September 21, 1999

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 unmat ed 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
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
Senior Managing Director

Gary McLoughlin
Senior Managing Director

cc:     W. Spector
       D. Mullen
       J. Maguire
       M. Riez
       (Bear Stearns & Co. Inc.)