BEAR STEARNS

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Government Securities Regulations Staff
Bureau of the Public Debt
999 E Street NW, Room 315
Washington, DC 20239-0001

Ladies and Gentlemen:

In response to the Department of the Treasury's ("Treasury") request for comments on the proposed methodology for a "redemption operation," Bear, Stearns & Co. Inc. ("Bear Stearns" or "We") would like to submit its view on the efficacy of the type of competitive auction process currently contemplated for use in a debt buy-back program for unmatured Treasury securities. We propose that the Treasury consider modifying the auction mechanism to utilize a single clearing price, which offers certain advantages to the multiple-price auction contemplated but the proposed regulations. In particular, this comment letter focuses on three issues related to a multiple-price auction: (1) avoidance of the "winner's curse"; (2) improved efficiency in the face of limited asymmetric information; and (3) the applicability of the single-price auction to purchasing securities rather than selling them.

Dutch Auctions

The single-price auction Bear Stearns proposes is also known as a second price or uniform price auction and is referred to as a Dutch Auction in the financial community. This competitive process is conducted by receiving sealed offers from Primary Dealers indicating the security to be purchased, price or prices to be paid and the amount to be sold. Each Primary Dealer submits one or more multiple prices and amounts for each security. All offers are binding and irrevocable. The Treasury then chooses the highest price ("the Clearing Offer") that it is willing to pay for each security. Every offer that is at or below the Clearing Offer is accepted at the Clearing Offer regardless of the offer submitted.

Winner's Curse

One of the issues with the Dutch Auction format proposed by the Treasury is the fear of public embarrassment on the part of participants from receiving a price that is substantially below other prices paid to other holders, thereby creating the potential for the "winners curse." Accordingly, participants are discouraged from taking part in the Dutch Auction or aggressively bidding in the Dutch Auction. From the point of view of minimizing the price paid for any given item, all auction formats should yield the same result when the item is unique. However, when the item is more like a commodity, with a common value, we would argue that a multiple-price auction does not take advantage of the increased amount of information available to certain holders of Treasury securities. Recognizing the strong potential for the "winner's curse" to occur, participants will make their offers less aggressively and "shade" their offers above their true valuations.[1] In a single-price auction, participants will not be disadvantaged if rival participants' valuations are much higher, since the highest price accepted is paid to all holders whose securities are accepted for purchase. Accordingly, participants will make offers more aggressively.

Limited Information

Beyond economic considerations, we believe that bondholder participation will be enhanced as well in a single-price auction. Consider an individual investor, who wishes to participate in the debt buy-back program but has minimal knowledge of trading activity in the Treasury securities selected for repurchase. Since the investor must place a competitive offer in the multi-price auction, non-competitive offers not being allowed, and must place their offer through a Primary Dealer, which has a considerable amount of information given the Primary Dealer's position in the process, the investor may feel disadvantaged by the process. In a multiple-price auction, this information disadvantage may translate into the investor receiving a lower price for the security versus those with better/more information. In a single-price auction, the clearing price represents a consensus valuation regardless of the asymmetry of information disclosed or available to the market.

Purchase *vs.* Selling

Bear Stearns is of the view; that implementing a Dutch Auction for purchasing securities (often called a "reverse" Dutch Auction) highlights an important issue that does not arise when implementing an auction for selling securities. Unlike the traditional Dutch Auction, a participant in a reverse Dutch Auction is not really a voluntary participant.[2] An investor has a vested interest in the outcome of the reverse Dutch Auction, whether the investor participates or not, because, as an owner the auction will affect the market's valuation of the security that is the subject of the auction. If Treasury determines to purchase for cash or exchange a significant portion of the outstanding amount of a

[1] Feldman, R. and Mehra, R. Auctions: "A Sampling of Techniques", *International Monetary Fund Finance & Development* **30**, No. 3, 32-35 (1993).
[2] Gay, G., Kale, J., and Noe, T. "(Dutch) Auction Share Repurchase", *Economica*. **63**, 57-58 (1996).

particular Treasury security, the remaining Treasury securities will suffer serious deterioration in market liquidity. An investor who determines not to participate in the reverse Dutch Auction could still face a substantial loss in value even though the investor took no action.

We appreciate the opportunity to express Bear Stearns' view on the contemplated buy-back mechanism. If you have any questions, please do not hesitate to call the undersigned or John C. Maguire or Matthew H. Riez at (212) 272-2000.

Sincerely,

Peter Herzig
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