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Please find enclosed Merrill Lynch's positions on the *35 Percent Rule and Net Long Position Calculation in Treasury Auctions*. We thank-you for the opportunity to comment on the proposed changes to this rule.

Background: The current rule regarding maximum auction awards to a single bidder states that the sum of a bidder's Net Long Position (NLP) in a security and its auction award must not exceed 35 percent. For a reopening, the NLP calculation includes holdings acquired in the WI market for the reopened security plus all holdings of the outstanding security. The six options put forth in the Advanced Notice of Proposed Rulemaking (ANPR, 31 CFR Part 356), along with Merrill's positions on these proposed changes, are detailed below:

1) Subtracting from the current holdings component of the NLP up to 35 percent of the combined prior offering amounts of that security. For example, let us assume that Treasury reopens a T-note that had a previous offering amount of $10 billion by offering an additional $10 billion, and a bidder already holds $5 billion par of that note and no other position in the security. That bidder would be able to exclude $3.5 billion from its NLP calculation for the reopening auction since $3.5 billion is 35 percent of the previous offering amount. Net, this entity would be limited to bidding for $2B at the auction (20%). If awarded this $2B, the NLP after the auction would be $7B (35%).

Merrill: We prefer this first alternative since it follows the spirit of the original regulation without unduly restricting dealers or investors from participating in the reopening auctions. This first alternative effectively precludes anyone from squeezing an issue because the maximum amount an entity could either bid for at the auction or own immediately after the auction is 35% of the total issued amount (including the reopening). Having these dual safeguards in place effectively precludes concentrated ownership, assures wide distribution of reopened issues and promotes price discovery in the When Issued (WI) trading period.

2) Eliminate the NLP reporting requirement altogether and reduce the 35 percent limit to 25 percent (or some other amount below 35 percent).

Merrill: **With the advances in technology, we do not believe that the operational difficulties of efficiently reporting the NLP are so great as to favor this alternative. As evidence, we acknowledge (and appreciate) how the Treasury has shortened the auction reporting times to about 10 minutes now. Further, lowering the auction award limit to 25% would penalize those investors/dealers who are not subject to the NLP reporting (under current rules) but wish to purchase a large block at the reopening.**

3) Keep the current NLP requirement, but compute the 35 percent limit based on the offering amount plus any previous offering amounts. For example, if Treasury offered $10 billion of a Treasury security in a previous auction and offered an additional $10 billion of the security in a reopening, a bidder with no net long position would be able to purchase up to $7 billion ($20 billion x .35%) of the reopening offering.

Merrill: **We do not like this alternative at all since it allows one entity to effectively "coup" the auction by potentially purchasing up to 70%. This proposal would not allow for wide distribution at the auction. Further, dealers may not be willing to provide adequate liquidity in the WI trading period since it could potentially be hard for them to cover their shorts in the auction at a reasonable price, knowing that one entity could purchase 70%. This proposal would be detrimental to WI liquidity.**

4) Redefine the NLP to include only the when-issued position when calculating the 35 percent limit on the reopening.

Merrill: **Although this proposal is our second choice, we do not totally favor it because some dealers/investors could still manipulate it for their advantage. For one, a trader could actively buy large amounts of the WI in the trading period and then "sell the roll" (sell the WI, buy the existing current) right before the auction. This latter trade would be hidden from the general market since it is just a repo transaction with minimal risk (only the repo dealer and trader would know). Then, this investor could bid for 35% at the auction since its "WI" NLP would equal zero. Not only could this result in WI market dislocations (again making it riskier for dealers to trade in the WI period and bid at the auction) but this new entity could control a large % (>35%) of the combined issue right after the reopening auction, potentially squeezing it in the repo market. Likewise, if a dealer owned $6.5B of an original $10B issue and purchased $3.5B of a reopened $10B issue, it would then own 50% ($10B) of the total amount issued, a rather large percentage and one which could potentially facilitate a squeeze.**

5) Keep the current NLP calculation requirement, but increase the 35 percent limit.

Merrill: **We do not favor this proposal because 1) it does not allow for wide distribution at the auction and 2) it could allow just two entities to effectively corner the auction (e.g., if the limit is increased to 40-45%).**

6) Retain both the 35 percent limit and the NLP reporting requirement as they exist now.

Merrill: **Due to the Treasury's regular use of re-openings and the constraints the 35% rule imposes on re-openings, we do not favor the status quo. Alternatives 1 (first choice) and 4 (second choice) are better.**

Sincerely yours,

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