



Claiming a Fails Charge for a Settlement Fail: Frequently Asked Questions

The following is intended to address questions about the Treasury Market Practice Group's (TMPG) recommendation that a charge for settlement fails in U.S. Treasury securities be adopted as standard market practice.

General

Why is the TMPG recommending a financial charge on settlement fails?

During the past several months, transactions in U.S. Treasury securities have exhibited widespread and chronic settlement fails. These fails prevent efficient market clearing and impose credit risk on market participants, and are therefore damaging to overall market liquidity and function. The imposition of a fails charge would provide an incentive to sellers to effect timely settlement and, it is expected, mitigate the fails problem that has been affecting the market.

Does the fails charge apply to cash and financing transactions?

A fails charge could arise from a conventional cash market sale or from a repurchase agreement or securities loan, 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. Please see the document titled "[*Claiming a Fails Charge for a Settlement Fail in U.S. Treasury Securities*](#)" for further discussion.

Who is considered a "buyer" and a "seller"?

A seller is any party who has agreed to deliver securities, or who has agreed to cause securities to be delivered, versus payment. A buyer is any party who has agreed to make payment, or to cause payment to be made, upon receipt of securities.

Does the fails charge apply to transactions where payment is not required upon receipt of securities?

No, the TMPG recommendation does not cover "free deliveries", where a recipient is not obliged to make a payment upon receipt of securities. Free deliveries can arise when, for example, an investor has to make a deposit of securities for margin purposes.

How does the TMPG recommendation apply to participants in the Treasury market?

Although the TMPG strongly recommends the adoption of the fails charge protocol, the TMPG's market practice recommendations are voluntary.

Why is the TMPG recommending an interest claim approach as opposed to a change in the invoice price?

The TMPG's original recommendation suggested that the invoice price of a transaction that failed to settle as originally scheduled should be reduced by the amount of the fails charge, but when market participants studied the recommendation further a consensus emerged that a monthly claims process is preferable to adjusting invoice prices because it presents a much lower operational burden than invoice price adjustment.

When will the recommended fails charge take effect?

The TMPG proposes a target implementation date of May 1, 2009 for commencing accruals of fails charges, and a date of June 12, 2009 for the first monthly submission of claims. These planned implementation procedures were formulated after consultation with a variety of market participants and reflect the desire to balance the operational, legal and other implementation challenges faced in adopting this new practice, with the need to expeditiously remedy the prevalence of widespread and persistent settlement fails. The implementation of the fails charge pursuant to this timeline will be subject to successful rule filing by The Depository Trust Company (DTC) with the Securities and Exchange Commission (SEC).

What if I have additional questions?

The TMPG will host a listen-only conference call on January 14, 2009 at 4 pm EST to discuss the fails charge framework and respond to related questions submitted in advance by market participants.

- To access the conference call, please utilize the following dial-in information:
 - USA Toll-Free: 888-428-4478
 - International: 651-291-0900
- If you would like to submit a question for consideration, please e-mail your question to: tmpg@ny.frb.org. We ask that questions be submitted no later than 10 a.m. on January 12, 2009.
- A replay of the conference call will be available from 6 pm on January 14, 2009 until 11:59 pm on January 21, 2009. To listen to the replay, please utilize the following dial-in information:
 - USA Toll-Free: 800-475-6701
 - International: 320-365-3844
 - Access Code: 979508

Fails Charge Calculation

What is the recommended rate charged on fails?

A fails charge will be assessed based on the TMPG fails charge formula which is now equal to the greatest of (a) 3 percent per annum minus the lower limit of the fed funds target rate band at the close of business on the business day prior to the originally scheduled settlement date, and (b) zero. When the fed funds target 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 fail charge will be capped at 3 percent per annum.

How is the recommended fails-related payment calculated?

The amount claimed for a failure to receive securities on a given day will be computed based on the *TMPG fails charge formula*:

$$C = \frac{n}{360} \cdot .01 \cdot \max(3 - R, 0) \cdot P$$

where:

- C = claim amount, in dollars
- n = number of calendar days to the following business day, or to the last calendar day of the month, whichever comes first,
- R = TMPG reference rate* at the close of business on the business day preceding the fail, in percent per annum, and
- P = total trade proceeds due from buyer, in dollars

* Note: 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.

Why is the recommended TMPG fails charge formula based upon a 3 percent rate level?

The TMPG recommendation is designed to give sellers an economic incentive to borrow securities to affect deliveries even when the general collateral repo rate, which is usually very close to the fed funds target rate, is low. Experience shows that fails have not become widespread and chronic if the general collateral rate is above about 3 percent. This suggests that market participants generally act to cure settlement fails reasonably promptly as long as the economic cost of a fail is bounded from above at not less than about 3 percent. It is possible that a future practice recommendation would suggest a rate higher or lower than 3 percent if future market dynamics differ from the historical experience.

What happens if there is a change in rates in the middle of the month?

Fails charges will be accrued on a daily basis, based on the prior day's reference rate and *TMPG fails charge formula*.

If the TMPG were to recommend a different rate to be charged on fails, what would be the lead time for such a decision and how would that be communicated?

In the event this were necessary, the TMPG would discuss the appropriate timeline for implementation for such a change with a wide range of market participants to assure that the change would not be disruptive to market function.

Fails Charge Claim Submission and Payment

What contracts does my firm need to sign in order to submit or be owed a claim?

The TMPG will publish a suggested framework of legal documents and market conventions through which a fails charge may be imposed and collected. This framework will include (1) a Trading Practice providing greater and more precise detail regarding the fails charge, which will be published and maintained by the Securities Industry and Financial Markets Association (SIFMA) on its website, (2) recommended language, referencing the Trading Practice, to be included in transaction confirmations and (3) a recommended form of notice, to be sent by dealers to counterparts, that transactions will be conducted in accordance with such Trading Practice.

The TMPG expects to publish the Trading Practice, form of confirmation and form of notice by January 15, 2009.

How often will fails charge claims be assessed?

Claims will be cumulated over the course of a calendar month and submitted and paid on a monthly basis the following month.

When will the claim be due to the counterparty and when does the claim have to be paid?

The TMPG recommends that buyers generally submit fails related claims by the tenth business day of the month following that in which the fails charge accrued. Payment of accepted claims and notice of rejected claims are due by the last business day of the month in which they were submitted.

To whom does my firm send the claim?

The recipient of a claim will differ depending on the counterparty type. Please see the document titled "[*Claiming a Fails Charge for a Settlement Fail in U.S. Treasury Securities*](#)" for further discussion of payment flow information.

When will I learn more about the industry utility referred to in the document titled "*Claiming a Fails Charge for a Settlement Fail in U.S. Treasury Securities*"?

The TMPG will engage in further consultation with market participants and industry representatives to explore the development of an industry utility for matching fails charge claims with *ex ante* acceptances submitted by market participants. The TMPG will continue to provide updates on progress toward this goal and expects to share the results of its research by mid-year.