ante* declaration of that intention, a declaration that other participants would likely find useful.

must similarly seek the prior consent of any participant to whom it wants to make a delivery.⁸

What is the Recommended Fails Charge Treatment Under this New Practice Guidance?

Among other things, the proposed revised closing time practices described above give an Option B buyer the ability to decline to accept the offer of an Option B seller to deliver Treasury securities between 3:00 p.m. and 3:15 p.m.⁹ This raises the question: Should an Option B buyer submit a fails charge to the Option B seller if the seller offered to deliver securities between 3:00 p.m. and 3:15 p.m. and the buyer declined to accept delivery.

The TMPG studied two alternatives for incorporating guidance on fails charges into the recommended revised closing time practices:

Alternative 1: No Fails Charge if Delivery was Proffered

The first alternative provides that an Option B buyer should not charge an Option B seller for failing to deliver Treasury securities on a given day if the seller offered to deliver the securities on that day between 3:00 p.m. and 3:15 p.m. and the buyer declined to accept delivery.

This alternative has the advantage of maximizing incentives to accept deliveries of securities between 3:00 p.m. and 3:15 p.m. Absent this alternative, an Option B buyer might have an incentive to decline to accept a proffer of securities made after 3:00 p.m. in order to extract a fails charge from the seller.

The alternative has two substantial drawbacks:

⁸ As mentioned previously in footnote 2 above, participants may bilaterally choose to have standing instructions that waive prior consent for each specific delivery and receive in the 3:00 p.m. to 3:15 p.m. window, if mutually agreeable.

⁹ Note that a buyer can not decline to accept a delivery of securities originated before 3:00 p.m., and that a seller can not originate a delivery of securities after 3:15 p.m.

- It would present significant record-keeping challenges, because market participants would be maintaining records of when (date and time) a seller offered to deliver securities and when a buyer rejected such an offer. Moreover, such records would be made during a potentially intense part of the day: the fifteen minute window during which buyers and sellers are attempting to clean up their residual settlement obligations.
- Additionally, dispute resolution would likely be intractable, due in part to the significant record-keeping challenges identified above.

Alternative 2: Fails Charge If Buyer Declines Delivery Proffered After 3:00 P.M.

The second alternative would not exempt this type of fail from the fails charge. Under this alternative, even if an Option B seller offered to deliver securities to an Option B buyer between 3:00 p.m. and 3:15 p.m. and the buyer declined to accept delivery, the buyer would charge the seller for failing to deliver the securities on that day.

This alternative has the advantage of operational simplicity. Additionally, it incentivizes sellers to originate their deliveries before 3:00 p.m., when they do not need counterparty consent to make the deliveries.

Recommendation

After study of these two alternatives the TMPG unanimously recommends the second alternative because the tracking burden and reconciliation difficulties cited above were seen to far outweigh the benefit of the first alternative. Moreover, one TMPG member believed adoption of the first alternative might cause harm by leading some participants who would otherwise choose Option B to choose Option A. Given that Option B includes an added window of time for those able to manage their securities deliveries at a high frequency late in the session to reduce fails, some aggregate market liquidity benefit might also be lost if Alternative 1 were recommended.

Appendix A. Current SIFMA Delivery Guidelines ¹⁰

- Any market participant can originate a delivery prior to 2:45 p.m.
- Between 2:45 p.m. and 3:00 p.m., a customer can not originate a delivery to a dealer, but dealers can originate deliveries to other dealers and to customers.
- Between 3:00 p.m. and 3:15 p.m., neither customers nor dealers can originate deliveries to dealers, but a dealer can originate a delivery to a customer.
- The interval between 3:15 p.m. and 3:30 p.m. is reserved for reversals only.

Comment: This scheme was put in place to allow dealers 15 minutes (between 2:45 and 3:00) to clean up fails to each other, and 15 minutes (between 3:00 and 3:15) to make deliveries to customers. It was thought that delivering a security to a customer removes the security from circulation, so deliveries to customers should be postponed until the last 15 minutes of the delivery day.

Appendix B. Current Industry Practice ¹¹

- Any market participant can originate a delivery prior to 3:00 p.m.
- Between 3:00 p.m. and 3:15 p.m.,
 - a customer can not originate a delivery to a dealer,¹²
 - a dealer can originate a delivery to another dealer with the permission of the dealer, but
 - a dealer can originate a delivery to a customer *without* the permission of the customer.
- The interval between 3:15 p.m. and 3:30 p.m. is reserved for reversals only.

¹⁰ Public Securities Association, *Government Securities Newsletter*, “PSA Amends Good Delivery Deadlines for Extended Fedwire Book-Entry System,” November 27, 1995, p. 2.

¹¹ Some dealers may observe slightly different conventions.

¹² Some dealers do allow a customer to originate a delivery during this 15 minute window with the permission of the dealer.

Appendix C. Current Fedwire Closing Times ¹³

- Any market participant can originate a delivery prior to 3:15 p.m.
- The interval between 3:15 p.m. and 3:30 p.m. is reserved for reversals only.

¹³ Federal Reserve Operating Circular No. 7 (August 19, 2005), Appendix B.