Treasury Fails Charge: May 1 Launch

2009-04-30

In response to the widespread and persistent delivery failures plaguing the U.S. Treasury market over the last several months, the Treasury Market Practice Group ("TMPG") and the Securities Industry and Financial Markets Association ("SIFMA") have published standard guidelines for assessing fails charges in the event of a failed delivery.[1] Commonly referred to as the "Trading Practice," these guidelines call for implementation of the fails charge for transactions involving U.S. Treasury securities ("Treasuries") entered into on or after May 1, 2009. Under this target implementation date, the first submission of claims for fails charges relating to delivery failures in Treasuries settled or resolved during May 2009 would be June 12, 2009 (the tenth business day of June). Although the adoption of the TMPG's market practice recommendations is strictly voluntary, it is expected that the Trading Practice will be followed by most market participants. The Federal Reserve Bank of New York ("New York Fed") has indicated that it will incorporate the Trading Practice in its Treasury transactions with primary dealers and the Fixed Income Clearing Corporation ("FICC") has submitted a rule filing to the Securities and Exchange Commission ("SEC") amending its rules to adopt a fails charge procedure.[2]

I. Background

TMPG's fails charge procedures were formulated after consultation with a variety of market participants and have been publicly supported by the New York Fed as well as the Treasury Department. In recent months, the high prevalence of delivery fails involving Treasuries has shaken investor confidence in the market. These fails have impeded efficient market clearing and undermined overall market liquidity by causing market participants to withdraw from the market. The purpose of the Trading Practice is two fold: (1) to expeditiously remedy the prevalence of widespread and chronic settlement fails and (2) to provide a mechanism for compensating a non-failing party in connection with a delivery failure.

A fails charge can arise from any transaction that (i) is between two market participants who have entered into a transaction subject to the Trading Practice and (ii) provides for the delivery of Treasuries against the payment of funds (delivery-versus-payment) or the transfer of securities (delivery-versus-transfer). The Trading Practice applies to, without limitation, conventional cash market sales, repurchase transactions ("repo trades"), and securities loan transactions (including the borrowing of funds on the start leg of a financing transaction and the return of funds at the conclusion of a financing transaction), as well as Treasury options and forwards. The Trading Practice does not cover "free deliveries," where a recipient is not obliged to make a payment of funds upon receipt of Treasuries (e.g., when an investor makes a deposit of securities for margin purposes).

II. Implementation

Acting jointly, the TMPG and SIFMA have published a suggested framework of legal documents and market conventions through which a fails charge may be imposed and collected. This framework includes (1) recommended language, referring to the Trading Practice, to be included in transaction confirmations and (2) a recommended form of notice, to be sent by dealers to counterparties, that transactions will be conducted in accordance with the Trading Practice. These documents have been published and will be maintained by SIFMA on its website.[3] Market participants should carefully review all language in transaction confirmations and notices sent by dealers to ensure that they are consistent with the recommendations in the Trading Practice.

The TMPG recommends that all fails charges be accrued over the life of the delivery failure and become due and payable upon resolution of the delivery failure. Following such resolution, whether by delivery of Treasuries or otherwise, the failing party shall make full payment of all fails charges no later than the last business day of the month following the month in which the resolution occurred (provided that the non-failing party provided notice of the amount due by the 10th business day of such month), unless otherwise agreed by the parties. Therefore, a delivery failure lasting more than one calendar month would result in a single claim, based upon the fails charge over the entire duration of the fail, in the month following the month in which the delivery failure was resolved.

Fails Charge Calculation

Under the Trading Practice, a fails charge would be calculated each day based on the greater of: (a) 3 percent per annum minus the TMPG reference rate[4] at 5:00 p.m. New York time on the preceding business day, and (b) zero. When the TMPG reference rate is greater than or equal to 3 percent under the current formula, there will be no explicit financial charge for failing, and under this formulation the fails charge will be capped at 3 percent.

$$C = 1/360 * 0.01 * \max(3\ R,0) * P$$

where: C = fails charge amount, in dollars

R = TMPG reference rate at 5:00 p.m. New York time on the preceding business day, in percent per annum, and

P = total trade proceeds due from buyer, in dollars

Exemptions

The Trading Practice currently contains an exemption for accrued fails charges less than or equal to

$500, on a per trade basis. The TMPG may revisit this threshold recommendation in the future should an industry need arise. When a transaction is executed by an investment manager or other agent on behalf of multiple principals and the allocation of the transaction to such principals is disclosed to their counterparty in the ordinary course, the $500 threshold will be applied separately to the fails charge calculated for each principal.

As the May 1 effective date approaches, there are still unresolved issues regarding the fails charge procedure. For example, there are currently no guidelines for how to handle disputed claims for fails charges. In the immediate future, the TMPG expects claims disputes to be handled bilaterally, acting in good faith. In addition, the TMPG has not commented on the tax treatment for fails charges. As accounting and tax related implications will vary among firms and institutions, the TMPG advises each participant to consult with its own accountants and tax advisors.

Finally, note that there is no exemption available to a seller who is failing to deliver because the seller itself is failing to receive securities on a separate purchase or repo trade with a third party. The seller may not assign the buyer's claim or otherwise step out of the claim process because there is currently no industry utility available for ex ante netting of claims across different parties.

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[1] The "U.S. Treasury Securities Fails Charge Trading Practice," www.sifma.org/capital_markets/docs/fails-charge-trading-practice.pdf.

[2]www.dtcc.com/downloads/legal/rule_filings/2009/ficc/2009-03.pdf. The FICC rule filing has been published for comment by the SEC but has not yet been adopted. At least one commenter has suggested that the fails charge will result in unintended consequences that will undermine the Treasury market. Particularly, the commenter has asserted that in the ordinary course of business, there are unintentional and unavoidable failures to deliver. The commenter is concerned that penalty charges will become cost prohibitive and force certain, smaller players out of the market. www.sec.gov/comments/sr-ficc-2009-03/ficc200903.shtml.

[3]www.sifma.org/capital_markets/docs/fails-charge-trading-practice.pdf.

[4] The current TMPG reference rate is the target federal funds rate specified by the Federal Open Market Committee ("FOMC") (if the Committee specifies a target rate) or the lower limit of the target band specified by the FOMC (if the Committee specifies a target band in lieu of a target rate). In the event the FOMC specifies neither a target rate nor a target band, the TMPG will recommend some other similar, readily observable, short term interest rate.