

MEMORANDUM

May 17, 1985

TO: Chairman Shad
Commissioner Cox
Commissioner Marinaccio
Commissioner Peters

FROM: Richard Ketchum, Director *RK*
Division of Market Regulation

SUBJECT: May 21 1985 Open Meeting on Regulation of the
Government Securities Markets

This memorandum is to inform you of the details of the Open Meeting on regulation of the government securities markets, and to provide you with information obtained from recent interviews with investors and government securities dealers. The composition of the panels and the views of the panelists (where known) are set forth below. The interviews with market participants are described in attached memoranda from my staff and Regional Administrators.

Open Meeting, May 21, 1985

- 9:30 - 9:45 -- Opening Statement by Chairman Shad
on the purpose and format of meeting.
- 9:45 - 11:00 -- Investor Panel:
- Bruce Cleveland, President,
Government Investors Trust
- Harold Boldt, Director of Finance,
Columbia, Missouri
- Ira Bailey, President,
Cross County Federal Savings & Loan, N.Y.
- Betty Dunkerley, Acting Finance Officer,
Beaumont, Texas
- 11:00 - 12:15 -- Primary Dealer Panel:
- Jon S. Corzine, Partner,
Goldman, Sachs & Co.
- Ralph F. Peters, Chairman,
Discount Corp. of N.Y.
- S. Waite Rawls, Managing Director,
Capital Markets Group, Chemical Bank
- Edward J. Mahoney, Manager,
International Marketing,
Merrill Lynch Government Securities, Inc.

12:15 - 1:30 -- Lunch for Panelists, Commissioners, and staff -- Commissioner Closed Meeting Room

1:30 - 2:45 -- Secondary Dealer Panel:

James Ogg, President
Westcap Corp, Houston, Texas

Griffith Clarke, General Partner
G.X. Clarke & Co., N.Y.

Thomas Kane, Chairman
Printon Kane & Co., Short Hills, N.J.

Stephen Barrett, Managing Director,
Alex Brown & Co., Baltimore

2:45 - 3:00 -- Break

3:00 - 4:00 -- Industry Groups:

Robert Shapiro, Chairman,
SIA (President, Wertheim & Co.)

Richard M. Kelly, Chairman,
Public Securities Association's
Primary Dealers Committee
(Aubrey G. Lanston & Co.)

Rex Teaney,
Dealer Bank Association
(Wachovia Bank, N.C.)

4:00 - 5:00 -- Regulatory Panel:

John J. Niehenke, Deputy Assistant Secretary
(Federal Finance), Treasury Department

Eric Hemel, Director, Office of
Policy & Economic Research
Federal Home Loan Bank Board

Views of Panelists (where known)

Investors: Betty Dunkerley, of Beaumont Texas (a victim of ESM), Ira Bailey, of Cross County S&L (a victim of BBS), and Harold Boldt of Columbia, Missouri, (Chairman of the Government Finance Officers Association's Cash Management Committee) all support some form of regulation of unregulated government securities dealers. Harold Boldt also supports requiring investors to take possession of collateral.

Primary Dealers: Jon Corzine of Goldman Sachs and Waite Rawls of Chemical Bank appear to share the view held by many primary dealers that the Federal Reserve should be given additional regulatory authority to supervise government securities dealers not presently subject to any regulatory oversight (i.e., non-primary dealers that are neither banks nor broker-dealers). This supervision would include authority to require regular reporting, monitor and audit statements, question management, and alter abusive and dangerous practices. Ralph Peters of Discount Corp. supports reliance on education of investors, active surveillance by the Federal Reserve, and better coordination between regulatory agencies, in place of any additional government securities regulation at this time.

Secondary Dealers: A major fear of secondary dealers is that they will be singled out for regulation: they all believe that, if regulation is imposed, it should apply to primary dealers also. James Ogg of Westcap Corp. supports regulation by a separate Government Securities Rulemaking Board with qualifications, capital adequacy, inspection and enforcement authority. Thomas Kane of Printon supports increased Federal Reserve monitoring, qualifications requirements, and NASD inspection and enforcement authority. In earlier Congressional testimony, Griffith Clarke of G.X. Clarke stated that he believed that the present Federal Reserve oversight was sufficient, but he has since indicated that enhanced regulation should be considered.

Industry Groups: Richard Kelly of the PSA, like the primary dealers, supports giving the Federal Reserve additional authority to supervise non-primary government securities dealers, including authority to obtain reports, audit, contact management, and require changes in procedures. (The PSA's Primary Dealer Committee is seeking to develop a standard form for repos.) In addition, the PSA would support SEC and NASD examination and enforcement of requirements adopted

by the Federal Reserve. The Dealer Bank Association has not yet reached a position on government securities regulation; the SIA indicated a preference for Federal Reserve regulation, but a senior staff official has indicated that the SIA's official position is still under review.

Regulatory Agencies: The Federal Home Loan Bank Board has said that institutions insured by FSLIC should not leave collateral in repo transactions in the hands of the dealer involved in the trade. It also plans to adopt security lending guidelines, recommended by the Federal Financial Institutions Examination Council, calling for institutions insured by FSLIC to obtain collateral in securities lending transactions worth 102% of the value of the lent securities. ___/

Exhibits:

- A. Interviews with Government Securities Dealers
- B. Telephone Conversations with Government Securities Investors
- C. Special Examinations of Government Securities Dealers (Fort Worth and Atlanta Regional Offices)

___/ The Federal Reserve, FDIC, National Credit Union Administration and the Comptroller of the Currency have adopted or are planning to adopt similar guidelines.

In addition, the accounting profession is studying whether or not the procedures for confirming collateral underlying repos can be improved upon. The AICPA is assessing the risks involved in collateralizing repos, and is attempting to apprise auditors of possible risks. The Financial Accounting Standards Board and the Government Accounting Standards Board are studying possible guidelines for financial accounting and reporting of investments in repos, especially concerning the nature, value, and location of the collateral.

MEMORANDUM

TO: Richard Ketchum

FROM: Government Securities Group

SUBJECT: Interviews with Government Securities Dealers

DATE: May 17, 1985

Over the last month we visited a variety of primary and secondary government securities dealers. ___/ Our interviews indicate that in many respects the primary dealers are a relatively homogenous group that do business in much the same way, differing principally in the scale of their operations. The secondary dealers, however, are a much more heterogenous group, many of whom have carved out a particular niche in the government securities business.

Primary Dealers

The Federal Reserve Bank of New York ("FRBNY") standards for primary dealers require market making participation in the full spectrum of Treasury securities, a wide customer base, reasonable participation in Treasury auctions, and adequate financial health. Historically, the FRBNY has required that an applicant's trading activity equal approximately one per cent of the secondary market volume of all primary dealers. ___/ Once a dealer has been designated as a primary dealer, the FRBNY will deal directly with it in the FRBNY's open market operations. Beyond that narrow result of primary dealer designation, the major effect of being a primary dealer is increased status in the market. The market generally views this designation as an important indication of quality.

The primary dealers with whom we spoke had expertise in trading all Treasury securities; many larger dealers also traded a wide range of agency securities such as GNMA's. Most of the primary dealers traded only with very large customers (e.g., the largest commercial banks, municipalities, pension and money funds, and S&Ls) as well as other primary and some secondary dealers. Most indicated that they preferred

___/ A list of the dealers we have visited is attached.

___/ This standard is flexible as more dealers apply for primary dealer status. In recent years the FRBNY has looked increasingly to ensure that new dealers have trading activity at least comparable with the smaller primary dealers.

to deal only in \$5 - \$10 million minimum transactions (some smaller dealers routinely did \$1 million transactions) both in trading and financing, but would trade smaller pieces down to \$1 million or to accommodate existing customers. The primary dealers also had a variety of credit committees and procedures to ensure the viability of the entities with whom they either traded or engaged in repurchase agreements. ___/

There is no general dissemination of transaction and quotation information in the government securities market. For this reason, the most important trading vehicle available to primary dealers is the so called "broker's brokers" screen. Four major brokers have terminals in all primary dealers' offices that provide current quotation information on the full range of Treasury securities. The dealers can trade among themselves by calling the brokers. The advantages of this system are twofold: (i) the convenience in having access to a broad range of quotes from other dealers, and (ii) anonymity because all trading is done blind, i.e., without knowledge of the other side. As a general rule, these screens are limited to primary dealers.

___/ One area highlighted as a potential problem by a number of dealers concerns the when-issued market in Treasury securities. An active when-issued market arises after an auction is announced (although we heard some reports that it may begin somewhat earlier) and ends after the auction, usually lasting a week to 10 days. However, there is no generalized margin and mark-to-market procedure, thus resulting in substantial potential exposure if a counter party defaults on a trade and there has been significant market movement in the securities. Dealers indicate they have taken a variety of measures to control these risks, including limiting the customers with whom they will trade on a when-issued basis to the most creditworthy, collecting margin indirectly (or for some smaller customers directly), and generally monitoring their overall when-issued trading exposure. In addition, the FRBNY now requires primary dealers to report all when-issued positions with any customer in excess of \$10 million. The dealers acknowledge, however, that even with these measures there remains significant risk exposure during the when-issued period.

All the primary dealers engaged in repurchase ___/ and reverse repurchase ___/ transactions as a means of financing net long or short positions; some also ran "matched books" ___/ as part of their business. Repo financing positions ran from \$2 million to \$500 million for smaller dealers and as high as \$10 billion for larger dealers, with matched books exceeding \$10 billion for the largest dealers. Most of the repos were overnight or open (i.e., callable by either side), but there also was significant term repo business.

All Treasury securities are eligible for transfer through the Fed wire (from agent bank to agent bank) at minimal costs to customers. ___/ Non-wire eligible

___/ A repurchase agreement is an agreement to sell securities subject to a commitment to repurchase from the same person securities of the same quantity, issuer, and maturity, usually at a higher price so as to provide a competitive yield to the opposite party.

___/ A reverse repurchase agreement is an agreement to buy securities subject to a commitment to resell to the same person securities of the same quantity, issuer, and maturity. In effect, the opposite party receives a loan of money collateralized by securities, generally at a lower rate than is available elsewhere.

___/ In a matched book, a primary dealer will enter into a reverse repo to obtain a security, and then will repo that security out to another customer. The interest it earns on the reverse repo will be higher than what it pays on the repo, thus resulting in a small profit. For instance, a dealer may obtain Treasury securities for 30 days in a reverse repo with customers and repo those same securities out for 30 days to another customer. If the net difference in rates in these trades is 5 points, the dealer would earn \$1,400 per billion per day.

___/ Wire costs depend on the time of day used, but average for a primary dealer less than \$11 per movement, and less than \$22 per round trip (i.e., delivery and return of the collateral). The only complaint about this process that we heard was that the wire can get backed up, causing delays in moving the collateral.

securities are much more expensive to move. ___/ Most primary dealers merely segregate repo collateral on their books for the benefit of customers, although collateral may be transferred for longer term repos. A number of larger dealers indicated that they invited customers to come in unannounced to inspect their books to ensure that collateral indeed has been set aside. Apparently, a number of customers have done so and were satisfied with the arrangements.

A very few of the largest dealers have instituted "third party repos" in which a bank acts as agent for both dealer and customer. The bank values the security and holds it for the account of the customer. In these situations (although they have not been tested legally) the parties believe the customers have legal possession, although the securities have not physically changed hands. Due to the role of the bank in the transaction, however, these arrangements often are costly ___/ and it is questionable how widespread this practice will become.

Reverse repo transactions are entered into by dealers for two purposes: to earn a profit through matched books and to cover short positions. In a sense, a dealer running a matched book "substitutes" its credit for a customer seeking to raise funds. In this situation, the dealer loans the money (backed by the securities) to the customer, charging a higher rate of interest than the dealer is charged when it raises funds through a matched repo. These transactions should be virtually risk-free assuming that the books are, in fact, matched with respect to yield and maturity. Dealers also enter into reverse repos to make delivery if they are short in a particular security. Obviously, in both situations they must obtain custody of the security in the reverse repo.

FRBNY Monitoring

At present, the FRBNY closely monitors the Treasury auction and trading activities of primary dealers. Dealers are required to submit to the FRBNY daily reports of trading, and monthly and

___/ Cost estimates ranged from \$35 to \$200 for a "round trip" move of a single GNMA pool.

___/ One firm has arranged a third party repo structure costing as little as \$2 per movement; however, it appears that this low cost arises from a special understanding between the firm and its bank.

annual financial statements, which the FRBNY monitors both to assess market conditions and the soundness of the primary dealers. The FRBNY open market desk contacts the larger primary dealers frequently during the day, and FRBNY staff meet with primary dealers on a regular basis.

Effects of ESM and BBS

Most dealers did not see major changes in their clientele since BBS and ESM because they deal only with large clients and normally would not deal with the smaller dealers. ___/ A few large dealers said that they have seen a "flight to quality" as new customers have sought to deal with them. A number of smaller primary dealers said they had lost customers who now only will deal with those primary dealers having relatively high capital. Moreover, the reverse repo market appears to have shrunk to some degree because of increased reluctance of investors to give up possession of securities in the wake of BBS and ESM. The GNMA repo and forward markets have been similarly affected.

The primary dealers had a generally uniform opinion with respect to further regulation. They believe that further regulation may well be appropriate to restore confidence in the market. They uniformly believe that the Fed is the appropriate regulatory body, based on the Fed's historic involvement in the market and its knowledge of the dealer community. They also believe that the Fed would be the most sensitive to ensuring a healthy and viable market due to its role in conducting the Treasury auctions.

They supported FRBNY regulation that would include registration, capital adequacy standards, inspection, and anti-fraud regulation. ___/ They also believe that, regardless of the ultimate form of regulation, primary dealers either should be exempt from further regulation or should be in a separate category due to their unique nature. Many primary dealers opposed a requirement that investors always obtain collateral in repo trades because it would increase their costs of repo transactions, particularly for overnight repos. Finally, they

___/ The few primary dealers who dealt with ESM and BBS collateralized their financing transactions and did not lose money in the failures.

___/ The primary dealers generally did not think a self-regulatory organization was necessary; if there were to be an SRO, they were uniformly opposed to the Municipal Securities Rulemaking Board having jurisdiction due to differences in the nature of the government and municipal securities markets and fear that the MSRB would apply its full panoply of rules (e.g., confirmation, suitability, mark-up rules) to the government markets.

appeared to support SEC and NASD enforcement and inspection authority over registered broker-dealers or currently un-registered dealers.

Secondary Dealers

Conversations with secondary dealers indicated that they are a much more varied lot. A number of dealers are seeking to qualify for primary dealer status (or intend eventually to qualify). Their business practices are similar to those of the primary dealers, though usually on a smaller scale. Historically, many of these firms have not attempted to cover the full range of Treasury securities; accordingly, they are hiring traders and extending their expertise to qualify with the FRBNY. These firms generally are already well-established in other securities activities and do not anticipate having any difficulty meeting capital, credit-worthiness, or other FRBNY requirements.

The majority of secondary dealers, however, have no desire to qualify as primary dealers. Most are not prepared to make markets in all securities or to make on-going commitments to any minimum level of participation in Treasury auctions. They might specialize in a certain type of Treasury security (e.g., bills, notes, bonds) or they may be willing to become active in a particular security for a short time when they see a business opportunity to do so. Some dealers have an even more specialized niche, such as proprietary arbitrage, GNMA's, or zero coupon bonds. Most of these dealers, however, do some business to accommodate customers across the full range of securities. ___/ The larger secondary dealers participate in Treasury auctions, although at lower levels than most primary dealers.

Secondary dealers usually deal with smaller customers, such as S&Ls, municipalities, bank and similar entities, as well as some individual investors. These dealers experienced widely different impacts on their customer base from ESM and BBS. Some larger secondary dealers, particularly those associated with established registered broker-dealers, have seen new customers approach them; other smaller dealers say they have been hurt as former customers seek to do business only with primary dealers or other recognized firms.

___/ An exception appears to be GNMA's and other mortgage-backed securities. Because these are physical non-wireable securities, they require significant expertise to trade and finance and most small dealers, including primary dealers, will not handle them on a regular basis.

Virtually all secondary dealers say they have been harmed by their inability to gain access to the broker's brokers' information screens and trading systems. ___/ These dealers generally rely for information purposes on information available on a nationwide system offered by Cantor Fitzgerald (which information usually varies about 1/32 of a point from the primary brokers' screen). Most dealers feel that their exclusion from the primary dealer broker systems impairs their ability to be fully competitive in the marketplace especially in the issues in which there is less trading and price information. ___/

The financing activities of the secondary dealers vary widely. Some rely on repos to finance positions, often using the primary dealer to raise funds. ___/ Others rarely use repos and rely instead on bank financing, usually at a higher rate of interest than the repo market. ___/ Some secondary dealers run their own matched books to facilitate customers borrowing. Several secondary dealers noted a tightening of the reverse repo market in response to ESM and BBS.

___/ See page _____, infra. At least one secondary dealer does have access to these screens as a result of an historical accident. Other larger secondary dealers indicate that they can gain access to at least the information through primary dealers or other means.

___/ Lazard Freres, a secondary dealer specializing in zero coupon securities, has launched a campaign to gain access to these systems. Its campaign has included discussions with the Antitrust Division of the Department of Justice over possible illegal refusals to deal by the brokers.

___/ The secondary dealers' borrowing is one part of the primary dealers' matched book. The primary dealers then will repo the securities themselves to raise funds. See note _____, supra.

___/ These dealers indicate that the costs of developing a repo system is not economical for them.

With respect to collateralization, secondary dealer practices are similar to those of primary dealers. Treasury securities are sent over the Fed wire in all repos involving eligible securities as long as the customer have agent banks that can receive such securities. For the few secondary dealers that deal in agency securities, such securities are delivered for most longer term repos, but rarely for overnight or short term repos; in these cases the dealers maintain possession and segregate appropriate collateral on their books. No secondary dealer with whom we spoke engaged in third party repos. The length of repos varied with most being overnight or open, and some term repos up to 90 days.

The secondary dealers generally (but not uniformly) favored some type of regulation. Like the primary dealers, they believed that registration, capital requirements, inspection and the like were necessary to preserve the integrity of the market. While some dealers thought the Fed should have primary jurisdiction, other supported a rulemaking board approach with SEC oversight. A number of secondary dealers regarded the need for regulation as more important than who did the regulating.

Almost all secondary dealers stressed the importance of ensuring that whatever regulatory structure was put in place not brand the secondary dealers as inferior to the primary dealers. They believed that primary dealer status was unrelated to quality and meant only that the dealer did a full range of business and met certain other criteria relevant only to their inclusion in the Fed open market system. They believed that many customers misconstrued primary dealer status and feared that if the primary-secondary dealer status was formalized in a regulatory scheme, the distinction would gain added importance and would harm their business. They generally felt that there was a need for more than 36 dealers to service all customers and that any possible legislation should not unfairly penalize the secondary dealer community.

Primary Dealers

Bank of America
Citibank
First National Bank of Chicago
Harris Trust and Savings Bank
Bear, Stearns & Co.
Goldman, Sachs & Co.
Salomon Brothers, Inc.
Merrill Lynch Government Securities Inc.
William E. Pollock & Co., Inc.
Kleinwort, Benson, Inc.
Aubrey G. Lanston & Co., Inc.
Refco Partners

Secondary Dealers

Dillon, Read and Co., Inc.
G.X. Clarke & Co.
Thomson Mckinnon Securities, Inc.
Wood Gundy Corp.
Oppenheimer Government Securities, Inc.
The Illinois Company
Lazard Freres & Co.
Printon, Kane & Co.

MEMORANDUM

May 17, 1985

TO: Richard Ketchum

FROM: Government Securities Group

SUBJECT: Telephone Conversations with Government
Securities Investors

Over the past few weeks staff from the Division and DEPA have had a number of telephone conversations with government securities investors. ^{1/} Most of these conversations were with savings and loans ("S&L's") and municipalities which had dealt with two failed government securities dealers, ESM and BBS. In addition, the staff spoke with other investors, including large S&Ls, city and state finance officers, and money market funds which apparently have not been affected by the failures.

The staff questioned investors about: (1) the extent and nature of their government securities trading and financing activities; (2) whether investment practices had changed in reaction to the secondary dealer failures; and (3) what, if any, additional costs they were incurring due to changed investment practices.

The staff found that the small investors that were victimized by the dealer failures have changed dramatically their government securities activities in response to those failures. They have withdrawn entirely from the repurchase market--and some from the trading markets in general--and are now placing their funds in lower yielding investments. The larger investors, however, believed that they had adequate procedures in place already and have continued to operate essentially as they had before. Also, with only a few exceptions, the investors with whom we spoke favored some additional government regulation of the unregulated dealer population. However, many of them stressed the need to reassess and change internal investment policies (either for the S&L or municipality) and to insist on delivery of collateral in repurchase transactions.

Investors which Dealt with ESM and BBS

1. S&Ls

The staff spoke with seven S&Ls which had lost money from engaging in repurchase transactions ("repos") with BBS. Many of these S&Ls engaged in repos with only BBS, which had solicited

1/ A list of investors we spoke with is attached.

a number of them. 2/ None of the S&Ls with which we spoke took possession of the collateral on these transactions, believing that the collateral was segregated at BBS' clearing bank. Having lost a significant amount of money from the firm's failure, all of these S&Ls are out of the repo market completely and investing any excess cash in bank certificates of deposit ("CDs"), Fed funds and insured money market accounts which yield between 50-250 basis points less than the repos. Due to the limitations on its investments, one S&L claims it is unable to offer competitive rates and is therefore attracting fewer deposits.

Several of these S&Ls had engaged in the identical financing transaction with BBS. 3/ Interestingly, none of these S&Ls had engaged in repos before it was contacted by BBS. In these transactions the S&L would purchase a GNMA, presumably outright, from BBS, fail to take delivery on the instrument, and immediately sell the GNMA back to BBS with an agreement to repurchase. The S&L then, through a reverse repurchase agreement, would lend the proceeds from the previous repo back to BBS (or one of its related entities). That reverse repo transaction (or repo from the dealer's perspective) was presumably now collateralized by different securities, a combination of Treasuries and GNMA's, which were also held by BBS. The terms of both the repo and reverse repo were matched, and upon their expirations the S&L would earn about 40 basis points. The S&L earned the 40 basis points because these transactions resulted in the S&L's borrowing funds from BBS (in the repo transaction collateralized by the originally purchased GNMA) at a lower rate than it was lending money to the firm (in the subsequent reverse repo transaction presumably collateralized by the additional Treasuries and GNMA securities). Until the collapse of the firm, the S&L also would receive a principal and interest payment on the GNMA it originally purchased from BBS. These payments have stopped since the bankruptcy. 4/

2/ Unlike a number of other situations involving Drysdale and Lion Capital in which money brokers acted as intermediaries between the dealers and customers, the investors with whom we spoke dealt directly with ESM and BBS.

3/ Ira Bailey, one of the investor panelists, is the president of Cross County Savings and Loan, Middle Village, New York, which engaged in such transactions with BBS.

4/ The S&Ls were uncertain whether these GNMA's had been registered in their names or in BBS'. This may be related to disruptions in the GNMA market as S&Ls have put stop orders on the disputed GNMA certificates. See S&Ls Seek Return of Securities Tied to Failed Concerns, Wall Street Journal, May 15, 1985, page 41.

2. Municipalities

The municipalities with which we spoke had dealt with ESM. One county claimed that it was "forced" to use secondary dealers because it was not large enough to do business with the primary dealers. Also, it stated that despite its prudence--the county reviewed the financial statements of the dealers it used and took possession of collateral on all long-term repos and on some short-term repos ^{5/}--it still lost money. The county failed to take possession of collateral for a short-term repo outstanding when ESM went out of business. The county is no longer engaging in repos and is investing its funds in CDs with local banks yielding 50-75 basis points less than the repos.

Another municipality was not nearly as prudent; it would invest its funds with any dealer that offered it the best rate on a repo. This municipality did not have any safekeeping arrangement with a bank; thus, because it lacked the means, the municipality did not take possession of collateral. The municipality assumed that the collateral was being segregated by ESM at the firm's clearing bank. The municipality is also out of the repo market now and is investing its \$1.5 million in available cash in guaranteed money market accounts with state banks at yields of 200 basis points lower than the repos. ^{6/} The municipality is now exploring establishing a full service arrangement with a local bank which would include safekeeping services.

These investors are uniformly in favor of regulation of the unregulated dealers. Because of the magnitude of losses sustained, many are uncertain about possible future reentry into the market even with additional regulation.

^{5/} The county took possession of collateral even though ESM informed them that it would earn 25 basis points less on the repo.

^{6/} Beaumont, Texas' experience with ESM is quite similar. (Betty Dunkerley, acting finance officer, is one of the investor panelists.) The city had 65% of its assets, or about \$20 million, invested in repos with ESM when the firm went bankrupt. Beaumont believed that its collateral was being safekept with Bradford Trust, ESM's clearing bank. Apparently, the city had required third party safekeeping of collateral in the past, and believed that ESM's method was consistent with that practice. The city is now investing in overnight deposits with local banks and certain approved S&Ls. Ms. Dunkerley says that the city is earning 5-10 basis points less than it was earning on repos.

Other Investors

The larger investors which had not suffered losses due to the ESM and BBS failures generally limit their financing activities to the primary dealers. While many take possession of collateral on all repo transactions as a matter of course, several indicated that they routinely do not take possession of collateral, relying on the reputation and segregation arrangements of the primary dealer. Several investors did note that returns on repos may be reduced if the dealer delivers collateral; others noted that primary dealers often offer slightly lower rates than secondary dealers on repos. With respect to bank safekeeping services, these investors explained that the fees are based on both asset value and the number of transactions into and out of the account. For example, fees to receive wire transfers of collateral are about \$10, one-third to one-fourth the amount charged to process the receipt of collateral in physical form, such as a GNMA.

Bruce Cleveland, president of Government Investors Trust, a money market fund, and one of the investor panelists, said that his fund will do business only with the top twenty firms in the country, without regard to their status as primary or secondary dealer. The fund always takes possession of collateral, marks the collateral to the market daily, and requires additional collateral when appropriate. Its bank custody fees range from 6 basis points for \$50 million to 2 basis points for \$100 million in custody.

In contrast, a large California S&L, which had not required delivery of collateral in the past and will begin to do so in the future, claimed that its clearing bank would not impose any additional charges to process receipt and delivery of collateral.

Harold Boldt, finance director of Columbia, Missouri, chairman of the Government Finance Officers Association's ("GFOA") cash management committee, and another investor panelist, believes that delivery of collateral should be required, in addition to government oversight of secondary dealers. However, there appears to be a split of opinion among the members of the GFOA cash management committee about the need to take possession of collateral. We spoke with another member, Gary Norstrem, the treasurer of St. Paul, Minnesota, who believes that possession is not necessary when dealing with the primary dealers, which will segregate the collateral. However, as noted previously, not every municipality has the option of doing business with a primary dealer.

One other former state finance officer with whom we spoke, who is now at a Big Eight accounting firm advising municipalities on government securities investments, stressed

the need for established investment policies. He believes that elected officials should be educated about the investment strategies and be held accountable for investment decisions of municipal finance officers. In addition, he emphasized the importance of taking possession of collateral despite the increased costs to the system. Finally, he pointed to the need for capital adequacy guidelines to provide protection in the event of a firm's error, if not for its fraud.

S&Ls

Southern Illinois National Bank, Fairview Heights, Illinois
First Federal Savings and Loan, Freeport, Illinois
Great American Federal Savings and Loan, Oak Park, Illinois
Citizens Federal Savings and Loan, Bellefontaine, Ohio
Cross County Federal Savings & Loan, Middle Village, New York
Worthen Banking Corporation, Little Rock, Arkansas
Fort Lee Savings and Loan, Fort Lee, New Jersey
Home Federal Savings & Loan, San Diego, California
Imperial Savings Association, San Diego, California
National Permanent Bank, Washington, D.C.

Municipalities

Beaumont, Texas
Dauphin County, Pennsylvania
Pompano Beach, Florida
Washington, D.C.
Atlanta, Georgia
St. Paul, Minnesota
Port Authority of New York and New Jersey
Columbia, Missouri
John Kiley, formerly Treasurer of Washington State

Money Market Funds

Government Investors Trust, Washington, D.C.
Calvert Group, Washington, D.C.

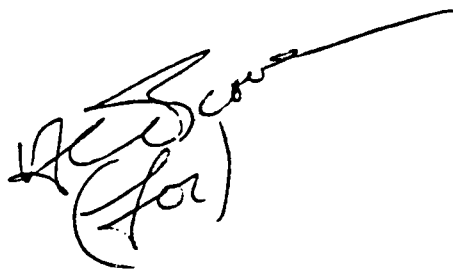
M E M O R A N D U M

TO: Richard G. Ketchum, Director
Division of Market Regulation
~~STOP: 5-1~~

FROM: Wayne M. Secore, Administrator
Fort Worth Regional Office

DATE: May 7, 1985

SUBJECT: SPECIAL EXAMINATIONS OF
GOVERNMENT SECURITIES DEALERS



On Tuesday, April 9, 1985, it was publicly reported that Bevill Bresler and Shulman Asset Management Corporation ("Asset Management") had ceased to do business and had been placed in an equity receivership. The following Friday, April 12, 1985, it was publicly reported that Broker's Capital Corporation ("Brokers") had between \$1 and \$2 million in exposure to losses on repurchase agreements with Asset Management and had ceased to do business. On that same day, Friday, April 12, 1985, the New Orleans office of the National Association of Securities Dealers, Inc. ("NASD New Orleans"), which has responsibility for member broker-dealers located in Little Rock, Arkansas, among other places, advised the Fort Worth Regional Office ("FWRO") that Collins Securities Corporation ("Collins"), a registered municipal securities dealer and a government securities dealer located in Little Rock, had \$29 million in repurchase agreements with Brokers; that it had an additional \$3.5 million in repurchase agreements with Midwest Securities, another government securities dealer known to be experiencing financial difficulty; and that Collins did not have sufficient net capital to absorb the losses anticipated, approximately \$5 million. The NASD New Orleans further advised the FWRO that other Little Rock dealers (most of whom specialize in government and municipal securities) might be similarly endangered.

On the same day, Friday, April 12, 1985, the FWRO contacted counsel for Collins and requested that the firm close and remain closed; that the FWRO would recommend to the Commission that a civil injunctive action seeking appointment of an equity receiver be instituted; and that FWRO attorneys and examiners would arrive in Little Rock the following Monday. On the same day, the FWRO

and the NASD New Orleans made arrangements to send as many examiners as were available to other Little Rock municipal government dealers the following Monday as well.

Firms doing a government business were identified and assessed a "risk" factor (1 - highest; 3 - lowest) based on the sizes of known open repurchase agreement positions, net capital and subjective considerations. Foremost among the subjective considerations was the existence of repurchase agreements with other government dealers known to be in financial distress.

On Monday, April 15, 1985, three FWRO examiners, six NASD New Orleans examiners and two NASD staff members from Washington, D.C. commenced examinations of the following municipal and government dealers, based on the priorities listed below:

<u>Firm</u>	<u>Repos?</u>	<u>Priority</u>
Boykin Sparks & Associates ("BSA")	No	3
Jon R. Brittenum & Associates, Inc. ("JRB")	Yes	1
Bryan, Worley & Co., Inc. ("BWC")	Yes	2
Collins	Yes	1
B. J. Compton & Sons, Inc. ("Compton")	No	3
Crews & Associates, Inc. ("Crews")	No	3
Delta Financial Investment Corp. ("Delta")	No	2
First Investment Securities, Inc. ("FISI")	Yes	2
Lasater & Company ("Lasater")	Yes	2
Powell & Satterfield, Inc. ("P&S")	No	3
T. J. Raney & Sons, Inc. ("Raney")	Yes	3
Stephens, Inc. ("Stephens")	Yes	2
Swink & Company, Inc. ("Swink")	Yes	1

FWRO examiners started with Collins and JRB, while the NASD New Orleans examiners started with Swink and Delta. Upon completion of these examinations, the FWRO examiners conducted inspections

at FISI, while the NASD New Orleans examiners inspected BWC, Crews, Lasater, Raney and Stephens. 1/

During the course of these examinations, special attention was given to large repurchase agreement positions and to the delivery of the securities collateralizing the transactions. Where repurchase agreements were "daisy-chained" to one or more other dealers, efforts were made to determine whether the other dealer(s) could be expected to honor such commitments. In this regard, the FWRO sought and received the assistance of the New York, Chicago and Atlanta Regional Offices, as well as the Federal Home Loan Banks in Chicago and Dallas.

With the exception of Collins, which was placed in an equity receivership on Tuesday, April 16, 1985, no problems requiring immediate Commission action have been encountered. JRB continues to dishonor \$5 million in repurchase agreements with Midwest Securities in Chicago, a firm which has closed, but is protected by off-setting repurchase agreements with the same firm. Lasater has been slow to deliver out collateral in safekeeping, but appears now to be doing so. 2/ Both matters are being monitored by this office. Stephens remains amply capitalized, even after infusing \$32 million into the Worthen Bank to compensate for the bank's losses on dishonored repurchase agreements with Asset Management.

The FWRO staff visited seven firms in Little Rock, Arkansas and one in Austin, Texas; we reviewed with either compliance personnel and/or financial principals the repurchase and reverse repurchase transactions that had been effected by the firms. (See Exhibit A for a list of the firms and a summary of the open repurchase agreements on the firms books at the time of our visit.) As part of our review of the government securities area, we prepared an outline of questions we felt were pertinent to the review of repurchase agreements (See Exhibit B).

1/ The FWRO examiners also visited Swink, Delta, Lasater, BWC, Raney and Stephens to assist the New Orleans examiners address specific problems as they arose and to gather certain basic information relating to the repurchase and reverse repurchase transactions effected by the firms. The FWRO examiners also conducted an oversight examination of Delta.

2/ Lasater may also have made misrepresentations to its customers concerning repurchase agreements with Midwest Securities, a matter which is the subject of a formal investigation presently being conducted by the Chicago and Fort Worth Regional Offices.

As a result of our review, we have identified what we perceive to be abuses in the repurchase agreement area as listed below:

1. Repurchase agreements being used as a sales come-on to induce customers to buy the security with the understanding that he will never have to pay for it;
2. Interest rate spreads between the repurchase and reverse repurchase of two or three percent (2%-3%) or more;
3. Secondary dealers operating in the repurchase agreements "daisy-chain" who are not adequately capitalized; and
4. Safeguards not being in place to protect reverse repurchase customer funds for the margin (market value of collateral less amount loaned) that is demanded on such transactions.

Attachments:

As stated above.

TCBrowne:lp

cc: Mark D. Fitterman, Associate Director ✓
Richard T. Chase, Associate Director
Sarah B. Ackerson, Assistant Director
Division of Market Regulation
STOP: 5-1

<u>Government Broker/Dealer</u>	<u>Type Transaction</u>	<u>Broker Margin</u>	<u>Number Dealers</u>	<u>Amt. Repo (Borrowed)</u>	<u>Number Customers</u>	<u>Amount Rev/Repo (Loaned)</u>	<u>Amount Customer Collateral</u>	<u>Customer Exposure (Assuming Par Cost)</u>
Jon R. Brittenum & Associates, Inc.	Matched	\$ 9.7MM	5 <u>1/</u>	\$121MM	16	\$112MM	\$128 MM	\$16 MM
Bryan, Worley & Company	Perfectly Matched	-0-	2 <u>2/</u>	\$ 4MM	2	\$ 4MM	\$ 4 MM	—
Collins Securities Corp.	Perfectly Matched	-0-	2 <u>3/</u>	\$ 31MM	9	\$ 31MM	\$ 33.6MM	\$ 2.4MM
First Investment Securities, Inc.	Matched	\$ 5 MM <u>4/</u>	1	\$ 31MM	8	\$ 31MM	\$ 45 MM	\$14 MM
T. J. Raney & Sons, Inc.	Matched	\$30 M	3	\$ 4MM	3	\$ 3MM	\$ 3.5MM	\$.5MM
Stephens, Inc.	Perfectly Matched		4 <u>5/</u>	\$ 64MM	6	\$ 64MM	\$ 67.5MM	\$ 3.5MM
Swink & Company	Matched		<u>6/</u> 1	\$ 16MM	7	\$ 16MM	\$ 16 MM	
Landmark Government Securities <u>7/</u>	Perfectly Matched	—	5	\$240MM	13	\$240MM	\$247 MM	\$ 7 MM

1/ Fifty percent repo with First South.

2/ Dealer keeps three points as margin - 75% repo with First South.

3/ Collins trades its repos with Brokers Capital and Midwest Government Securities.

4/ Securities and cash deposits.

5/ Firms other than Stephens deal with secondary dealers.



6/ Additional securities required to be deposited with firms.

7/ Located in NASD District No. 6.

Office Memorandum • SECURITIES AND EXCHANGE COMMISSION

DATE: May 2, 1985

TO : Michael K. Wolensky
Regional Administrator

FROM : Kenneth E. Newman 
Securities Compliance Specialists
Howard Dennis, Jr. 
Securities Compliance Examiner

SUBJECT: Examination of Government Dealers

On April 15, 1985 examinations of four unregistered government dealers headquartered in Memphis, Tennessee were started. The following is a brief summary of the firms that were examined and the results of those examinations. The firms examined were all government dealers that had an affiliated registered dealer and had agreed to the examinations prior to our visit. Detailed reports will be prepared for each examination later.

UMIC Government Securities, Inc.

UMIC Government Securities, Inc., (Govt) is a wholly-owned subsidiary of UMIC, Inc., a holding company that also owns 100% of the capital shares of UMIC Mortgage Company, Inc., and UMIC Securities, Inc., (Securities). Govt does not inventory any securities and does only matched book repos and reverse repos. Govt had 240 million in match book repos at the time of this examination.

The examination of Govt began on April 15, 1985 and was completed on April 18, 1985. The examination consisted of a full review of the financial records of Govt and the underlying subsidiary records. The bulk of the examination was spent verifying that Security Pacific Corp., (SPC) was holding the various pieces of collateral for customers or firm accounts as claimed by the firm and that collateral had not been pledged more than once. From a review of the firm's records and SPC it was determined that Govt had all the collateral that it claimed to have and that it had been properly separated at SPC. It should be noted that Govt did not have a collateral loan since it had been able to match all of its trades and in fact SPC owed Govt \$3,500,000 as of the end of March. The records of Govt were current and had been reconciled with the records of the clearing corporation as of the date of this examination.

The principals of Govt indicated that they were going to close the unregulated government dealer before the end of April because of the bad publicity associated with ESM and the other government dealers that have been in the news lately.

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Carty Government Securities, Inc.

Carty Government Securities Inc., (Govt) is a wholly-owned subsidiary of Carty & Company, Inc., who also owns 100% of the capital shares of Carty Securities Company. Carty & Company is owned entirely by Bill Carty who also is the chief operating officer of all the companies.

The examination of Govt commenced on April 15, 1985 and was completed on April 16, 1985. Govt was not transacting any repo business at the time of this examination and did not contemplate executing any of this type of business in the near future. The firm was buying and selling government securities only which were being held at Security Pacific Corp. (SPC) for Govt. The review of Govt's records disclosed that all securities had been accounted for and all security positions and money had been reconciled from the firm's records back to the records of SPC.

Townes Government Securities, Inc.

The examination of Townes Government Securities, Inc., (Govt) began on April 16, 1985 and was completed on April 16, 1985. Govt was an inactive company that had last transacted business in February 1985. The records of Govt and the clearing company were reviewed to make sure that Govt had in fact not transacted any business recently and that Govt did not have any open position at the clearing Corp. From the records of both the clearing company, and the Govt Corp., it appears that the company had in fact been inactive.

Duncan-Williams Government Corp.

Duncan Williams Government Corp., (Govt) is owned entirely by a Duncan Williams who is also the sole owner of Duncan Williams, Inc., a registered municipal securities dealer. The examination of Govt began on April 16, 1985 and was completed on April 18, 1985.

Govt was actively transacting a business in repos and reverse repos at the time this examination commenced. The records of Govt were not current at the time of this examination. When this was brought to Duncan Williams' attention he immediately had his auditors commence working on Govt's records to bring them up-to-date. A review of the collateral securing the loans made by Duncan Williams disclosed that in at least one instance collateral had not been transferred to Govt's safekeeping account at Security Pacific Corp., (SPC) even though the funds had been transferred. When this

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deficiency was brought to Duncan Williams' attention he immediately went to New York and had the borrowing broker transfer the collateral over to Govt's safekeeping account at SPC. A copy of the receipt was obtained and made available for review before the examination was completed.

Morgan Keegan & Company, Inc.

Morgan Keegan & Company, Inc., is a member of the New York Stock Exchange that transacts government business through the regulated dealer as opposed to having an unregistered dealer transact the government business. The visit to Morgan was made solely for the purpose of determining how they were handling their government business and if the recent failures in other dealers had an adverse impact on Morgan.

From a quick review of the records of Morgan it was determined that there had not been any problems from the failure of ESM or any other dealers. Morgan's records were current and no problems were noted.