Regulation of the Government Securities Market

Minority Report of Commissioner Aulana L. Peters
of The Securities and Exchange Commission
to the Subcommittee on Telecommunications, Consumer
Protection and Finance of the Committee on Energy and
Commerce of the U.S. House of Representatives

June 20, 1985

I. Executive Summary

I am providing this Minority Report to the Telecommunications, Consumer Protection and Finance Subcommittee of the House Energy and Commerce Committee in response to its request, on March 21, 1985, for the Securities and Exchange Commission's (the "Commission's") views on the regulation of the government securities markets. I am unable to adopt the conclusions expressed by my fellow Commissioners in their submission primarily for two reasons. First, the Commission's Majority Report fails to answer a question specifically put by a member of this committee to our agency, namely whether problems in the government securities market warrant a legislative response. In the wake of the recent failures of several small government securities dealers which resulted in substantial losses to investors and on the basis of the overwhelming input from market participants, I have concluded that some limited legislative response is indeed warranted. Second, I dissent from the majority's recommendation that Congress grant the Department of the Treasury ("Treasury") rulemaking authority over government securities dealers. In my opinion, either the Commission or the Federal Reserve Board ("FRB") would be preferable rulemakers.

I concur in the majority's position that the recent failures of government securities dealers have had a disproportionate unsettling effect on the government securities markets. Moreover, after evaluating the information obtained by the Commission in the last 90 days, I recognize that the market and existing regulatory bodies have responded in a variety of ways to the particular problems raised by these failures. To that extent, I concur in the discussion on pages 6-25 of the Commission's Majority Report.

Nonetheless, I firmly believe that the creation of a narrowly focused regulatory scheme for the government securities market as outlined in the following report is necessary to limit the occurrence of similar problems in the future. A narrowly focused regulatory system would be valuable in protecting investors and maintaining the depth, liquidity, and efficiency that currently characterize the market for government securities. Given the importance of this market to the effectuation of the nation's monetary and fiscal policies, I believe that it is essential to preserve both the efficient operation of this market and public confidence in its integrity and soundness. I also believe that these aims can best be achieved by a carefully delineated expansion of the regulatory authority regarding the government securities market.

In an ideal world, I would place regulation of all government securities dealers in the hands of the Commission, which is the undisputed expert in the area of regulating broker-

dealers. Commission rulemaking authority would also be consistent with the concept of functional regulation. For practical reasons, I have elected to recommend a regulatory system compatible, if not fully consistent, with my philosophical views. Based on the recent comments and testimony of participants in the Commission's recent fact gathering process, I believe market participants are more likely to support FRB rulemaking authority than Commission rulemaking authority.

The Commission's Majority Report recommends that rulemaking authority be vested in the Treasury. Such a result, in my opinion, would be unfortunate and inappropriate. The FRB, not the Treasury, is currently the most knowledgeable federal agency with respect to the government securities market and its operations. The FRB, therefore, is better able to promulgate rules and exercise oversight for those markets. Moreover, I believe that it is preferable to have an independent agency as the repository of rulemaking authority for the government securities markets since an independent agency is less susceptible to the vicissitudes of different administrations. Lastly, to confer rulemaking authority on an issuer selling in a marketplace seems anomalous as an issuer could favor itself to the detriment of competitors and customers.

With respect to registration, I recommend requiring currently unregistered dealers to register with the Commission, and banks to register with their present bank regulators. FRB rulemaking authority would include the power to adopt rules concerning

dealer capital, independent audit and recordkeeping, collateralization requirements, and certain trading practices. All government securities dealers would be subject to the FRB collateral requirements and trading regulations, while previously unregulated dealers would also be subject to the capital, audit and recordkeeping requirements. Registered broker-dealers and banks would, of course, continue to be subject to the existing Commission or bank capital, audit, and recordkeeping requirements of their present regulatory agencies.

Inspection and enforcement of rules under this system would be the responsibility of the bank regulatory authorities for banks, and the Commission and the self-regulatory organizations for non-bank dealers. The Commission, however, should be given residual inspection and enforcement authority. The FRB would maintain its present relationship with primary dealers.

II. Discussion

I believe that the actions taken by market and regulatory participants in response to the troubles in the government securities market generally have had a positive effect, and that most of these measures should be encouraged. However, I do not believe that reliance on this market reaction in and of itself is a sufficient response to the problems in the government securities market. While market response appears to have reduced the need for any all-encompassing regulatory scheme, I believe that a legislative response is appropriate and necessary

to address specific problem areas. Accordingly, I recommend that legislation 1/ be enacted that would:

- Require non-bank dealers in government securities to register with the Commission, and bank dealers to register with their appropriate bank regulator;

- Vest in the FRB the authority to adopt rules pertaining to capital adequacy standards, recordkeeping, collateralization or segregation requirements, margin, and when issued trading practices;

- Give the Commission, FRB, and other bank regulators the authority to inspect government securities dealers, to enforce the FRB rules and to bar or suspend persons who violate those rules;

- Allow the Commission to regulate government securities clearing agents, including agent banks.

Before discussing the above proposal, it would be beneficial to consider two other alternatives that received the attention of some commentators: (1) reliance on market forces and investor regulation responses and (2) imposition of an across-the-board requirement to deliver collateral in all repurchase agreements ("RP").

A. Current Market Responses

As discussed the Commission's Majority Report, dealers, investors and regulators have taken a number of actions to

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1/ As noted on page 2, *supra*, the legislative package I recommend represents a philosophical compromise since it is not fully consistent with the concept of functional regulation. However, the above described proposal has the advantage of relying on a preexisting regulatory framework, thus (1) momentarily avoiding the cost of establishing a new framework or expanding an existing one, and (2) being acceptable to the vast majority of the government securities dealers.

address the recent failures in the government securities markets, and, in particular, the problems concerning RPs that resulted in substantial investor losses. These actions generally have been positive and will help increase the soundness and efficiency of the government securities market. Knowledge of the risks of not knowing the contra party, and of not taking possession of securities in RPs, are important steps to help prevent a repeat of the most recent abuses. Nevertheless, such actions are insufficient in and of themselves to ensure the continued soundness and efficiency of the government securities market. There are a number of reasons that lead me to this conclusion.

First, I believe that fundamental recordkeeping and financial responsibility rules coupled with periodic examinations of all government securities dealers permit flexible responses to new problems which develop in the government securities market. While the market has reacted over time to each of the problems presented (such as the specific set of circumstances that led to the failure of Drysdale Government Securities, Inc.), the lack of a regulatory body with responsibility for the market impedes the speedy implementation of such reforms. Similarly, without a centralized rulemaking body, it also is difficult to address potential regulatory issues in advance in a coordinated manner.

I also believe that, while the FRB has taken certain informal steps such as adoption of the voluntary capital guidelines and issuance of an educational circular, there is a clear limit to its ability to act in the absence of any formal authority.

Private bodies and regulatory agencies have more extensive capabilities to address the conduct of investors in government securities. Nonetheless, such measures, if not coupled with regulation and oversight of the dealer community, have proven to be insufficient in the past and may not be sufficient in the future to curtail abuse.

For example, while the accounting profession may address issues relating to RPs, and regulators such as the Federal Home Loan Bank Board may issue guidelines concerning investors' actions, many investors dealing with ESM Government Securities, Inc. ("ESM") and Bevill Bressler Schulman Asset Management Corp. ("BBS") ignored existing regulatory guidelines and professional practices. I am informed by the staff that even in the wake of ESM and BBS, some investors are still failing to protect themselves adequately. Regulating the dealer community will provide a complimentary and necessary system of regulation to supplement the private market initiatives.

In this regard, I believe that a central regulatory system is the most appropriate method to address certain of the problems currently facing the government securities market. For example, there currently is no method to police effectively the criteria for entry into, or continued participation in, the government securities market. Furthermore, a uniform national approach will provide a single set of regulations covering all market professionals in a manner similar to the regulatory system that fairly and uniformly governs participants in other securities markets.

To fail to accept minimal cost-effective regulation of government securities dealers, and to rely solely on private sector and investor regulator initiatives, could have adverse consequences on the market. Absence of regulation invites investors to overreact to the problems in the government securities market by withdrawing from the market entirely or curtailing their activity significantly. As noted in the Commission's Majority Report, the Commission's study of recent developments in the market has indicated that many investors are wary of conducting business with unregulated secondary dealers and have imposed restrictions on the dealers with whom they will do business. While I believe that it is beneficial for investors to scrutinize closely the dealers with whom they deal, I am concerned that arbitrary decisions in this area may unfairly penalize legitimate secondary dealers. Similarly, to the extent dealers remain unregulated, or subject only to voluntary guidelines, agencies that regulate investors in the government securities market may well either preclude regulated institutions from utilizing those dealers or at least impose substantial safeguards on participation that may make doing business with those dealers impractical or economically not feasible. These uncoordinated private and regulatory responses ultimately may lead to a contraction in the dealer community and a possible loss of liquidity, particularly if there is no dealer base to service the small to medium-sized customers.

Finally, I am concerned that investors who remain in the government securities market nevertheless may withdraw from the RP market, with potentially serious consequences. The withdrawal of a significant number of investors from the RP market could constrict the financing available to dealers, and hence reduce dealers' ability to position significant amounts of government debt. Panelists at the Commission's Open Forum noted that the loss of even small investors could have some effect, and at least one panelist remarked that he had already observed a contraction in the RP market. 2/ Thus, I believe that a limited centralized regulatory system is desirable to help restore public confidence in the RP market.

B. Delivery of Securities Subject to Repurchase

1. The Commission's Majority Report argues that a requirement that customers take delivery of securities subject to repurchase in all instances would not be cost-effective. For the reasons noted in the Commission's Majority Report, I concur in that view. However, I would like to make certain observations which are not made in the Commission's Majority Report. First, requiring delivery in RPs does not address other serious problems in the government securities market. For example, losses of margin deposits are estimated to account for two-thirds of the losses in ESM and over 15 percent of the losses in BBS. Second,

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2/ Statement of Thomas Kane, Partner, Printon Kane & Co., at the Commission's Open Forum, May 21, 1985. See also letters dated May 17, 1985 to John Wheeler, Secretary, Commission, from Ronald D. Upton, Executive Vice President, Irving Trust Company; and May 17, 1985 to John Wheeler, Secretary, Commission, from Robert M. Gardiner, Chairman and Chief Executive Officer, Dean Witter Reynolds, Inc.

focusing only on physical possession of securities would not address the problems of keeping "bad actors" managing, or employed by, problem dealers from subsequently reentering the industry with another firm. Third, this approach does not require dealers to maintain adequate books and records, does not provide for routine inspections, and does not provide for other regulatory initiatives that are important to help restore public confidence in the market. In sum, as a static response, it does not provide any ability to deter or respond to different fraudulent activity which may occur in the government securities market in the future. For this reason, I do not recommend legislation mandating delivery in RPs in all cases. I recognize, however, that there may be types of investors for whom a delivery requirement is justified. 3/ Similarly, I have reached no conclusion on whether a delivery reqirement for all long-term RPs may be appropriate. Instead, as discussed below, I recommend that the FRB be given rulemaking authority which would enable it to promulgate cost-effective delivery or customer segregation requirements for the RP market.

C. Proposed Regulatory Program

In proposing a legislative response to the question of whether to regulate the government securities market, I would emphasize that I only endorse legislation drafted narrowly to

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3/ For example, I believe that, for the protection of investors, it is important that all money market mutual funds take possession of securities in RPs. In light of their large volume of RPs, they are also capable of arranging for delivery at low cost.

address areas in which there have been demonstrated problems in the market. As discussed in the Commission's Majority Report, the government securities market is by far the largest securities market in the world and historically has functioned remarkably free of serious difficulties without any formal regulatory structure covering dealers in that market. Furthermore, these markets are central to the United States' fiscal and monetary policy, and unwarranted regulation could have unpredicted effects on the ability of the Treasury to finance the national debt. Many dealers are already subject to broad regulatory schemes and new regulation should, wherever possible, neither conflict with, nor add new burdens on, those dealers at this time.

1. The FRB is an appropriate rulemaking body 4/

The FRB is the most knowledgeable federal agency with respect to the operation of the government securities market. The FRB, through the reserve banks (primarily the Federal Reserve Bank of New York) ("FRBNY") has responsibility for conducting Treasury auctions and, through its open market operations, implementing fiscal policy. The FRBNY also has a business relationship

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4/ Philosophically, I view regulation of the government securities market as regulation, not of the market *per se*, but as regulation of the players in that market. Thus, if I were to recommend the ideal regulatory scheme to meet the identified problems, I would recommend rulemaking by the SEC. However, in examining the alternatives for a workable, cost-effective solution that would meet the least resistance, one must conclude that rulemaking by the FRB is preferable.

with the primary dealers and collects monthly information from reporting secondary dealers. Accordingly, not only is the FRB familiar with the operation of the government securities market, but, as indicated by the comment letters received by the Commission, market participants are familiar with the FRB and support a more formal oversight relationship with the FRB.

In this regard, it is important to note that the FRB already has begun an informal supervisory process over the heretofore unregulated government dealers, primarily through its recently adopted voluntary capital adequacy standards. 5/ The FRBNY also collects monthly information from a number of secondary dealers on a voluntary basis. In addition, the FRB prepares educational materials for participants in the government securities market and is conducting educational seminars on this market around the country. In view of the deep involvement of the FRB in the government securities market, I believe that the most cost-efficient regulatory system for the market would be simply to make the FRB the principal regulator of the market. 6/

5/ See p. 6, *supra*.

6/ There is a similarity between my current proposal and the manner in which securities margin currently is regulated. Pursuant to Sections 7 and 8 of the Securities Exchange Act of 1934 (the "Act"), the FRB has jurisdiction over margin rulemaking, with the SEC having enforcement authority over broker-dealers and the bank regulators having authority over the banking community.

I recognize that there have been a number of proposals, including proposed legislation, 7/ that would vest rulemaking authority for the government securities market in a new self-regulatory organization ("SRO") or in an existing SRO, such as an expanded Municipal Securities Rulemaking Board (which would be renamed the Public Securities Rulemaking Board). For the reasons noted in the Commission's Majority Report, I do not believe that SRO rulemaking is appropriate for the government securities market, at least at this time.

Similarly, I concur with the majority of the Commission that it would not be appropriate to expand the jurisdiction of either the stock exchanges or the National Association of Securities Dealers, Inc. ("NASD") to cover government securities rulemaking. I would note particularly that SRO rulemaking authority is unnecessary since a government agency, the FRB, already exists with the expertise and resources necessary to perform this task. 8/ In this regard, it is not contemplated that increased rulemaking responsibilities would impose significant resource burdens on the FRB.

The majority of the Commission recommends a legislative scheme that provides for rulemaking authority to be granted to the Treasury. In my opinion, the Treasury would be an inappropriate rulemaking body in this context for a number of reasons. As I have already indicated, the FRB is most

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7/ Proposed "Public Securities Act of 1985," H.R. 2032.

8/ See Costs of proposed regulation, *infra*, at p. 22.

knowledgeable about the government securities market and its operations, including dealer practices. Although the Treasury has fiscal and, to some extent, monetary policy expertise, it has neither market knowledge nor dealer regulation expertise. In effect, the Treasury has delegated all contact with the market to the FRB. Therefore, it is illogical for the Treasury to assume partial oversight of the market.

Second, in my view it is preferable to place rulemaking in an independent regulatory agency that is less susceptible to changes in administrations and political philosophies. Rulemaking by an independent agency would also be a more efficient, less burdensome procedure since rulemaking initiatives would not be subject to Office of Management and Budget ("OMB") review. 9/

Finally, and perhaps most importantly, to confer rulemaking authority over this very important market to an issuer in the market seems anomalous in the extreme. The legislative response favored by a majority of the Commission would have an issuer in a position to favor itself, disadvantage its competitors and pressure its customers.

2. The FRB's rulemaking authority should be narrow in scope

I would like to emphasize that the grant of rulemaking in the government securities market should be narrow in scope, addressing only those areas of the market in which there have

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9/ Except, of course, OMB must review recommendations subject to the Paperwork Reduction Act.

been demonstrated abuses. Specifically, I recommend that legislation be adopted to provide for regulation of the following aspects of the government securities market.

Registration. An initial step in all regulatory systems is to ensure that the appropriate regulators have jurisdiction over the relevant market participants. All government securities brokers and dealers therefore must register. 10/ Registration, where possible, should be consistent with existing regulatory relationships to reduce potential burdens. Therefore, currently registered broker-dealers who conduct their government securities business as part of the registered entity would retain their Commission registration. Currently unregistered non-bank dealers also would register with the Commission. Bank dealers, or discrete units of banks that are dealers, would register with their appropriate bank regulatory agency as government securities dealers.

10/ "Dealer" would be defined in a similar manner to securities dealer (Section 3(a)(5) of the Act) and municipal securities dealer (Section 3(a)(30) of the Act); "broker" similarly would be defined (Sections 3(a)(4) and 3(a)(31) of the Act). I recognize that significant interpretive advice will be necessary in the early stages of the registration process to address the issue of who is a government securities dealer, and that exemptive relief may be appropriate for specialized groups. For example, it has been argued that mortgage bankers should be regarded as issuers of GNMAs so that regulation of them as dealers would be inappropriate. See letter dated June 3, 1985 to John Wheeler, Secretary, Commission, from Glen S. Corson, Senior Staff Vice President, Mortgage Bankers Association of America.

Statutory Disqualifications. An integral part of the registration requirement must be the authority to deregister a government securities dealer and discipline its associated persons. A consistent theme in many of the recent government securities dealers' failures has been that key personnel from one firm move to other firms which subsequently run into difficulty. While I believe that the Commission presently has the authority to prevent these "bad actors" from moving from firm to firm, bank regulatory authorities have no similar ability. Accordingly, I believe that a system of "statutory disqualifications" should be established in the government securities market to ensure the ability of each of the appropriate regulators to police the movement of personnel in the industry. 11/

Capital Adequacy Standards. One significant problem in the government securities market has been the lack of adequate capitalization of dealers; indeed, the largest failures have involved dealers that operated for substantial periods of time while insolvent. Accordingly, the FRB would be empowered to adopt a capital adequacy rule. I expect that such a rule would be based on the current FRB voluntary standard and Commission Rule 15c3-1. As an adjunct to this rule, the FRB may choose to require financial reporting by government securities

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11/ See Sections 3(a)(39), 6(c)(2), and 15A(g)(2) of the Act.

dealers to permit effective monitoring of their compliance with this standard. I believe that the FRB should have the authority to require such reports to be audited. Dealers whose government securities business is part of a registered broker-dealer would continue to be subject solely to the Commission's net capital rule. Bank dealers would continue to be subject to bank regulation of reserve requirements. Currently unregulated dealers would be subject to the FRB rule. Naturally, the Commission and FRB would work to coordinate their respective rules.

Recordkeeping. In addition to capital adequacy standards, any regulatory system is dependent on a dealer maintaining adequate records to verify compliance with applicable regulations. Currently registered broker-dealers are subject to Commission Rules 17a-3 and 17a-4 concerning books and records, while banks are subject the bank recordkeeping requirements promulgated by bank regulators. I believe that the FRB should be authorized to promulgate recordkeeping rules applicable to currently unregulated dealers.

RP Practice Rules. The failure of ESM and BBS were related to abuses in the RP market involving segregation or delivery of securities subject to repurchase, areas where the FRB should have authority to adopt rules governing the business practices of dealers. As discussed above, however, I believe that questions regarding the type of regulation, if any, which should be imposed in this area, raise difficult and complex issues. The FRB, for the practical reasons noted above, will be in a good position to set minimum standards to ensure safe and efficient RP practices.

Government Securities Clearing Agents. As discussed in Appendix 1 to this Report, clearing agents play a significant role in the processing of both government securities transactions and RPs. Following the instructions of its dealer, clearing agents make securities and money settlement as well as generally financing the dealer's transactions. Although the largest non-bank clearing agents are subsidiaries of regulated banks or bank holding companies (and thus are regulated by federal bank regulators), there is no direct federal regulation of this important aspect of the government securities market. I believe that regulation of government securities clearing agents is necessary because it would permit external review of government securities clearance and custody arrangements, promote safe and efficient government securities processing and enhance investor protection. For example, in a number of recent government securities dealer failures, there has been considerable investor confusion over the role of the clearing agent and whether the securities held by the agent were held for the account of the investor or for the account of the dealer, with the agent having a lien on the securities. To help clarify the role of government securities clearing agents, I believe that non-bank government securities clearing agents should be subject to the current scheme of clearing agency regulations. I also believe that this regulatory approach would help clarify the role of the clearing agent in the government securities market.

I believe that all government securities dealers, including primary dealers, generally should be subject to this central core of requirements. 12/ If the FRB is granted authority to grant exemptions to generalized requirements where the nature of the market dictates such differences, I believe that such exemptive authority should be kept to a minimum and should be related to the nature of the business of such dealers. Limiting exemptive authority will keep differences in regulation to a minimum and will help ensure that a two-tiered system of regulation that unfairly penalizes the current secondary dealer community does not develop. Such unequal regulation could lead to a market perception of a "second class" status of non-primary dealers, and would undo much of the benefits that the proposed legislation is meant to acccomplish.

In addition, I recognize the unique interest of the Treasury in this regulatory system. The FRB acts as the Treasury's agent in conducting auctions, and the Treasury has the primary responsibility for financing the national debt. Accordingly, I recommend that the FRB be required to consult with the Treasury on all proposed rules.

12/ An overwhelming majority of participants at the Open Forum recognized that a comprehensive scheme of requirements would have a beneficial effect on the entire government securities market. Specifically, 86% (18 of 21) of primary dealer commentators, 76% (19 of 21) of secondary dealer commentators, 67% (10 of 15) of investor commentators and 61% (14 of 23) of other commentators supported further regulation.

3. Inspection and enforcement; other regulatory matters

Regular inspection of government securities dealers is fundamental to my recommended regulatory scheme. While no regulatory system can completely eradicate the risks of fraud, regular inspections deter and permit earlier detection of fraudulent activity. While I have suggested that the FRB should have the primary rulemaking authority with respect to the government securities market, I believe that the primary authority to enforce such rules and inspect government securities dealers should reside in current regulatory bodies. Thus, the regulatory costs of the system are minimized because existing regulatory agencies are used. Such agencies also are used in the most cost-effective manner because, in many instances, the oversight of the dealers' government securities business can be combined with more general oversight of the dealer.

With respect to full-service broker-dealers currently registered with the Commission, the Commission, in conjunction with the SROs, already has authority to inspect all business areas of the registered entity, including government securities activities. In addition, the Commission and SROs would be given jurisdiction to enforce the FRB's rules. Currently unregulated dealers also would be subject to Commission and SRO inspection and enforcement; accordingly, such dealers would be required to join an SRO as well as register with the

Commission. 13/ It should be emphasized, however, that while the SROs would have inspection and enforcement authority, the full rules and regulations of the SRO would be inapplicable to a dealer that limits its activities to government securities.

With regard to bank dealers, the bank regulatory authorities -- the FRB, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation -- would have authority over these dealers within their respective jurisdictions. Conferences between these various regulators should be held on a periodic basis to discuss issues of common interest uncovered in the inspection and enforcement programs. In addition, the FRB, as the primary rulemaker in the industry, should receive copies of all inspection reports. Finally, in recognition of the Commission's responsibilities to enforce the anti-fraud provisions of the securities laws, the Commission should be provided residual enforcement authority and authority to inspect all government securities dealers. Granting this "backup" authority to the Commission will also help ensure consistent interpretation and enforcement policies and therefore make the legislative proposal more consistent with the functional regulation approach espoused by the Bush Task Force.

13/ A currently unregulated government securities dealer would be required to join the NASD.

As a final regulatory matter, I do not believe that coverage under the Securities Investor Protection Act of 1970 ("SIPA") should be extended to cover currently unregistered government securities dealers. As discussed, the investors in this market are primarily institutional and are not the type of individual investors that SIPA primarily was intended to protect. Furthermore, the current limits on SIPC coverage of $500,000 per account, no more than $100,000 of which can be for cash, are unrealistically low to offer meaningful protection in the government securities market, where any transaction below $1 million is considered an odd-lot.

4. Costs of proposed regulation

Although I recommend adoption of the proposal detailed above, I recognize that there are certain costs attendant to any regulatory program for the government securities market. Initially, it should be recognized that while the registration and regulation process should enhance investor protection in the government securities market, no system can prevent all fraudulent activity.

Finally, while attempting to design a system that minimizes any cost burden, I recognize that there are costs associated with any regulatory system. The Commission staff estimates that the additional cost on the FRB for its rulemaking functions would be less than $1 million annually. Annual costs imposed on the Commission and SROs for registration, inspection and enforcement responsibilities would be approximately $1.1

million for the SROs and $300,000 for the Commission. Direct costs to currently unregulated dealers probably would average between $25,000 to $50,000 per firm. In light of the size of the government securities market, one must conclude that these costs are minimal. Of course, certain indirect costs also would be imposed on such dealers; the amount of these costs would be totally dependent on the scope of the rules adopted by the FRB. 14/ We have only to look to the history of securities laws to conclude that the minimal cost expected to result from limited regulation of the government securities market will be more than offset by the anticipated significant benefits.

V. Conclusion

I have been encouraged by the private market reaction to the recent government securities dealer failures. I believe that, to some extent, the market is self-correcting and that many actions already taken go a long way toward alleviating the problems in the market. Nevertheless, in order to restore confidence in the market and to establish a mechanism to attempt to forestall further problems, I recommend that legislation be adopted to provide a minimum amount of regulation of the government securities market to address areas of

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14/ I understand, however, that most dealers did not raise serious cost concerns with respect to the FRBNY's proposed capital adequacy standards.

demonstrated abuse. Such rulemaking is based on existing regulatory agencies and includes registration of all government securities dealers, rulemaking by the FRB and enforcement and inspection by existing regulators.

I thank the Subcommittee for this opportunity to present my views on the important issues raised in this area. I would be pleased to offer whatever assistance the Subcommittee requests in drafting legislation encompassing my proposals and working toward its prompt adoption.

Appendix I: Clearance and Settlement in the Government Securities Market

Most government securities dealers use bank clearing agents 1/ to clear and settle their government securities transactions. The four major bank government securities clearing agents are Manufactures Hanover Trust Company, The Bank of New York, Irving Trust Company and Marine Midland National Bank. Approximately 400 smaller dealers use the clearance services of Security Pacific Clearing and Services Corporation, a non-bank subsidiary of a bank holding company. Bank clearing agents predominate for several reasons, primarily because securities positions in many government securities are maintained exclusively in book-entry form 2/ on electronic

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1/ Bank "clearing agents" are different from "clearing agencies." Clearing agencies must register with the Commission under the Securities Exchange Act of 1934 (the "Act"). Bank clearing agents generally are exempt from clearing agency registration under the Act. *See* Sections 3(a)(23) and 17A(b) of the Act.

2/ U.S. Treasury bills and new Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Association ("Freddie Mac") securities are issued in book-entry form. Old FNMA and Freddie Mac issues are being converted to book-entry form, and the Treasury plans to issue U.S. Treasury notes and bonds in book-entry form next year. While Treasury notes and bonds are not issued solely in book-entry form, the vast preponderance are in fact held in book-entry form. In contrast, Government National Mortgage Association ("GNMA") pass-through securities are certificated, and no formal plans exist at this time to issue GNMA's in book-entry form.

books maintained by Federal Reserve Banks, 3/ access to which is limited to depository institutions, i.e., "member banks" and "non-member depository institutions." 4/ Indeed, Security Pacific Clearance and Settlement uses Security Pacific Trust Company, a bank affiliate, to process dealer book-entry securities positions.

Dealer transactions processed through a clearing agent include customer purchases and sales and dealer and dealer-customer financing through repurchase and reverse-repurchase transactions (collectively "RPs"). 5/ Purchases and sales

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3/ Dealers use Federal Reserve member banks or other depository institutions as clearing agents for a variety of reasons. Because transactions in most government securities, including repos, settle in same-day funds, the dealer generally needs a clearing agent to deliver or receive funds over the Fed Wire on their behalf. In addition, clearing agents often finance dealer activities and combining financing with clearing activity may be economical for both parties.

4/ A "member bank" is a depository institution that is a member of the Federal Reserve System ("FRS"). All national banks are required to be members, and state-chartered commercial banks and mutual savings banks may elect to become members.

A "non-member depository institution" is a depository institution (commercial bank, mutual savings bank, savings and loan association, credit union or U.S. agency or branch of a foreign bank) that is not a FRS member. Non-member depository institutions that offer transaction accounts or nonpersonal time deposits are subject to reserve requirements set by the FRS and they also have access to the FRS window and FRS services on the same terms as member banks. See 12 USC §461.

5/ RPs may be overnight, definite "term RPs" or "open RPs."

of book-entry U.S. government securities generally settle the day after trade execution in same-day funds. RPs settle in same-day funds, but actual settlement occurs according to the contract between the parties. While RPs are treated as collateralized loans for dealer accounting purposes, they are cleared and settled like any other purchase or sale of the underlying government securities. 6/

Generally, the clearing agent processes these dealer transactions exclusively upon the instructions of its dealer. It makes securities and money settlement on a transaction-by-transaction basis in accordance with those instructions. In addition, clearing agents generally finance the dealer's transactions. 7/ Indeed, the Commission understands that these financing services may generate as much income as processing dealer trades. These services, however, create risks to the clearing agent. The most significant risk involves dealer insolvency, which, among other things, could expose the clearing agent to serious financial risk from outstanding dealer clearance loans.

6/ Clearing agents inform us that the underlying nature of each transaction generally is unknown to them. In other words, they are unaware if a dealer's transaction is part of a RP.

7/ For example, if the dealer has a debit balance at the end of the trading day the clearing agent would make an overnight "clearance loan" to the dealer to cover the difference between the value of securities received on the dealer's behalf and the dealer's cash balance with the clearing agent.

To protect itself from those risks, the clearing agent enters into an agreement with the dealer that clarifies their contractual rights and duties and establishes a number of important financial safeguards. The agreement not only governs clearance loan terms, 8/ it also gives the clearing agent a security interest and lien on the dealer's account. Moreover, the agreement usually grants the clearing agent the right as a secured party to dispose any portion of the collateral securities in the dealer's account to satisfy any of the dealer's outstanding obligations to the clearing agent. Not all securities in a clearing agent's possession are subject to that lien and security interest, however. Agreements customarily provide that: (1) customer-fully-paid securities 9/ be segregated by the clearing agent in accordance with the dealer's instructions; and (2) those securities are free of the clearing agent lien and security interest.

Customer-segregated accounts, together with dealer accounts, generally are carried by the clearing agent on an omnibus basis. That is, the accounts are not broken down into sub-

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8/ For example, RP agreements may provide for a right of substitution, i.e., the purchaser does not have to resell the identical securities purchased, but may substitute different securities of the same issue. Additionally, some RP agreements may provide that cash is an acceptable substitution.

9/ "Customer-fully-paid" securities refers to securities that have been fully purchased by the dealer's customer, e.g., an institutional or public investor.

accounts for each of the dealer's customers. 10/ Indeed, the Commission understands that clearing agents generally do not want to "know" the identity of the dealers' customers, the nature of their transactions with the dealer and claims they may have to securities in the dealer's clearance account. Clearing agents give several reasons for this. First, sub-accounting regimens are costly. 11/ Second, specifically identifying customer securities would expose the clearing agent to increased potential liability to the dealer's customers because it would increase the likelihood that the dealer's customers could assert that the clearing bank was acting as their agent and press legal claims against the bank for any fraud or mishandling of their accounts by the dealer.

Transactions in government securities, particularly RPs, are processed using three general arrangements: (i) use of agents by each party, (ii) dealer/clearing agent third party agreements, and (iii) exclusive reliance on the dealer's clearing agent (or the dealer itself if the dealer is also a clearing agent, as are the bank primary dealers). According to participants in the RP market, the third type of

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10/ In the equity securities industry, most clearing broker-dealers carry their introducing broker-dealers' customer accounts on a fully-disclosed basis.

11/ Costs would relate to modifying substantially existing automated accounting systems, buying entirely new systems or engaging a service bureau to provide necessary services.

arrangement probably is the most prevalent, although there has been increased interest shown in third party arrangements particularly since the Comark, ESM and BBS incidents. 12/

Under the first arrangement, the dealer and customer each retain their own agent bank, and money and securities settlement occurs on a delivery versus payment basis. Because the customer and dealer each have their own agent who acts pursuant to their instructions, risks of dealer insolvency should be limited. While this method is efficient for book-entry securities, it can be both time-consuming and costly, particularly for all overnight RPs. If the seller did not receive back its securities from the purchaser's agent until late in the day on an overnight RP, the seller may suffer a loss due to its inability to redeliver the securities. In addition, even for book-entry securities that can be transferred by Fed wire, delivery costs can be material for overnight or smaller denomination RPs; for certificated securities delivery by armed carrier or messenter can be much more costly. 13/ Moreover, a risk of loss, theft or destruction exists with respect to certificated securities.

12/ Indeed, the four major New York City clearing banks have established third party arrangements and Security Pacific Clearing and Services Corporation may be taking similar steps in the near future.

13/ See p.__ of the Report, *supra*.

The second RP processing arrangement also features customer-purchaser control of collateral. In this type, the "third party" arrangement, the customer, the dealer and the dealer's clearing agent sign a contractual agreement that sets forth the rights and obligations of the parties. The dealer's agent maintains sub-accounts for the dealer on behalf of the dealer's customers and securities in those accounts are free of any clearing agent lien. In accordance with the agreement, both the dealer and the clearing agent send a written confirmation of transactions to the customer.

Third party arrangements come in a close second to the customer clearing agent method with respect to customer protection. The existence of a purchaser/customer's perfected security interest is not as definite as it is in the customer-clearing agent method. Nevertheless, because this approach offers advantages of efficiency and speed through book-entry transfers that occur on the books of the clearing agent for both certificated and uncertificated securities. Because of stringent credit and financial requirements for clearing agent acceptance of dealers for these arrangements, however, many lower-tier government securities dealers may be unacceptable for third party arrangements. 14/ Further, the

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14/ Generally, an institution must meet three requirements before a clearing agent will enter into a clearing agreement with the institution. First, the clearing agent, from an operational standpoint, would have to be
(Footnote continued)

fees involved would be a greater percentage of the interest income of these entities, potentially making collateralization cost-ineffective. Thus, lower-tier-dealers, in all likelihood, will continue to offer "trust me" RPs. 16/.

The last arrangement is the "trust me" or "on premises" RP. Here, the selling dealer or its clearing agent retains custody of the purchaser's securities. After the first leg of a RP is executed, the selling dealer advises the purchaser-customer that the dealer's clearing agent is retaining the securities and is instructing the clearing agent to segregate those securities in the dealer's account with the clearing agent. In effect, the dealer says "trust me" with the

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14/ (Continued footnote)

able to provide the type of services the institution requires. Second, the institution must meet certain financial and credit standards. Third, the clearing agent considers the institution's market reputation. If an institution has a poor market reputation or has no market reputation, the clearing agent will not provide clearing services.

15/ While many well-capitalized dealers have third party arrangements, those dealers still offer "trust me" RPs to customers who cannot qualify for those arrangements because of, for example, credit reasons or infrequent repo transaction volume. Those top-tier firms, however, are large, well-respected registered broker-dealers like Salomon Brothers, Inc., and Goldman, Sachs & Co., on which customers can rely.

collateral. 16/ Often, the dealer will inform its bank clearing agent to segregate the securities in the dealer's omnibus account, as discussed above. Sometimes, however, the dealer may commingle the customer's securities in the dealer account at the clearing agent.

16/ Dealers may give an open invitation to customers to inspect their records and their clearing bank's vaults at any time to ascertain that their collateral is being safekept. As a practical matter, this can prove cumbersome. Because each customer's securities are not earmarked at the bank, a vault inspection in itself is insufficient, but must be accompanied by a simultaneous review of the dealer's own customer account records.