REGULATION OF THE GOVERNMENT SECURITIES MARKET

Report by 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

EXECUTIVE SUMMARY

I. Response to date by the market, investors, state and federal regulators and dealers to the ESM and BBS failures.

A. Market Response:

1. Acting Assistant Secretary of the Treasury Niehenke testified at the open SEC meeting that the failures have not had a perceptible adverse impact on the cost of financing of the national debt.

2. Some commentators have indicated that some investors have withdrawn from the government and repo market, especially the GNMA repo market.

B. Many investors are:

1. perfecting their security interests in repos;

2. not providing excess margin in reverse repo transactions;

3. limiting their dealings to better known and capitalized dealers, particularly regulated or primary dealers.

C. Regulatory bodies have taken the following actions:

1. The Federal Financial Institutions Examination Council has proposed, and the FRB and FDIC have adopted, guidelines for securities lending activities requiring adequate collateralization.

2. The FHLBB has rearticulated its investment guidelines for savings and loan associations and is considering requiring securities and underlying repos to at least equal the value of the repo, possession or third party control of these securities, dealings only with regulated broker-dealers, and frequent marking-to-market of securities.

3. Municipal investment regulators, such as the NY State Comptroller, the State of New Jersey, and a number of municipalities, have issued or are considering issuing strict standards requiring possession or third party control of securities underlying repos, limiting the dealers that can be used, or prohibiting repos.

4. The FRB has issued voluntary capital adequacy guidelines, stepped up its visits to dealers, and issued educational materials, such as "Its 8:00 a.m. -- Do You Know Where Your Collateral Is?" Individual Federal Reserve Banks are holding educational seminars for investors.

5. The SEC has recently brought enforcement actions against certain government securities dealers and individuals associated with those dealers; is investigating the conduct of other persons who were affiliated with those government securities dealers; and is conducting examinations of certain governnment securities dealers who have voluntarily agreed to the examinations.

6. It has been reported that other federal and state law enforcement authorities are examining the conduct of certain government securities dealers and persons associated with those dealers.

7. The SEC Division of Investment Management has reiterated to all investment companies the need to perfect and maintain a security interest in repos (i.e., the need to take possession of securities and to mark them to market).

8. The SEC Chief Accountant's office and Division of Corporation Finance are preparing a proposed release which would require greater disclosure of repo activities and risks by registrants.

9. The AICPA has formed a task force to address repo auditing issues. The Government Accounting Standards Board and the AICPA are also working on repo disclosure projects. These initiatives have occurred under SEC oversight.

II. The FRB, Treasury and SEC differ somewhat in their views of the necessity for legislation. If Congress concludes that additional legislation is to be enacted, they would find the following approach acceptable.

A. All currently unregulated dealers in Treasury or government-sponsored agency securities to be registered. Information on these dealers to be accessible to all relevant regulators. The SEC and the Treasury differ as to which should be the registrar.

B. The SEC and the bank regulators to be granted the authority to provide sanctions against or to bar those who violate either the securities or the banking laws.

C. The Treasury, in consultation with the FRB, to be granted authority to adopt rules as necessary on:

(1) capital,

(2) independent audit and recordkeeping,

(3) collateralization (e.g., segregation or delivery requirements), margin, and when-issued trading practices.

D. (1) All government and agency securities dealers to be subject to C(3);

(2) Presently unregulated dealers to be subject to C(1) and C(2) as well;

(3) All others to continue to be subject to SEC or banking agency capital and recordkeeping requirements.

E. Inspection and rule enforcement of

(1) non-bank dealers by existing self-regulatory organizations, under SEC oversight, including inspections;

(2) bank dealers by banking agencies.

III. FRB to continue to exercise surveillance over primary dealers.

IV. While the Commission has not conducted a formal cost-benefit analysis, if legislation is to be enacted the Commission recommends the following approach.

A. All currently unregulated dealers in Treasury or government-sponsored agency securities to be registered with the SEC. Information on these dealers to be accessible to all relevant regulators.

B. The SEC and the bank regulators to be granted the authority to provide sanctions against or to bar those who violate either the securities or the banking laws.

C. The Treasury, in consultation with the FRB, to be granted authority to adopt rules with respect to currently unregulated dealers in Treasury or government-sponsored agency securities as necessary on:

(1) capital,

(2) independent audit and recordkeeping.

D. All others to continue to be subject to SEC or banking agency capital and recordkeeping requirements.

E. Inspection and rule enforcement of

(1) non-bank dealers by existing self-regulatory organizations, under SEC oversight, including inspections;

(2) bank dealers by banking agencies.

F. FRB to continue to exercise surveillance over primary dealers.

I. Introduction

On March 21, 1985, the Securities and Exchange Commission indicated in hearings before the Telecommunications, Consumer Protection and Finance Subcommittee of the House Energy and Commerce Committee that it would review the government securities market in the wake of recent government securities dealer failures, in consultation with the Federal Reserve Board ("FRB") and the Department of the Treasury, and advise Congress whether it believed additional regulation is needed, and if so, the most cost-effective approach. To this end, the Commission has (1) issued a release seeking public comment on reactions in the marketplace, the need for additional regulation of the government securities market, if any, and if so, the cost and benefits, 1/ (2) conducted extensive interviews with government securities investors and dealers, and (3) held an Open Forum to obtain directly the views of representatives of investors, dealers, industry groups, and regulators.

This report reflects the views of the Commission, developed in consultation with the FRB and the Treasury.

The FRB, Treasury and SEC differ somewhat in their views of the necessity of legislation. If Congress concludes that additional legislation is to be enacted, they would find acceptable the proposal outlined in Parts II and III of the Executive Summary.

1/ Securities Exchange Act Release No. 21959 (April 19, 1985) ("April Release"). A copy of this release is attached as Exhibit 1.

A. Problem Incidents in the Government Securities Markets

The market for government securities 2/ is by far the world's largest and most efficient securities market. The monthly trading value of just the 36 primary government dealers that report to the FRB amounts to over $1.5 trillion 3/ or approximately 15 times the volume of all transactions in corporate securities traded on all the nation's securities exchanges and over-the-counter markets. 4/ This highly liquid, keenly competitive market operates largely on the basis of confidence in the integrity and financial soundness of the market participants. Government securities dealers are a pivotal element in this market, facilitating the distribution of the

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2/ In referring to government securities, the Commission includes both securities sold by the U.S. Treasury ("Treasury securities"), and securities issued or guaranteed by government or government-sponsored agencies ("agency securities"), such as the Government National Mortgage Association ("GNMA"), Student Loan Marketing Association, and Federal Home Loan Mortgage Corporation ("Freddie Mac").

3/ Office of the Secretary, Department of the Treasury, Treasury Bulletin, 1st Quarter, Fiscal 1985. Of this amount, $1.247 trillion was in marketable Treasury securities.

4/ Based on SEC Statistical Review, February 1985, Table M-110, and NASD 1984 Annual Report. These figures are not directly comparable because of differences in the way dollar volume is calculated in these markets.

increasing amounts of government debt offered to investors, and providing continued liquidity with respect to investments in these securities.

Dealers finance their government securities activities with their own capital, term and bank loans and repurchase agreements ("RP"). 5/ Dealers also use reverse repurchase agreements ("RRP") 6/ to obtain securities and match with RP's that exceed those needed to finance inventory. Through these means, government securities dealers have had remarkable success in purchasing and placing increasing amounts of government debt.

5/ A RP is an agreement to sell securities with a commitment to repurchase the same securities from the buyer at a future date. Buyers in RP transactions generally view RPs as investments carrying little risk. In practice, the buyer in a RP transfers cash to a seller and receives securities (or has securities held on its behalf) as "collateral," and the seller agrees to repurchase the securities for the cash plus interest at a future date.

6/ A RRP is an agreement to buy securities with a commitment to resell the same securities to the seller at a future date. In effect, RRPs and RPs are two sides of the same transaction, and sometimes are referred to collectively as RPs in the discussion that follows.

The failures of several small government securities dealers, 7/ which have resulted in alleged losses of about $900 million to investors since 1977 (before taxes, insurance and civil suit recoveries, if any), have raised questions about the need for some form of oversight. These dealer failures occurred for a variety of reasons, including apparently normal trading reverses, 8/ the transfer of large losses from affiliates, improper use of accrued interest 9/ and

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7/ These failures (or near failures) included Winters Government Securities, Inc. (1977), Hibbard & O'Connor Government Securities, Inc. (1982), Drysdale Government Securities, Inc. ("Drysdale") (1982), Comark, Inc. (1982), Lombard-Wall, Inc. (1982), Lion Capital Group, Inc. ("Lion") (1984), RTD Securities, Inc. (1984), ESM Government Securities, Inc. ("ESM") (1985), Bevill Bresler Schulman Asset Management Corp. ("BBS") (1985), and Parr Securities Corp. (1985). For further information on several of these failures, see Statements of John S.R. Shad, Chairman of the Securities and Exchange Commission, to the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, Concerning the Government Securities Market, (April 13, 1985) and (May 15, 1985). See also text at note 16 infra (Brokers Capital, et al.).

8/ E.g., Lombard-Wall, Inc.

9/ E.g., Drysdale.

the fraudulent use of customer securities and margin payments. 10/ In several of these instances, RP customers found upon the failure of the firm in question that the securities subject to repurchase had been used in other RP transactions, 11/ or that the value of securities subject to repurchase had declined. In addition, RP customers that had provided excess margin lost the difference in value between the securities provided as margin for RP transactions and the cash received. 12/

Among the more prominent of these failures were Drysdale, Lion, ESM, and BBS. In the first of these situations, Drysdale (and later an affiliate formed to conduct its government securities activities) sought out securities with accrued interest for RP trades. Because customers did not take into account accrued interest in valuing securities in RP transactions, Drysdale was able to use such accrued interest to finance its operations.

10/ The failures of Winters Government Securities, Inc. and Hibbard & O'Connor Government Securities, Inc., allegedly involved sales practices abuses, including misrepresentations of the risks and terms of investment of securities, unsuitable recommendations, and high pressure sales techniques.

11/ *E.g.*, ESM, BBS, Lion, and Comark, Inc.

12/ *E.g.*, ESM and BBS.

Ultimately, however, Drysdale was responsible for payment of the interest, and when it was unable to do so, its customers incurred approximately $300 million in alleged losses before recoveries, if any. The Drysdale failures resulted in the market, under the leadership of the Federal Reserve Bank of New York ("FRBNY"), taking accrued interest into account in RP trades.

The failure of Lion in 1984 resulted in alleged losses before recoveries, if any, of approximately $40 million to about 60 institutions. Many of these institutions allegedly had engaged in RP transactions after receiving rate quotations from a money broker. In many cases, customers allegedly believed that the securities subject to repurchase were held on their behalf by Lion's clearing agent, when in fact that clearing agent claimed after Lion's failure that it was holding those securities as security for loans to Lion rather than in trust for Lion's customers. The Lion failure, together with other failures, resulted in legislation to clarify the status of RPs in bankruptcy.

ESM, an unregistered government securities dealer located in Fort Lauderdale, Florida, failed in March 1985, with alleged losses, before recoveries, if any, of over $300 million to institutional investors. 13/ It is alleged that, although ESM

13/ April Release, *supra* note 1, at 16.

incurred $38 million in trading losses and $32 million in operating expenses in 1984 (with comparable losses and expenses in previous years), it was able to continue to transact RPs by fraudulently failing to reflect these losses in its financial statements. 14/ It is also alleged by the ESM receiver that about $200 of the $300 million of ESM losses were incurred by two savings and loan associations ("S&Ls") controlled by the same individual. 15/

It appears that the remaining $100 million of losses to ESM customers in RP transactions occurred largely because these customers had failed to obtain possession or otherwise perfect a security interest in the securities underlying the RP. Customers allegedly were told that their transactions were secured and that securities were being held in safekeeping by ESM's clearing agent for their benefit. ESM's clearing agent has stated that it held these securities as collateral for loans to ESM. Losses by the two S&Ls in RRP transactions with ESM apparently resulted from their providing ESM with margin greatly exceeding the cash received for the securities.

14/ Report on the Condition of ESM Companies by Thomas Tew, Receiver, SEC v. ESM Group et. al., Case No. 85-61 civ-Gonzalez, In the U.S. District Court (S.D.Fla. April 2, 1985). These losses allegedly were disguised by transfers between ESM and an affiliate.

15/ Id.

Upon the failure of ESM, they were left with claims for the difference between the market value (including accrued interest) of the securities sold to ESM and the amount received for these securities.

BBS, an unregistered government securities dealer located in New Jersey, failed in April 1985, with alleged customer losses of as much as $235 million, before recoveries, if any. It is alleged that BBS fraudulently entered into RPs without proper collateralization in order to finance large trading losses incurred by an affiliated unregistered government securities dealer. It is also alleged that a registered broker-dealer affiliate (which has been placed in SIPC liquidation) solicited government securities transactions which were placed with BBS.

RP customers of BBS, including S&Ls, banks, and other dealers, suffered losses for similar reasons as in ESM: they found the securities underlying their transactions were claimed by other parties, and their purportedly secured RPs were in fact unsecured. It appears that in many instances government securities purportedly held for the benefit of customers had been resold or otherwise converted by BBS. Losses also were sustained by RP customers that had provided excess margin. As a result of their dealings with BBS, three small government securities dealers, Brokers Capital Ltd., Midwest Government

Securities, and Collins Securities Corp. incurred alleged aggregate losses of about $9.7 million and failed or were liquidated. 16/

B. Commission Review

In response to the ESM and BBS failures, and in order to provide Congress with its views on regulation of the government securities market, the Commission reviewed the background of the recent problems and the market responses to these problems through several means. Commission staff members, in preparation for the Commission's Open Forum discussed below, contacted by telephone over two dozen investors in the government securities markets, including municipalities, credit unions, S&Ls, and investment companies, and interviewed in person approximately twenty primary and secondary dealers in government securities. The staff sought information concerning any problems these market participants had observed as a result of the ESM and BBS failures, their individual or any general market responses to these problems, and their views on the question of additional oversight of the government securities markets. Commission staff also conducted telephone inspections of the RP practices of 292 investment companies.

16/ For further details on these failures, *see* Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission, to the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, concerning the Government Securities Market (May 15, 1985).

In addition, the Commission, on April 19, 1985, published a release requesting comments on reactions in the marketplace to the widely-publicized ESM and BBS failures and the form, costs, and benefits of any recommended additional federal regulation of government securities dealers. Seventy-nine comments have been received to date. 17/ To further obtain the views of market participants regarding these questions, the Commission on May 21, 1985, held a full day Open Forum, consisting of panels representing investors, primary dealers, secondary dealers, industry groups, and regulators. 18/ In addition, the Commission has consulted with the Treasury and FRB and received the results of dealer surveys 19/ compiled by both agencies. These sources provided considerable information on the response of the market to ESM and BBS and contributed materially to the Commission's analysis regarding regulation of the government securities market.

17/ A summary of these comments is attached as Exhibit 2.

18/ A summary of the views expressed by panelists at this Open Forum is attached as Exhibit 3.

19/ The FRBNY has conducted an informal survey of the effects of recent market developments on government securities dealers, and has been collecting information on the dealers active in the government securities market. The Treasury also conducted an informal survey of the market practices in the RP market.

C. Market Response

In reviewing the market response to the ESM and BBS failures, Acting Assistant Secretary of the Treasury (Domestic Finance) John J. Niehenke testified at the Commission's Open Forum that the ESM and BBS failures have not had a perceptible adverse impact on the cost of financing of the national debt. 20/ Other commentators, however, indicated that these failures have led some investors to cease trading in the government securities market and that the long-term effect of these failures could lead to a contraction in the dealer community, thus decreasing liquidity. One commentator also suggested that this contraction could increase Treasury financing costs. 21/

In considering the problems raised by ESM and BBS, it also is important first to note that the improper practices which occurred in those cases do not reflect standard practices in the government securities market. A survey by the Treasury Department indicates that in February, prior to ESM, respondents delivered to investors or held in third party arrangements approximately 86.9% of the dollar value of RPs on Treasuries and 33.3% of the dollar value of RPs on other collateral

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20/ Statement of John J. Niehenke, Acting Assistant Secretary for Domestic Finance, Treasury Department, at the Commission Open Forum (Transcript at 206, 218) ("Niehenke Statement").

21/ See letter from Ronald D. Upton, Executive Vice President Irving Trust, to John S.R. Shad, dated May 17, 1985, at 7 ("Irving Trust Letter").

(e.g., GNMAs). In addition, most dealers that maintained custody of the securities in a RP transaction properly segregated those securities from their proprietary account.

Moreover, each of these recent dealer failures involve RP activities and not trading or sales practice abuses in the secondary market for government securities. In light of government securities dollar trading volumes well in excess of $1 trillion per month, this absence of identified abuse is impressive.

With the exception of the registered securities affiliate of BBS, none of the fraudulent activity identified relates to any of the primary dealers or registered securities or bank dealers. Therefore, while the failures of ESM and BBS were significant, they were "fringe" participants in the government securities market.

The highly publicized ESM and BBS failures have prompted the following responses by institutional investors dealers, state and federal regulatory bodies and others.

With respect to investors, it is important first to note that, unlike the market for corporate and municipal securities, the government securities market is primarily institutional. Accordingly, while some of these investors may not be as sophisticated as many institutional investors, the nature of the government securities market is different than the markets for other securities. As to the reaction of these investors, they generally have shown greater caution in their investment practices. Some investors have withdrawn from the government securities market or the RP market, choosing to accept lower returns for what they perceive as safer investments. 22/ For example, Beaumont, Texas, which suffered losses of approximately $20 million in the ESM collapse, now restricts its investments to deposits in local banks and S&Ls. 23/

22/ See, e.g., letter from Danny O. Crew, Assistant City Manager, City of Pompano Beach, Florida, to Michael Simon, Assistant Director, SEC, dated May 17, 1985; letter from S. Waite Rawls, III, Managing Director, Capital Market Group, Chemical Bank, to John S.R. Shad, Chairman, SEC, dated May 17, 1985, at 4; letter from James W. Thompson, Corporate Executive Vice President, NCNB National Bank, to John S.R. Shad, Chairman, SEC, dated May 17, 1985, at 2.

23/ Statement of Betty Dunkerley, Acting Finance Officer, City of Beaumont, Texas, at Commission Open Forum. The Commission contacted 11 investors that had experienced problems in dealing with ESM and BBS; of these, 10 have withdrawn from the RP market.

A number of commentators and panelists at the Commission's Open Forum noted that many investors have begun a "flight to quality." 24/ Some have chosen to deal only with dealers recognized as "primary dealers" by the FRBNY, 25/ instead of making independent determinations of the capital adequacy and credit worthiness of dealers. Other investors have restricted their dealings to "regulated" dealers, such as primary dealers, banks, and registered broker-dealers having a specified minimum capitalization, e.g., $100 million. 26/

Many investors also appear to have responded to ESM and BBS by taking steps to ensure that they have a security interest

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24/ See, e.g., letter from John E. Haupert, Assistant Director, Finance Department, The Port Authority of NY & NJ, to John Wheeler, Secretary, SEC, dated May 17, 1985; letter from L.N. Wesley, Jr., Senior Vice President-Finance, Sears Savings Bank, to John S.R. Shad, Chairman, SEC, dated May 20, 1985.

25/ The FRBNY recognizes 36 government securities dealers as "primary dealers" with whom it deal in its open market operations. These dealers consist of 13 banks, 12 registered broker-dealers, and 11 unregistered dealers (5 of which are affiliated with registered broker-dealers). The FRBNY has emphasized that designation as a primary dealer should not be taken by investors as an FRBNY endorsement of these firms' creditworthiness.

26/ The Commission contacted 11 investors that had not experienced problems with BBS and ESM, in addition to the 11 above mentioned "victims". See note 23, supra. Four of these investors indicated they had recently changed investment policies, including restricting the dealers with whom they would deal to more familiar dealers.

in the securities in RP transactions. 27/ Most frequently, these investors take possession of the Treasury securities underlying the RP through an independent custodian bank, even though this results in wire transfer and custodial charges that can reduce the yield in a RP transaction. 28/ Delivery of the securities also has been facilitated by the increasing availability of so-called "third party" RP arrangements, 29/ in which a custodian bank acts as agent for both the dealer and the customer, making account entry transfers of the securities subject to repurchase from the dealer's account to the customer's account in RP transactions. In addition, there appears to be an increasing tendency for market participants to monitor more actively the securities underlying the RP transactions. 30/

Dealers apparently have responded to ESM and BBS with increased care in making credit evaluations of contra parties in transactions, and in obtaining perfection of a security

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27/ See letter from Howard Whitman, Senior Executive Vice President, Thomson McKinnon Securities, Inc., to John Wheeler, Secretary, SEC, dated May 17, 1985; letter from James W. Ogg, President, Westcap Corp., to John Wheeler, Secretary, SEC, dated May 8, 1985.

28/ Certificated securities such as GNMAs, however, cannot be wire-transferred.

29/ See Irving Trust letter, note 21 supra.

30/ Id.

interest in RP transactions. 31/ They also appear to have reduced their RP activity, although this is at least partly a result of lower investor RP demand. 32/

This increase in institutional investor and dealer caution in response to ESM and BBS has been supplemented by actions of regulatory bodies and industry groups. Educational efforts have begun, with the publication by the Public Securities Association of a booklet, "Business Practices Guidelines for Participants in the Repo Market" in 1982, and the recent publication by the FRBNY of its cautionary brochure, "It's 8:00 a.m., Do You Know Where Your Collateral Is?" In addition, the FRB, through the Federal Reserve Banks, is holding investor educational forums on the government securities market around the country. These efforts are intended to acquaint market participants with the risks and available safeguards for RP transactions.

Enforcement actions also have been brought against certain government securities dealers, thus highlighting for the investment community the need for care in their dealings. The Commission has brought enforcement actions against several government securities dealers; 33/ is investigating the conduct of other persons who were affiliated with government securities

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31/ Letter from S. Waite Rawls, III, Managing Director, Capital Market Group, Chemical Bank, to John S.R. Shad, Chairman, SEC, dated May 17, 1985; letter from Robert P. Mulhearn, Managing Director, Morgan Stanley & Co., to John S.R. Shad, Chairman, SEC, dated May 17, 1985.

32/ Id.

33/ Actions have been brought in the ESM (SEC v. E.S.M. Government Securities, Inc., et. al., No. 85-6190 (S.D. Fla.)) BBS (SEC v. Bevill Bresler & Schulman & Co.s 85-3451 (S.D.N.Y)), and Parr Securities (SEC v. Parr Securities Corp., 85-1715) (D.N.J.)) failures.

dealers; and has conducted examinations of certain government securities dealers who have voluntarily submitted to such examinations. Other federal and state law enforcement authorities reportedly are examining the conduct of certain government securities dealers and persons associated with those dealers.

Other regulatory agencies have taken additional steps to help ensure careful investment by regulated entities. The Federal Financial Institutions Examination Council ("FFIEC"), consisting of the FRB, the Federal Deposit Insurance Corporation ("FDIC"), the Federal Home Loan Bank Board (FHLBB"), the National Credit Union Administration, and the Office of the Comptroller of the Currency, has recommended guidelines for securities lending activities by regulated institutions. 34/ These guidelines have been adopted by the FRB and FDIC. In addition, the FHLBB has in place guidelines governing government securities transactions for S&Ls regulated by the FHLBB or insured by the Federal Savings and Loan Insurance Corporation ("FSLIC"), 35/ and the FHLBB is considering adopting additional

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34/ These guidelines indicate that securities should not be lent unless cash or other collateral has been delivered to the lending institution or a third party trustee before or at the time the loan is made. They also support a minimum initial collateral of 102% of the market value of lent securities plus accrued interest. They further support credit committees, credit limits, and maintenance of a daily recordkeeping and reporting program.

35/ These guidelines include requirements that S&Ls (1) know the dealer before engaging in any government securities transactions, (2) inspect the certified financial statements and other filings required by any agency that regulates the dealer, (3) do a credit analysis of counter parties, (4) use capital adequacy guidelines in choosing dealers, (5) ensure that an adequate security interest in collateral exists, and (6) review RPs to see if the market value of the securities exceeds funds received.

guidelines that would, among other things, require S&Ls to deal only with "regulated" dealers, obtain possession or use a third party depository arrangement for control of the securities underlying RPs, and ensure that they received securities at least equal in value to funds they provide in RPs. 36/

In addition to these actions by federal agencies, certain states and localities have drawn up or are preparing guidelines to guide investments, including RPs, by government bodies. For instance, the Office of the New York State Comptroller distributed guidelines requiring, among other things, that local governments perfect security interests in their RPs by having the local government or its agent obtain possession of the securities, and that local governments deal only with "regulated" dealers. 37/ New Jersey is considering similar investment policies and it appears that on the local level explicit policies governing investments are being developed. 38/

36/ Letter from Norman Raiden, General Counsel, FHLBB, to John S.R. Shad, Chairman, SEC, dated May 20, 1985.

37/ See Cash Management and Investment Policies and Procedures for use by Local Government Officials (Office of the N.Y. State Comptroller, December 1984). These guidelines were adopted primarily in response to the losses suffered by many New York school districts and municipalities in the Lion and Lombard-Wall failures. The Office of the N.Y. State Comptroller argued that federal regulation of government securities dealers was needed to supplement these requirements. See Letter from J. Dwight Hadley, Assistant Deputy Comptroller, Office of the N.Y. State Comptroller, to John Wheeler, Secretary, SEC, dated May 20, 1985.

38/ See statement of Harold Boldt, Finance Director, City of Columbia, Missouri, at the Commission's Open Forum, May 21, 1985.

Efforts are also underway to improve the operation of book-entry record systems and to add more securities to these systems, in recognition that the use of book-entry systems for recording ownership of securities is an important means of enabling parties to efficiently transfer control of collateral. In particular, the Federal National Mortgage Association ("Fannie Mae") and Freddie Mac have begun issuing certain securities in book-entry form, and efforts are underway to accelerate the conversion of certificated Fannie Mae and Freddie Mac securities to the FRB book-entry system. In addition, on March 25, 1985 the Mortgage Backed Securities Clearing Corporation ("MBSCC"), operated by a subsidiary of the Midwest Stock Exchange, Inc., began to offer depository services in GNMA securities on a pilot basis to a small number of firms. If successful, this or other programs could replace the present physical delivery of GNMAs with a system allowing delivery in a book-entry format.

Commission staff also has reviewed investment company RP practices and reiterated to these funds the need to perfect a security interest in RPs (i.e, the need to take possession of collateral and to mark-to-market). The staff has written the

Investment Company Institute reiterating that, under existing Commission interpretative positions, investment companies must obtain the securities underlying the RP transactions and mark-to-market, and asking that this position be recommunicated to Institute members. 39/

The accounting profession has also responded to the ESM and BBS failures with a number of initiatives reviewing the need for modification or clarification of audit or accounting standards regarding RP transactions by dealers and investors. The American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board formed a special task force to look into these auditing issues. This task force is expected to produce a final report by June 30, 1985 indicating that present auditing standards provide adequate guidance for customers engaged in RPs, but that additional educational material discussing auditing considerations should be added to current specialized industry guides. The AICPA is also considering issuing a statement of position providing additional guidance for disclosure of RP transactions by the thrift industry. The Governmental Accounting Standards Board is considering issuing a standard that would provide additional guidance to municipalities regarding accounting for RP transactions. Finally, the Commission's Chief Accountant's

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39/ Letters from Division of Investment Management, SEC to Matthew Fink, General Counsel, Investment Company Institute, dated January 25, 1985, April 17, 1985, and June 19, 1985.

Office and Division of Corporation Finance are preparing a proposed release which would require greater disclosure of RP activities and risks by registrants.

The FRBNY has responded to the problems resulting from ESM and BBS by increasing its informal oversight of primary dealers, and by the adoption of voluntary capital adequacy standards for dealers not otherwise subject to regulation. 40/ These standards are intended to provide investors with a definable measure of firms' capital positions, to be used in customers' determinations of which firms to deal with. FRB supervised institutions are prohibited from dealing with firms not providing certified statements of compliance with these capital adequacy standards, and other investors are encouraged to similarly restrict their dealings to firms demonstrating compliance with these standards.

These responses by investors, dealers, and regulators appear on the whole to have resulted in greater care being taken in transactions in government securities, and in particular, in RP transactions. At the same time, these responses by their nature are uncoordinated and may sometimes impose costs on RP investors which could cause them to decrease their activity in, or cease trading in the markets. The principal impact of this heightened caution appears to have fallen on smaller secondary dealers, many of whom have experienced increased

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40/ FRBNY, Capital Adequacy Guideline for Government Securities Dealers, (May 20, 1985).

increased customer reluctance to engage in RP trades. 41/ Indeed, several primary dealers observed a trend among customers of dealing only with primary or otherwise regulated broker-dealers. 42/ In addition, the problems resulting from BBS involving fails to deliver in GNMA RPs appears to have caused a contraction in the GNMA RP market. Thus, some industry commentators, concerned about this market reaction, called for a limited regulatory scheme for the government securities market. Specifically, of the comments received on the Commission's Release or at the Open Forum, 78% (18 of 23) of primary dealer comments, 86% (19 of 22) of secondary dealer comments, 83% (10 of 12) of investors and 63% (14 of 22) of other commentators supported further regulation. Acting Assistant Secretary of the Treasury Niehenke and other commentators, however, expressed concern that additional regulations could cause some legitimate dealers to withdraw from the market. 43/

41/ Letter from Griffith X. Clarke, G.X. Clarke & Co., to John Wheeler, Secretary, SEC, dated May 17, 1985; letter from Ronald D. Upton, Executive Vice President, Irving Trust, to John Wheeler, Secretary, SEC, dated May 17, 1985, at 6-7.

42/ See discussion at note 17 supra.

43/ See note 20 supra; see also letter from James W. Thompson Corporate Executive Vice President, NCNB National Bank, to John S.R. Shad, dated May 17, 1985.

II. Discussion

A. Joint Agency Regulatory Program

As discussed, 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 United States fiscal and monetary policy, and additional regulations could increase the cost to finance the national debt.

Commentators have noted that an insignificant increase in federal interest costs would increase the annual deficit, without eradicating fraudulent activities, which the SEC already has the authority to expose and prosecute. However, it is generally acknowledged that better market place disciplines and regulation could deter and permit earlier detection of fraudulent activities.

The government securities market is more professional and institutional than the corporate or municipal securities market, and any regulatory program for this market should reflect this basic difference. Unlike the corporate and municipal securities markets, customers in the government securities markets are principally regulated entities. Therefore, in assessing what, if any, additional regulation is needed for government securities dealers, consideration must be given to regulations in place for customers in the government securities markets. As discussed above, there already has been a substantial "regulatory" response by entities regulating customers in this market.

Accordingly, if legislation is to be adopted, the Commission would recommend only legislation drafted narrowly to address areas in which there have been demonstrated abuses. Specifically, all bank and many non-bank dealers are already subject to a broad regulatory scheme. New regulation, if determined to be necessary, should, wherever possible, neither conflict with existing regulation, nor add new burdens on those dealers.

The components of this legislative approach would be as follows:

Registration. An initial step in all regulatory systems is to ensure that the appropriate regulators have jurisdiction over the relevant market participants. All currently unregistered government securities brokers and dealers therefore should be registered. 44/ The Commission believes that

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44/ "Dealer" would be defined in a similar manner to securities dealer (Section 3(a)(5) of the Securities Exchange Act of 1934 ("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). The Commission recognizes 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 from Glen S. Corson, Senior Staff Vice President, Mortgage Bankers Association of American, to John Wheeler, Secretary, SEC, dated June 3, 1985.

currently registered broker-dealers who conduct their government securities business as part of the registered entity should retain their existing Commission registration. Similarly, banks that engage in dealer activities should not be required to register separately. The SEC and Treasury differ as to which should be the registrar for currently unregulated dealers.

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 that subsequently run into difficulty. While the Commission and the bank regulators currently have the authority to prevent these "bad actors" from moving from firm to firm within their respective industries, cross-over from bank to non-bank dealers may require additional administrative proceedings. A system of "statutory disqualifications" in the government securities market would ensure the ability of each of the appropriate regulators to police the movement of personnel in the industry. 45/ Accordingly, if legislation is to be adopted, the Commission believes that the bank regulators and the Commission should be granted authority to provide sanctions against, or bar those, who violate either the securities or the banking laws.

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

Rulemaking. The Treasury and the FRB are charged with the responsibility of administering the nation's fiscal and monetary policies, and are the agencies in the best position to promulgate the most cost-effective rules to govern this market. Accordingly, if Congress concludes that additional legislation is to be enacted, the FRB, Treasury and the SEC would find it acceptable for the Treasury, in consultation with the FRB, to be granted the authority to adopt rules as necessary on capital, independent audit, and recordkeeping requirements.

Capital Adequacy Standards. With respect to the scope of such rulemaking, one significant problem in the government securities markets 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. Concerns were also raised by commentators regarding the need for limitations on the levels of risk and leverage taken on by government securities dealers. Accordingly, the Treasury, in consultation with the FRB, would be empowered to adopt a capital adequacy rule; require financial reporting by government securities dealers to permit effective monitoring of their compliance with this standard; and require such reports to be independently audited on a periodic basis. This independent audit should specifically certify that the dealer is in compliance with the capital adequacy requirements.

Registered broker-dealers that conduct a government securities business would continue to be subject 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 Treasury's rules, in consultation with the FRB. The Commission and Treasury would work to coordinate their respective rules.

Recordkeeping. If legislation is to be adopted, the Treasury, in consultation with the FRB, should be given the authority to adopt, as necessary, rules to assure maintenance of adequate records to verify compliance with applicable regulations. Currently registered broker-dealers are subject to Commission rules 17a-3 and 17a-4 under the Act concerning books and records, while banks are subject the bank recordkeeping requirements promulgated by bank regulators.

Collateralization and Other Rules. The FRB, Treasury and SEC also have concluded that if legislation is to be enacted, they would find it acceptable for the Treasury, in consultation with the FRB, to adopt rules as necessary concerning collateralization, margin and when-issued trading practices. Rules relating to collateralization might involve matters such as segregation of customer funds and securities or delivery requirements.

<u>Inspection and enforcement</u>. While no regulatory scheme can be expected to eradicate fraud, inspections may deter it and permit earlier detection. While the Commission believes that the Treasury, in consultation with the FRB, should have the primary rulemaking authority in the government securities market, the Commission believes that the primary authority to enforce such rules and inspect government securities dealers should reside in current regulatory bodies, similar to the regulatory system in the municipal securities market. Specifically, the body having primary regulatory jurisdiction over a dealer would enforce the rules and conduct inspections. 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 dealers' government securities business can be combined with more general oversight of the securities firms and banks.

With respect to full-service broker-dealers currently registered with the Commission, the Commission, in conjunction with the self-regulatory organizations ("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 rules applicable to government securities dealers. Dealers that are currently unregulated also would be subject to Commission and SRO inspection and enforcement. 46/ 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 respect to bank dealers, the bank regulatory authorities -- the FRB, the Office of the Comptroller of the Currency and the FDIC -- would have authority over those dealers within their respective jurisdictions.

B. Commission Proposal

While the Commission has not conducted a formal cost-benefit analysis, if legislation is to be enacted, the Commission recommends the joint approach described above that the Commission, FRB and Treasury find acceptable, with two modifications. First

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46/ A newly-registered government securities dealer would be required to join the SRO, or SROs, such as the NASD or stock exchanges, that is most appropriate for its mix of business. For example, a government-only subsidiary of a New York Stock Exchange ("NYSE") member firm may elect to join the NYSE. Regulatory responsibility for a dealer would be allocated to the appropriate SRO. *See* Rule 17d-2 under the Act.

because the Commission is the federal agency responsible for registering all broker-dealers the Commission believes that it would be preferable for it to register sole government securities dealers. Because the Commission and the SROs will have inspection and enforcement authority over previously unregistered dealers, registration with the Commission also would provide more efficient monitoring of these dealers and their associated persons.

Second, with respect to scope of Treasury rulemaking, in consultation with the FRB, the Commission concurs that such authority should encompass capital, independent audit and recordkeeping requirements. With respect to rulemaking authority on collateralization, margin and when-issued trading practices, while the Commission would find such rulemaking acceptable, it believes the combination of present anti-fraud authority under the federal securities laws and the other new inspection and rulemaking authority outlined in the model described above, are sufficient to address the problems underlying the recent failures of government securities dealers. In addition, the state and federal regulators of the institutional investors in government securities have addressed, or are addressing, collateralization and related issues. Therefore, the Commission's preferred approach would be not to include such rulemaking authority in the current legislative package.

C. Other Regulatory Proposals

The Commission recognizes that other regulatory initiatives have been proposed and believes that two of those proposals warrant specific discussion. Those initiatives are the proposals (i) that customers take possession of securities underlying RPs in all instances; and (ii) that there be a SRO to govern the government securities market.

With respect to RPs, a significant amount of the customer losses in both ESM and BBS resulted from the failure of certain customers to require their dealers to deliver the government securities underlying RPs. In response to these losses, and because taking delivery of securities is generally viewed as good business practice, there has been significant discussion about requiring customers to take possession of underlying securities in all RPs. Indeed, one legislative proposal would generally require government securities dealers to deliver the securities underlying RPs to the investor, or permit the investor to perfect a security interest in the securities through a third party RP. 47/ The Commission appreciates the reasons underlying these discussions and

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47/ Proposed "Government Securities Market Protection Act", H.R., 2521. In a third party RP the custodian bank acts as agent both for the dealer and the customer; the customer thus can be viewed as being in possession of the securities.

proposals. The Commission is not prepared, however, to support a requirement that customers take possession of collateral in all instances.

While the Commission believes that physical possession of securities underlying RPs is desirable and should be encouraged, more cost-effective alternatives are often available. In the great majority of government securities financing activities, there are legitimate situations in which alternatives to physical delivery may be appropriate. For example, primary dealers "hold-in custody" arrangements provide for segregation of customers' securities. 48/ Also, physical delivery of short term RPs and RPs in certificated securities would be prohibitively expensive. In recognition of this fact, 17 of the 22 government securities dealers commenting on this issue in response to the Commission's release opposed any statutory requirement of perfecting a security interest through possession or otherwise.

With respect to the costs of delivery, the Commission understands that bank charges to customers for either delivery

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48/ Hold-in-custody arrangements for government securities RPs are functionally the same as custody arrangements for customer funds and securities under Commission Rule 15c3-3 under the Act. Registered broker-dealers that deal in government securities generally use such custody accounts to immobilize government securities positions. To require physical delivery of all non-wireable securities, therefore, may actually impede Commission efforts to facilitate the immobilization of securities.

or receipt of securities subject to repurchase over the FRB wire range from $15 to $50 for each end of the RP (including both wire charges and bank handling charges). For certificated securities, the charges can be significantly higher -- cost estimates range from $30 to $60 per security delivery and redelivery, with the possibility that a single RP may involve delivery of a number of securities. 49/ These costs are sufficient, in the view of commentators, to render economically infeasible any short-term RP for less than a million dollars, and an even greater variety of RPs involving certificated securities. 50/

49/ Delivery also requires a customer to establish a separate bank custodial account, estimated to cost approximately $300 a month.

50/ The Commission has attempted to quantify the costs of requiring delivery in a short-term RP. The Commission has used a nominal 8% RP with total transaction costs of $120 ($30 per receipt and delivery for each of the two parties). The Commission further assumes that the purchaser pays all costs in an RP and the seller pays the costs in an RRP. Under such circumstances, the effective annual yield to be received by a purchaser (after transaction costs) is only 3.68% for an overnight RRP of $1 million. This rate would increase to 7.38% for a one week RRP, 7.86% for a one month RRP and 7.93% for a 60 day RRP. Conversely, in a RP of the same size and rate, the seller would pay 12.32% for an overnight RP (after transaction costs), which would decrease to 8.62% for a one RP, 8.17% for a one month RP and 8.07% for a 60 day RP.

In addition to being costly, an across-the-board delivery requirement would impose operational burdens on the industry. With respect to book-entry Treasury and agency securities, there already are significant delays on the FRB wire system, and its use for additional RP deliveries could increase delays. The FRB has estimated that expanding the system to facilitate delivery of securities in all RPs would entail a one-time cost of \$10 - \$20 million with ongoing costs of \$25 - \$100 million a year.

Even more serious problems would be raised by a delivery requirement for certificated securities, particularly GNMAs. GNMA deliveries are time consuming and complex, and, in the view of many commentators, the unavailability of hold-in-custody arrangements would restrict the availability of GNMAs and other similar instruments for RPs and impair the operational integrity of the GNMA market. This, in turn, would make it more difficult for dealers to finance GNMA positions and would likely impact adversely spreads and yields in the GNMA market.

For these reasons, the Commission does not recommend legislation mandating delivery of securities subject to repurchase.

With respect to the proposal of an SRO for the government securities markets, the Commission recognizes that there have been a number of proposals, including proposed legislation, 51/ that would vest rulemaking authority for the government securities market in a new SRO or in an existing SRO, such as an expanded Municipal Securities Rulemaking Board ("MSRB") which would be renamed the Public Securities Rulemaking Board ("PSRB"). The Commission would not recommend such an SRO rulemaking body for the government securities market.

First, with respect to expanding the jurisdiction of the MSRB, as noted by a number of commentators, the government and municipal securities markets are significantly different and it would be difficult to constitute a single board with sufficient expertise in both areas to respond to the unique aspects of each market. The MSRB represents well the various aspects of the municipal securities industry, including representatives of municipal issuers and sole municipal securities dealers. Commentators suggest, however, that these board members would not necessarily be appropriate members of a board overseeing the government securities industry.

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

In a dual market board, the need for such representation of the municipal securities market would have to be balanced against sufficient representation for all aspects of the government securities markets, such as primary dealers (including banks, full service broker-dealers and sole government dealers) and the wide range of secondary dealers and investors.

Second, the Commission does not believe that a separate SRO for the government securities market should be established. As discussed, the Commission believes that any rulemaking in the government securities market should be relatively narrow in scope. Beyond promulgating an initial set of regulations, commentators questioned whether there would be sufficient need for continuing SRO involvement in the rulemaking process to justify the ongoing expenses of a PSRB. Rather, the Treasury, with the consultation of the FRB, will be in the best position to "fine-tune" the regulatory system as the need arises, entailing little additional expenses.

Finally, the Commission believes 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. These SROs have historically limited their rulemaking activities to corporate securities and the Commission believes that it would be an unjustified expense to require them to develop expertise in the government securities market. In this regard, it is not contemplated that increased rulemaking responsibilities would impose significant resource burdens on the Treasury.

V. Conclusion

The Commission has been impressed by the marketplace's prompt reaction to the recent government securities failures. Market participants have a "pocketbook" interest in minimizing their risks on a cost-effective basis.

While the FRB, Treasury and SEC differ somewhat in their views of the necessity for legislation, if Congress concludes that additional legislation is to be enacted, they would find acceptable the approach set forth in Sections II and III of the Executive Summary above.

While the Commission has not conducted a formal cost-benefit analysis, if legislation is to be enacted the Commission recommends the approach set forth in Section IV of the Executive Summary above.

The Commission thanks the subcommittee for this opportunity to present its views on the important issues raised in this area. The Commission would be pleased to offer whatever assistance the subcommittee requests in drafting legislation it believes to be appropriate.

Exhibit 1

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-21959; File No. S7-17-85]

Request for Comments on the Oversight of the U.S. Government and Agency Securities Markets

AGENCY: Securities and Exchange Commission.

ACTION: Request for Comments.

SUMMARY: The Commission is seeking comments on the U.S. government and agency securities markets and dealers, in order to determine, in consultation with the Treasury and the Federal Reserve Board, whether legislative or regulatory initiatives are necessary to address the problems posed by recent failures of government securities dealers; and if so, the most practical, cost-effective form of such rules and regulations.

DATES: Please respond not later than May 20, 1985. Your prompt response is appreciated. The Commission intends to hold a public meeting on May 23, 1985 where respresentatives of the government securities markets will have an opportunity to discuss the issues posed in this release.

ADDRESS: Please file five copies of your comments with John Wheeler, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Refer to File No. S7-17-85. All comments will be available for review at the Commission's Public Reference Room.

FOR FURTHER INFORMATION CONTACT: Andrew E. Feldman, (202) 272-2388, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

Executive Summary (5 pages):

The Problem: Over the past seven years, the widely publicized failures of several small government securities dealers, including within the past month E.S.M. Government Securities, Inc. ("ESM") and Bevill Bresler & Schulman Asset Management Corp. ("BBS"), have had repercussions throughout the financial markets.

The SEC estimates that over $500 million of losses have been sustained by the firms and institutions, that dealt with ESM and BBS. Such losses have been attributed principally to: fraudulent concealment of ESM's and BBS's financial conditions; their use of the same collateral for multiple transactions; and in the case of ESM, over $200 million of its $300 million of losses have been attributed to transactions with thrift institutions which the receiver has alleged were under the control of the same individual. Additional losses were sustained by individuals, including taxpayers and employees of municipalities and the customers of 71 Ohio thrift institutions who lost access to their funds.

The Market: The annual dollar volume of trading in U.S. government and agency obligations is over 15 times that of all U.S. securities exchanges and over-the-counter markets. It is by far the world's largest and most efficient securities market. It is of paramount importance to the effective, low-cost financing of the national debt as well as administration of the nation's fiscal and monetary policies. In addition, the government securities markets are important to the other nations that use U.S. dollars and government securities for their reserves and as a medium of international exchange; as well as to commercial enterprise throughout the free world.

The Regulatory Structure: There are 36 primary government securities dealers that report to the Federal Reserve Board ("FRB") on a daily, monthly, and annual basis; and an unknown number of secondary dealers, whose government securities transactions are largely unregulated although 27 report to the FRB on a monthly basis. These firms primarily deal with institutions as opposed to individuals, although these institutions have varying degrees of sophistication. Representatives of the FRB have indicated that it intends to adopt voluntary capital adequacy guidelines for dealers not otherwise subject to federal regulation.

Neither the FRB nor the SEC has specific statutory authority over those firms that deal exclusively in government securities. Nevertheless, the vast majority of secondary market government securities transactions are handled by primary dealers subject to monitoring by the FRB; banks subject to the jurisdiction of the FRB, the Comptroller of the Currency and/or the FDIC; or registered broker-dealers subject to inspection and regulation by the SEC and self-regulatory organizations. The SEC also has the authority to sanction these firms and anyone else that engages in fraudulent securities activities.

The Question: Can losses in the government securities market be inhibited, reduced or prevented in the future? How can that be done on a cost-effective basis? The rationale and factual basis for your response to those questions of which you have special knowledge or experience is requested. Some of the key questions are summarized below.

How widespread are these problems? Are the underlying practices of double collateralization and demanding excess margin common among government securities dealers? If so, is there a significant risk of other government securities dealers failing?

What is the reaction in the marketplace to the widely publicized ESM and BBS failures? Are those who deal in the government securities market now properly perfecting their collateral? Are they shifting from small to large dealer?

Are there likely to be more failures as a result of investor reactions to the ESM and BBS failures?

If greater regulation is necessary, which of the following alternatives would be the most cost-effective? Which would maximize investor protection and reduce or eliminate mistakes and deceptions at the least cost?

Should dealers be required to deliver through the FRB's or other book-entry systems, government securities that are transferred, or pledged under repurchase agreements?

Should the FRB's proposed voluntary capital-adequacy guidelines for government dealers be made mandatory? Should those guidelines be expanded to include voluntary registration and segregation of customer positions subject to audit and inspection by the FRB?

Should there be direct regulation of government securities dealers by the FRB or the SEC? Or should a self-regulatory organization be created under the aegis of the SEC -- or the FRB? Or should the authority of the Municipal Securities Rulemaking Board, under the SEC's oversight, be expanded to include government securities markets and dealers? What responsibilities and authority should the SRO have? In particular, should the SRO's authority be limited to imposing financial and operational requirements or should it also be authorized to regulate the business practices of government securities dealers?

As a result of the losses incurred in ESM and BBS, Congressional committees have requested the Commission's recommendations of cost-effective means to reduce, inhibit, or prevent such losses in the future. The Commission is, therefore, seeking comment on the current functioning of the market for government securities and possible regulatory and other initiatives. In view of the broad range of the questions, commentators are not expected to respond to all of them, but factual responses and estimates within commentators' areas of expertise or experience are respectfully requested.

I. Introduction

A. The Governments and Government-Related ("Agency") Securities Markets

The market in U.S. government and agency securities is by far the largest and most efficient securities market in the world. The monthly trading volume of just the 36 primary government dealers that report to the FRB amounts to over $1.5 trillion 1/ - or approximately 15 times the total volume of all

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1/ Office of the Secretary, Department of the Treasury, Treasury Bulletin, 1st Quarter, Fiscal 1985, Table FD-2, at 15 ("Treasury Bulletin"). Of this debt, $1.247 trillion was in marketable Treasury securities. Government agency debt (e.g., Government

(footnote continued)

transactions in corporate securities traded on all the nation's securities exchanges and over-the-counter markets. 2/ In the government market, the "spread" between bid and asked prices and the brokerage commissions are a fraction of those in other securities markets.

Individuals hold nine percent of U.S. government obligations. Much of the remainder is held by a wide variety of institutions including municipalities, corporations,

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(footnote continued)

National Mortgage Association ("GNMA") securities) outstanding totalled $35 billion and government-sponsored agency debt (e.g., Studen Loan Marketing Association ("SLMA") Securities) outstanding totalled $224.3 billion in October 1984. Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, March 1985, Table 1.44, at A-33. ("Federal Reserve Bulletin").

2/ In 1984, dealers reporting to the Federal Reserve Bank of New York ("FRBNY") reported transaction volume averaging $52.7 billion daily in Treasury securities and $7.8 billion daily in agency securities. Federal Reserve Bulletin, supra note 1, Table 1.42, at A-31. In contrast, the daily dollar volume of trading in 1984 on all United States stock exchanges and the NASDAQ over-the-counter market averaged only $4.5 billion. Based on SEC Statistical Review, February 1985, Table M-110, and NASD 1984 Annual Report. These figures are used for illustrative purposes only; they cannot be directly compared because of differences in the way dollar volume is calculated in these markets.

and pensions funds. 3/ Most of the dealers that participate in the original issue and resale of these securities to institutional investors maintain active ongoing secondary markets for these securities.

In the Treasury securities market a system of "primary" and "secondary" dealers exists. "Primary dealers" are those dealers with whom the FRBNY is willing to deal directly in conducting its open market operations to implement the FRB's monetary policy. The FRBNY regards the primary dealers as the principal market makers in the secondary market. At present there are 36 primary dealers in Treasury securities, of which 13 are banks, 12 are broker-dealers registered with the Commission, and 11 are unregistered dealers.

Primary dealers are expected to bid for a substantial share of Treasury securities in Treasury auctions 4/ and make continuous

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3/ See Treasury Bulletin, supra note 1, Table OFS-1; 2, at 31. In December 1984, private investors held 72% of the outstanding Treasury securities, including 8.7% held by individuals. The remaining share of this debt was held by United States Government accounts and Federal Reserve Banks. Id.

4/ The Treasury Department, through the Federal Reserve Banks, sells marketable Treasury securities to the public through an auction process. These securities are bought directly at auction primarily by dealers but also by investors. Report of the Joint Treasury-SEC-Federal Reserve Study of the Government-Related Securities Markets (December 1980) at 37 ("Government-Related Securities Report").

markets in these securities. In addition, they are required to submit daily, monthly, and annual reports to the FRBNY showing their transactions, positions, and capital; the FRBNY monitors the activity and financial soundness of these primary dealers through these reports and by frequent contacts through telephone calls and on-site visits.

In addition to these primary dealers, there are a larger number of secondary dealers that trade Treasury securities but do not deal directly with FRBNY. The number of these secondary dealers is unknown although officials of the FRB have estimated there may be 200 or more government securities dealers. 5/ The FRBNY has encouraged secondary dealers to report on a monthly basis information similar to that provided by primary dealers. As of April 1985, 27 non-bank secondary dealers 6/ were voluntarily reporting this

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5/ The Commission specifically requests commentators to provide estimates of the number of secondary dealers active in these markets at present; their aggregate positions; and the annual dollar transaction volume of their transactions.

6/ The agency securities market is not differentiated into primary and secondary dealers. While many of the dealers in Treasury securities also make markets in agency securities, the precise number of dealers in this market also is unknown. Information concerning the size, nature, and number of dealers in this market would be appreciated.

information. 7/ In addition to directly monitoring primary dealers and encouraging secondary dealers to report voluntarily, the FRBNY has indicated that it intends to adopt shortly voluntary capital adequacy guidelines for Treasury securities dealers not otherwise subject to federal regulation. 8/

These oversight activities depend largely on voluntary compliance and moral suasion, and, for the primary dealers, the ultimate threat of the FRBNY ending a firm's primary dealer status. The FRBNY has no statutory investigation or

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7/ Comment is requested on the efficacy of these reporting requirements. In this regard, it should be noted that ESM was a reporting dealer.

8/ FRBNY, Capital Adequacy Guidelines for U.S Government Securities Dealers, Request for Comments (February 7, 1985). These guidelines would require that a dealer in Treasury securities keep the size of its risk consistent with the amount of liquid capital available to absorb losses. While compliance would be voluntary, the FRBNY would require primary dealers, and strongly encourage other dealers, clearing and lending banks, and customers to deal only with firms who have been certified by their auditors as complying with these guidelines. The FRBNY also would encourage other bank supervisors to look for certification letters in examining bank clearing and lending activities for Treasury securities accounts.

enforcement authority over these dealers. However, 25 of the 36 primary dealers, and approximately half of the 27 secondary dealers voluntarily reporting to the FRBNY, are regulated by one or more bank regulatory agencies or the SEC.

The Commission similarly has no direct statutory authority over the government securities markets. Government securities are exempt from the registration provisions of the federal securities laws, 9/ although transactions in such securities are subject to the anti-fraud provisions of these laws. 10/ Broker-dealers who effect transactions exclusively in government securities are exempt from the broker-dealer registration provisions of the securities laws. However, those that also effect transactions in corporate or municipal

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9/ Sections 3(a)(2) of the Securities Act of 1933 (the "Securities Act") and 3(a)(12) of the Securities Exchange Act of 1934 (the "Exchange Act") define government securities as exempt for purposes of the registration and periodic reporting provisions of these Acts.

10/ Sections 17(a) of the Securities Act and 10(b) of the Exchange Act, and Rule 10b-5 thereunder, apply to the offer, purchase, or sale of any securities. As a result, these sections apply to government securities. While the Commission lacks statutory authority to examine regularly sole government securities dealers, it may conduct investigations to determine whether these firms have violated the anti-fraud provisions.

securities must register with the Commission. 11/ The government securities activities of registered broker-dealers are subject to Commission financial responsibility, recordkeeping, reporting, and other regulations.

In addition to the informal oversight activities of the FRBNY for primary dealers in the government securities area, all activities of banks, including their government securities activities and investment practices, are subject to the direct regulatory oversight of the appropriate regulatory authority for the bank (the FRB, the Comptroller of the Currency, or the Federal Deposit Insurance Corporation). Moreover, the investment activities of many institutional entities in the government securities market are subject to review by regulatory bodies that supervise them. For instance, the FHLBB provides regulatory oversight over savings and loan associations and other thrift institutions, the National Credit Union Association ("NCUA") over credit unions, the Department of Labor over pension funds, and state insurance commissions over insurance companies. 12/

11/ Section 15(a)(1) of the Exchange Act. In addition, exclusive government securities broker-dealers are not required to become members of a self-regulatory organization ("SRO") under the Commission's oversight.

12/ For an account of this oversight for government securities, see generally Government-Related Securities Report, supra note 4, at 176-204.

Overall, the government securities markets function efficiently under the present regulatory framework. 13/ A number of developments in recent years, however, have placed increased pressure on these markets. The most significant of these developments is the increasing amount of government debt required to be financed each year. In addition, the volatility of interest rates at times in recent years has greatly increased the market risks of taking positions in government securities. 14/ These risks are exacerbated by virtue of the complexity and high degree

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13/ See, e.g., Statement of E. Gerald Corrigan, President, FRBNY, before the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Finance and Urban Affairs (April 1, 1985), at 12 ("the market as a whole continues to function effectively in fair weather or foul").

14/ The development of a variety of financial futures and options, such as futures on Treasury bonds, has enabled market participants to hedge against these increased derivative risks. At the same time, these instruments also can be used themselves to assume highly leveraged unhedged positions that can carry substantial risks.

of leverage possible in the government securities markets through the use of repurchase agreements. 15/

Moreover, despite the importance of the government securities markets for the nation's financial system, entry into these markets as a dealer, with its potential impact on other participants, is relatively simple. In the absence of dealer registration and capital requirements, it is possible to go into business as a government securities dealer with a minimum of capital or experience. 16/ However, the interconnected nature of the market may cause the misfeasance or failure of even a small firm to have repercussions disproportionate to its size. Furthermore, the nature of the investors in the market may cause any such failure to have widespread consequences throughout the financial system.

15/ The term "repurchase agreement" refers to an agreement to sell securities subject to a commitment to repurchase from the same person securities of the same quantity, issuer, and maturity. See Rule 15c3-1(c)(2)(iv)(F)(9) under the Exchange Act.

16/ Illustrative of the ease of entry into the government securities markets is the case of Eldon Miller. After operating Miller Truck and Sales Service in Iowa, in the early 1970's Miller renamed his company Financial Corporation and in January 1974 opened an office on Wall Street. Starting with $400,000 in capital, by July 1975 Financial Corporation held $1.9 billion in assets, but approximately $18 million more than that in liabilities. The court declined to issue an injunction against Miller although it found that Miller had violated Rule 10b-5 under the Exchange Act. SEC v. Miller, 495 F. Supp. 465 (S.D.N.Y. 1980).

B. Problem Incidents in the Government Securities Markets

Over the past seven years, there have been a number of highly publicized failures or near-failures involving unregistered government securities dealers, most of which have been affiliates of registered broker-dealers. These include Winters Government Securities (1977), Hibbard & O'Connor Government Securities (1979), Drysdale Government Securities (1982), Lombard-Wall (1982), Lion Capital (1984), and most recently ESM and BBS (1985). These incidents have involved market participants that have engaged in highly speculative, and in some instances, fraudulent trading activities in government securities. The failure or near failure of these firms has resulted in losses totaling hundreds of millions of dollars with broad, and even international, 17/ repercussions. These failures underscore the dangers of problem incidents to other participants in these markets and to public confidence in these markets generally.

The two recent failures of ESM and BBS exemplify the problems that have arisen and their potential effects. The failure of ESM in March 1985 allegedly resulted in losses to investors involved in repurchase and reverse repurchase transactions

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17/ Foreign Currencies Gain on Troubles at Bevill Bresler, Wall Street Journal, April 9, 1985, at 50.

with ESM of over $300 million. 18/ It also resulted in the failure of a privately insured Ohio savings bank. ESM, an unregistered government securities dealer, allegedly failed for over five years to reflect in its financial statements the fact that it had incurred substantial losses from trading reverses and high expenses incurred by the firm. ESM allegedly was able to continue operating despite these losses because of its inaccurate financial statements; transactions with two thrift institutions, which the receiver has alleged to be under the control of the same individual, that essentially funded a large portion of ESM operations; and because ESM customers were not adequately collateralized in their transactions. 19/

The April 1985 bankruptcy of BBS, an unregistered government securities dealer, may result in losses to customers, mostly savings and loan associations and banks that had engaged in repurchase and reverse repurchase transactions with BBS, of as much as

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18/ These are estimated losses without consideration of tax consequences, insurance, and civil suit recoveries, if any.

19/ Report on the Condition of the ESM Companies by Thomas Tew, Receiver, SEC v. ESM Group et. al., Case No. 85-61-90-Civ-Gonzalez, In the U.S. District Court (S.D.Fla.) April 2, 1985.

$233 million. 20/ BBS allegedly provided financing for a related government securities dealer which has incurred large trading losses. BBS allegedly also engaged in loans with an affiliate, a registered broker-dealer. BBS allegedly was able to continue operating, in part, because customers were not adequately collateralized. Apparently as a direct result of BBS's failure, Bevill, Bresler & Schulman, a registered broker-dealer affiliate of BBS; Brokers' Capital (and an affiliated futures commission merchant); and Collins Securities, Inc., another registered broker-dealer, either have been enjoined from or voluntarily have ceased doing business. Losses with respect to Brokers' Capital and Collins Securities, Inc. have been estimated to be less than $5 million.

II. Discussion

The failures of ESM and BBS, coming after the series of other incidents involving small, unregulated government securities dealers, have raised concerns about the possible adverse effects of these incidents on confidence in the government securities markets. The failures have also raised questions about whether there is a need for corrective action with respect to participants in these markets. At hearings on March 21, 1985 before the

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20/ These are estimated losses without consideration of tax consequences, insurance and, civil suit recoveries, if any.

Telecommunications, Consumer Protection and Finance Subcommittee of the House Energy and Commerce Committee, the Commission indicated it would consult with the FRB and the Treasury and advise Congress within 90 days on whether additional regulation is needed and if so the most cost-effective approaches.

In responding to the specific matters discussed below, the Commission requests that commentators bear in mind the following three general considerations. First, because of the importance of the government securities markets to the monetary and fiscal policies of the nation, it is crucial to ensure their continued efficient operation. Maintaining or, if possible, improving the efficiency of these markets is of paramount importance. Accordingly, the Commission requests that commentators, in responding to the specific questions raised by the Commission, attempt to address the effects of possible regulatory actions on the ability of the Treasury and FRB to fund the public debt and execute the nation's monetary policy in the most efficient and least costly manner possible. In particular, commentators are asked to provide information about the costs and benefits of increased regulation to the Treasury Department and other entities issuing government securities.

Second, any evaluation of regulatory alternatives for the government securities markets must carefully consider the costs of that regulation as well as the potential benefits to investor protection, market efficiency, and investors' confidence that additional regulation might provide. While such a cost-benefit analysis is an important element in any regulatory initiative, it is particularly critical in the government securities markets because of size and importance of these markets. For example, one cost of government securities dealers failures could be the withdrawal from the market of a substantial number of investors. On the other hand, such failures could induce a "flight to quality" in which investors deal only with more established firms. Thus, in evaluating the specific issues discussed below, commentators are requested to identify and quantify to the extent possible the costs and benefits of taking further regulatory action, as well as declining to take further action.

Third, the regulation by the Commission and the SROs of non-exempt securities broker-dealers generally has operated effectively. While no system is fool-proof and there have been some major failures of regulated broker-dealers, the Commission believes that the regulatory system for registered broker-dealers promotes investor protection. It deters fraud and permits earlier detection of fraudulent activities. Nevertheless, there are a number of differences in the customers and activities of government securities dealers and broker-dealers presently regulated by the Commission. Broker-dealers currently registered with the Commission generally deal directly with individual investors as well as institutions; whereas government securities dealers deal primarily with other dealers and corporate, municipal, and institutional investors.

In responding to the specific questions raised below, the Commission requests comment on the relevant similarities and differences between the activities of government securities dealers and registered broker-dealers. 21/ In this regard, as the BBS case illustrates, activity in the government securities markets can have repercussions for related registered broker-dealers and their customers. Hence, commentators also are requested to discuss the impact on the corporate and municipal or other securities markets of taking regulatory action, and declining to take such action, in the government securities area.

The Commission has divided its specific questions into two general categories: (1) issues relating to the costs and benefits of further federal regulation of government securities dealers and the structure that any such regulation should take; and (2) if further regulation of government securities dealers is considered necessary, the specific areas that should be

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21/ The Commission also requests specific comment on which market participants should be considered as dealers in government securities, and how this universe should be defined. The Exchange Act's definitions of "dealer" (Section 3(a)(5)) and "municipal securities dealer" (Section 3(a)(30)) turn on whether a person buys and sells securities as part of a regular business. This language has been interpreted to distinguish between professional investors and market makers. Commentators should consider whether this type of distinction is feasible in a market where large positions may be taken for cash management purposes as well as to generate trading profits.

regulated. In addition, the Commission invites commentators to address any other issues they believe to be important.

A. Costs and Benefits of Regulatory Alternatives

Possible responses to recent problems range from working within the present regulatory framework to creating an SRO for government securities dealers, perhaps coupled with registration with, and regulation by, one or more federal agencies.

1. Responses by the Private Sector and Regulators of Investors

One approach would be to rely primarily on responses by the private sector, and possibly regulators of institutions that invest in that market, to meet the problems raised by the recent failures. In that connection, how effectively is the marketplace responding to the widely publicized problems of ESM and BBS? Please describe steps that are being taken. Abuses involving GNMA standby contracts in the late 1970's dissipated when the less sophisticated institutional investors who had engaged in transactions in standbys substantially reduced their participation in that market. In addition, the NCUA, FHLBB, and bank regulatory agencies each adopted guidelines or rules intended to limit the activities of regulated institutions in standbys and forwards. 22/ Similarly, the losses incurred in the Drysdale failure were largely the result of a failure by investors to

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22/ See Government-Related Securities Report, supra note 4, at 176-204.

account for accrued interest on securities loaned to Drysdale, a shortcoming that has since been corrected by standard industry practices. 23/

In both ESM and BBS, it appears that investors incurred substantial losses because they were not properly collateralized. This apparently occurred because investors failed to take all the measures necessary to assure adequate possession or control of their collateral. This also was alleged to have resulted from fraud and deception on the part of the government securities dealers (and perhaps their registered broker-dealer affiliates) involved in these failures. With respect to ESM, substantial losses also were incurred by two institutions, apparently controlled by the same individual, which provided ESM with excessive margin. The Commission requests comment on the private sector's response to these failures. What steps have dealers, including secondary dealers, taken to respond to these failures? In addition, are investors that do business with government securities dealers taking actions to ensure that their transactions are properly collateralized? Are they more actively auditing their collateral when it is held in custody by a government securities dealers? If so, how could such an auditing task efficiently be carried out? Have the recent failures resulted in a "flight to quality"

23/ See, e.g., Public Securities Association, Business Practice Guidelines For Participants in the Repo Market (October 1982).

with investors transferring their repurchase activities to larger, better known dealers.

Commentators who believe there has been or will be significant private sector response to ESM and BBS are requested to discuss whether this response reduces the risk of future frauds of a similar magnitude. At the same time, commentators are also requested to address whether one cost of a solely private response to government securities dealer failures is the withdrawal from the market of a substantial number of investors and whether any such withdrawal may adversely affect the government securities markets on a short and long term basis.

2. <u>Collateralization</u>

An alternative approach would be legislation or additional regulation requiring government securities dealers or customers to take steps to ensure that such transactions, including repurchase agreements, are properly collateralized, possibly through electronic book-entry systems. This approach would reduce the risk of a dealer using the same collateral to secure more than one transaction. The Commission requests comment on the feasibility of and the expenses associated with such collaterization of both long and short term transactions. Those who incurred losses in ESM and BBS apparently were primarily, if not entirely, dealing in long term transactions.

The Commission understands that the charge to an institutional investors of a Treasury securities movement over the Fed wire is approximately $38. In this connection, the Commission requests comment on the costs to investors of transfer of a Treasury securities position, and the receipt, custody, and examination of a position in a safekeeping account for the benefit of customers.

The Commission also requests comments on the costs of collateralizing GNMA securities which are presently not included in a book-entry system. Some government securities dealers have indicated that the cost to transfer GNMA securities could be as high as $20 per pool, and noted that the delivery of a round lot (one million dollars) of GNMA securities may involve up to three pools. The Commission also requests comments on any operational problems in collaterizing GNMA transactions. 24/

In addressing the costs entailed in a collateralization requirement, commentators should distinguish between the costs for overnight and term repurchase agreements. In this connection, the Commission notes that the collateralization abuses occurring in ESM and BBS apparently involved term repurchase

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24/ For a discussion of automated systems for the transfer of government-related securities, see *infra* notes 48-49 and accompanying text.

agreements. Comment is requested as to whether there is a similar risk of abuse in overnight repurchase agreements. Finally, comment is requested as to the need to impose any collateralization requirement on banks or regulated broker-dealers already subject to examinations and segregation requirements.

Also, please consider possible alternatives to collateralization, such as a requirement that a dealer segregate its customers' collateral. Would the viability of such a customer segregation requirement depend on an auditor's examinations, or the ability of the customer or a regulatory body to inspect or externally audit the dealer's accounts? Evaluation of possible means of providing such an external check is requested. 25/ Comment also is requested on whether it is necessary or appropriate for the regulators of institutional investors to adopt rules to ensure that they follow such protective measures.

25/ The Commission also seeks comments on whether specific measures such as the expansion of book-entry systems in government securities would be useful in ensuring that investors can obtain adequate collateralization in connection with repurchases and similar short-term transactions. In this connection, the Commission seeks comment on whether adequate collateralization would protect investors from abuses apart from possible dealer insolvency, or whether some additional guidelines or regulations directed towards dealers engaged in a government securities business might be necessary. *See infra* notes 26-33, 37-66 and accompanying text.

3. Expansion of Statutory Disqualification Provisions

Another approach which could be used alone or in conjunction with other approaches would be to expand the present authority to suspend or bar securities market participants. Currently, SROs under the Commission's jurisdiction are empowered to deny membership to a broker-dealer registered with the Commission and bar any person from becoming associated with a registered broker-dealer who is subject to a statutory disqualification. 26/ The SRO must file with the Commission a notice within 30 days if it knows, or in the exercise of reasonable care should have known, that it has admitted into membership a person subject to a statutory disqualification or allowed a person subject to a statutory disqualification to become associated with a member. 27/

26/ Section 6(c)(2) and 15(A)(g)(2) of the Exchange Act. *See also* Section 15B(c)(4) of the Exchange Act. The term "statutory disqualification" is defined broadly in Section 3(a)(39) of the Exchange Act to include, among other things, persons: expelled, suspended from membership in, or barred from association with, a member of an SRO; subject to a Commission order suspending or revoking broker-dealer registration; or who have violated the federal securities laws.

27/ Rule 19h-1 under the Exchange Act.

The Commission notes that, to some extent, the recent problems in the government securities markets appear to have resulted from certain persons connected with one troubled dealer later moving to another dealer which subsequently encountered difficulty. Accordingly, comments are requested on the possibility of extending the review of persons subject to a statutory disqualification to cover all dealers, including currently unregistered government securities dealers. Please also comment on whether such a review is feasible without registration and examination of government securities dealers to enforce such provisions; and discuss whether this additional oversight would be effective as the only additional regulation of government securities dealers, or whether it could best be utilized in conjunction with other regulatory initiatives.

4. Expansion of FRBNY Guidelines

An alternative regulatory approach could be the use of voluntary guidelines governing the conduct of firms engaged in a government securities business. For example, the FRBNY's proposed voluntary capital adequacy guidelines could be expanded to establish standards in other areas such as the segregation of customer securities and the maintenance of complete books and records. Alternatively, voluntary guidelines could be adopted by a relevant industry group. The FRBNY's proposed voluntary guidelines rely on pressure to comply from customers, and indirectly, from regulatory agencies requiring supervised institutions to ensure compliance by the firms with whom they deal. Complying firms would obtain certification of compliance by an independent public accountant, thus providing customers with a basis on which to choose the firms with which to deal.

The Commission seeks comment on whether voluntary guidelines for government securities dealers could adequately protect investors and maintain the integrity of the government securities markets. In this connection, it would be useful if commentators would assess the potential cost-effectiveness of the FRB's current reporting program for secondary dealers and the proposed voluntary compliance program, as well as whether the voluntary standards could be enhanced by voluntary inspections, perhaps by a federal agency or a relevant industry group, auditing of all affiliates by a single auditor, or certification by auditors of internal controls as well as financial statements. In order to be effective would it be necessary for such standards to be mandatory?

5. Creation of a Self-Regulatory Organization

Another oversight approach would be the creation of an SRO for government securities dealers. Important issues include: whether such an SRO should have rulemaking power only or also have inspection and enforcement powers over members; 28/ and whether membership in such an SRO should extend to all government securities dealers, or be limited to non-bank dealers or unregistered firms that deal solely in government securities. Any regulatory scheme for oversight of government securities dealers must recognize the

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28/ At present there are two basic types of SROs: those with rulemaking authority only, such as the Municipal Securities Rulemaking Board ("MSRB"); and integrated SROs with rulemaking, inspection, and enforcement authority, such as the National Association of Securities Dealers, Inc. ("NASD") and the national securities exchanges. The MSRB's fifteen-member board with expertise on municipal securities has authority under Section 15B(b)(2) of the Exchange Act to adopt rules governing transactions by brokers, dealers, and municipal securities dealers, subject to Commission approval. The MSRB is divided evenly among representatives of dealer banks, securities firms, and the public. Responsibility for ensuring compliance with MSRB rules, however, rests primarily with bank regulators for dealer banks and the NASD for registered broker-dealers. In contrast, the NASD and the national securities exchanges have integrated rulemaking, inspection, and enforcement authority subject to Commission oversight, over registered broker-dealers and member firms, respectively. The Commission also has enforcement and inspection authority over the entities subject to SRO rules.

important role of the primary dealers in the auction process and the FRBNY open market operations, as well as the unique oversight role of the FRBNY with respect to the primary dealers. Accordingly, comment is sought on whether the primary dealers should be exempted from SRO membership or subject to a more limited form of SRO oversight.

A government securities SRO could be a separate, limited SRO, modeled after the MSRB; or could be an expansion of the MSRB to include responsibility for regulation of the government securities market. 29/

A limited SRO which had rulemaking but not inspection or enforcement authority could take several forms. The form most similar to the MSRB could have rulemaking authority over all government securities dealers, including banks and dealers registered with the Commission. Inspection and enforcement authority could repose in the bank regulators for bank dealers, the FRBNY for primary dealers, and the NASD or the New York Stock Exchange ("NYSE") for non-bank dealer members.

A second form of SRO could be limited to adopting rules applying to government securities dealers not regulated by

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29/ This is the approach taken in the Public Securities Act of 1985, introduced on April 15, 1985 by Congressman John Dingell and several other co-sponsors in the House of Representatives. See H.R. 2032, 99th Cong., 1st Sess. (1985).

any other SRO or agency. It would not govern the government securities activities of registered bank dealers and registered broker-dealers. Enforcement and inspection authority over unregistered government securities dealers could be delegated to the NASD or the NYSE.

Alternatively, a government securities SRO could be given fully integrated rulemaking, inspection, and enforcement authority like that of the NASD and the national securities exchanges. This integrated approach may provide greater consistency between rulemaking and rule enforcement and permit consolidation of expertise in a single entity. On the other hand, an integrated SRO for all government securities dealers might be duplicative in part. 30/

Another approach which could be used alone or in conjunction with the creation of an SRO for currently unregulated government securities dealers would be to expand the jurisdiction of an existing SRO to include government securities dealers. For instance, all or certain government securities dealers could be brought within the purview of the MSRB, the NASD, or the national

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30/ The Commission requests that commentators discuss whether an integrated SRO might nevertheless be appropriate for sole government securities dealers which, if they are not primary dealers, currently are not subject to any form of regulation. The principal advantage of the limited SRO model is that it avoids creating an additional inspection and enforcement structure for currently regulated entities.

stock exchanges. This approach could include a requirement that subsidiaries of registered broker-dealers be combined with the registered broker-dealer or that broker-dealer audits and inspections extend to government securities dealer subsidiaries. Such an approach might substantially reduce the start-up costs of a government securities SRO. Because these SROs are not presently oriented toward government securities, however, they might have to revise their organizational structures and examine the applicability of their rules in order to regulate effectively government securities dealer activities. 31/

The Commission asks commentators to evaluate the cost-effectiveness of these various forms of self-regulation. Comment is sought on whether self-regulation is appropriate for the government securities markets on the whole, and whether the benefits from uniform rulemaking for the government securities industry would outweigh possible costs of compliance. 32/ Commentators also should assess whether subjecting less than

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31/ The Commission also notes that, pursuant to Section 17(d)(1) of the Exchange Act and Rule 17d-1 thereunder, the Commission has the authority to allocate authority to SROs in areas of potential overlap. The Commission requests comment on whether, if government securities regulation is accomplished through an SRO, the Commission should use its authority under this section to allocate regulatory responsibilities. It also should be note that, under Rule 17d-2, SROs can agree to allocate responsibility for examining dual members' compliance with SRO and Commission requirements to one of the SROs.

32/ In this connection, the Government-Related Securities Report attempted to assess the costs of an SRO approach. See Government-Related Securities Report, supra note 4, at 232-234.

all dealers to self-regulatory oversight might unfairly burden the firms subject to this oversight by creating regulatory disparities. Comment is also requested as to whether any of the other possible SRO models may have adverse competitive effects on any sector of government securities dealers.

6. Direct Federal Regulation

A further alternative is increasing the direct federal role in regulating the government securities markets. Government securities dealers could be required to register directly with the Commission, as is currently required of registered broker, dealers, and municipal securities dealers, the FRB, or some other entity, and be directly subject to federal regulations concerning financial responsibility and other subjects discussed below. 33/ Another possibility would be to give to the FRB the direct ability to regulate the government securities market, thus strengthening its present informal oversight activities. This alternative could operate separate from or in conjunction with other approaches to overseeing the government securities market.

7. Federal Oversight

A further issue raised by the consideration of additional regulatory structures is what form of ultimate federal oversight should exist. One approach could be for either the

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33/ See infra text accompanying notes 37-63.

Commission or the FRB to have sole oversight authority over a government securities SRO or other regulatory structure. The Commission and the FRB each have experience in different areas that might pertain to such an SRO or regulatory structure. The Commission has substantial experience in overseeing a variety of securities SROs, including the MSRB, the NASD, and the national securities exchanges. It is the appropriate regulatory authority for broker-dealers, and is charged with responsibility for administering the federal securities laws. In that capacity, it currently has anti-fraud authority over participants in the government securities markets. The FRB has substantial expertise with respect to the government securities markets. The FRBNY already is active in monitoring closely the activities of primary dealers, receives information from other dealers on a voluntary basis, and is responsible for implementing national monetary policy through transactions in government securities. Accordingly, the Commission seeks comment on the appropriateness of sole FRB or Commission oversight.

Another possibility would be joint supervision of an SRO by the Commission, the FRB, and the Treasury. This approach was proposed in the Government-Related Securities Report. This oversight could operate either directly through a joint council or through consultation procedures similar to those in clearing agency regulation under Section 17A of the Act 34/ or between the Commission and the Commodity Futures Trading Commission under the Commodity Exchange Act ("CFTC-SEC Accord model"). 35/ The Commission solicits comment on the relative advantages of these various oversight approaches.

34/ See Section 17A(a)(2), (3)(A) of the Exchange Act. Under the clearing agency model, one agency would be the principal oversight agency, and would consult and cooperate with other interested agencies to insure that each fulfills its respective regulatory responsibilities, especially when proposed SRO rules are involved. In addition, interested agencies would make and enforce their own rules with respect to government securities dealers over whom they have jurisdiction.

35/ Securities Exchange Act Release No. 20578 (January 18, 1984), 49 FR 2884. Under the CFTC-SEC Accord model, one agency would be the principal oversight authority, and other agencies would be able to comment upon and in certain instances veto action taken by the principal authority.

B. Areas of Regulation

In conjunction with determining whether further federal oversight of the government securities market would be cost-effective, comments are requested on the areas such regulation should cover. In its regulation of brokers, dealers, and municipal securities dealers (both directly, and through its oversight of the SROs), the Commission in the past has developed and reviewed regulations in three general areas: (1) financial and operational regulation; (2) professional qualification regulation; and (3) business practices regulation. 36/

36/ As discussed above with respect to the scope of SRO and federal oversight of government securities dealers, see supra text accompanying notes 28-33, the Commission recognizes that, even if additional regulation of the government securities market is deemed to be cost-effective, some of these types of requirements may not be found to be applicable to all government securities dealers. Accordingly, the Commission requests commentators to address each of the areas of possible regulation and to discuss the costs and benefits of imposing such regulations on various participants in the government securities markets. The Commission further requests commentators to describe any specific operational characteristics of the government securities markets that may be relevant to a discussion of whether a particular aspect of regulation is cost-effective.

1. Financial and Operational Regulation

The cornerstones of the Commission's financial regulation of brokers and dealers are the Net Capital Rule 37/ and the Customer Protection Rule. 38/ The primary objective of the Net Capital Rule is to ensure the liquidity of a broker-dealer to enable it to meet its obligations promptly. The Customer Protection Rule has two principal objectives: (1) to require a broker or dealer to obtain promptly, and thereafter maintain, possession or control of customers' fully paid and excess margin securities; 39/ and (2) to require brokers and dealers to deposit, in effect, excess customer monies in a special reserve bank account for the exclusive benefit of such customers. 40/

The Commission requests comment on whether this type of financial regulation should be applicable to government securities dealers and, if so, at what level the requirements,

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37/ Rule 15c3-1 under the Exchange Act.

38/ Rule 15c3-3 under the Exchange Act.

39/ Rule 15c3-3(b) under the Exchange Act.

40/ Rule 15c3-3(e)(2) under the Exchange Act.

particularly net capital requirements, should be established. It would appear that the impact of many of the recent government securities dealer failures would have been lessened considerably if there had been a functioning net capital rule in place and audits or inspections had detected the significant trading and other losses incurred by those firms and related firms. At the same time, the substantial leverage in the government securities industry, and the selective absence of significant capital reserves for many firms, suggests that caution would have to be exercised in applying any financial responsibility standards in this market. In this context, the Commission specifically requests commentators to discuss the FRBNY's proposed voluntary capital adequacy standards 41/ and whether any capital standards should be made mandatory. 42/

The Commission also requests commentators to discuss whether there should be specific margin requirements imposed on transactions in government securities. The Commission requests commentators to consider direct Federal regulation

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41/ *See supra* note 8.

42/ The Commission also requests comment on whether there should be periodic financial and operational reporting by government securities dealers in a manner similar to the FOCUS Reports filed by registered broker-dealers on Form X-17A-5 under the Exchange Act.

of margin, such as that engaged in by the FRB under Section 7 of the Exchange Act with respect to transactions in corporate securities, 43/ or, alternatively, margin regulations established by an SRO, subject to government oversight, 44/ or SRO margin regulation that is not subject to any formal government oversight. 45/

Many of the recent problems in the government securities markets have involved repurchase transactions. Hence, the Commission requests comment on whether it is desirable to establish specific financial and operational regulations governing the repurchase agreement market. For example, should there be regulations concerning the collateralization

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43/ See Regulations G (12 CFR § 207); T (12 CFR § 220); U (12 CFR § 221); and X (12 CFR § 224) promulgated by the FRB.

44/ Margin regulation established by an SRO, subject to government oversight, would be similar to the manner in which margin requirements currently are established for options on stock indices, debt securities, and foreign currency, and in which they have been proposed to be established for individual stock options. See FRB Docket No. R-0538. Various alternative approaches toward margin regulation are discussed in an extensive recent study by the FRB staff. See FRB, A Review and Evaluation of Federal Margin Regulations (December 1981).

45/ For example, margins for futures are established by the board of trade, and the CFTC is statutorily precluded from reviewing those margins. See Section 5a(12) of the Commodity Exchange Act.

of repurchase transactions? 46/ In this regard, what regulations should be adopted, and what changes should be made to existing regulations governing either book-entry, physical delivery, or segregation of collateral for these transactions? Also, should the extent of regulation vary according to the duration of the transaction? 47/ Finally, should there be specific regulations governing mark-to-market payments in these types of transactions?

With respect to regulation of the operational and processing aspects of the government securities market, the Commission first notes that evidence of ownership of Treasury bills is now solely in book-entry form and that settlement in these securities occurs by electronic communication systems. Beginning in 1986, all new issues of Treasury bonds and notes also will be issued and traded in this manner. In addition, the Commission notes that the MBS Clearing Corporation ("MBSCC"), a subsidiary of the Midwest Stock Exchange, was established in 1979 to offer settlement services to firms active in the GNMA market. In March 1985, MBSCC, in conjunction with Chemical Bank, also began offering depository services on certain GNMAs. 48/

46/ See also supra text accompanying notes 24-25.

47/ The Commission also requests comment on whether specific regulatory programs are necessary to address other particular types of transactions in government securities, such as GNMA forward and standby transactions.

48/ The Commission understands that GNMA recently has indicated interest in the development of a book-entry system for GNMA securities and has stated to MSBCC that, should its depository prove viable,

(footnote continued)

As a general matter, however, most transactions in government-related securities are not processed in an automated environment.

On February 25 and 26 and March 8, 1985, the Commission hosted a series of workshops on increasing the immobilization, and ultimate elimination, of securities certificates. A primary focus of the workshops was to identify steps that could be pursued to immobilize or eliminate certificates in the government-related securities markets. Virtually unanimous support was expressed for developing book-entry or similar systems. The Commission currently lacks direct authority over clearing agencies or their participants engaged exclusively in processing of such securities. Accordingly, the Commission requests comment on what regulatory action, if any, is appropriate to facilitate more efficient processing of government securities. Commentators are requested to focus both on the long-term adequacy of current book-entry processing system, especially if trading volume greatly increases in these instruments, and on the need for automated clearing facilities in instruments not issued solely in book-entry form. 49/

(footnote continued)

it was interested in holding discussions with MBSCC on further measures to streamline efficient operation of the GNMA market. Ginnie Mae Will Use MBS for Clearance of its Securities, Bond Buyer, April 11, 1985.

49/ In considering this area, the Commission notes that the MSRB recently adopted rules requiring municipal securities brokers and dealers to use the facilities of a clearing agency for clearance of transactions in municipal securities if they are members of one or more clearing agencies that offer such services. MSRB rule G-12(f).

The Commission also requests comment on the need for specific record retention requirements to facilitate inspections programs. While inspection programs are an essential portion of any direct regulatory scheme, the question of who should conduct the inspection has been raised previously.

A final issue relating to financial and operational regulation relates to insurance or similar protection for customers of government securities dealers that enter liquidation. Specifically, the Commission requests comment on whether the Securities Investor Protection Act of 1970 ("SIPA") should be extended to provide protection to customers of government securities dealers not currently registered with the Commission. 50/ If so, commentators are requested to consider whether the current levels of coverage provided under SIPA would be cost-effective for government securities dealers, or for losses from government securities transactions by broker-dealers. 51/

50/ The Commission notes that government securities positions held by customers of registered broker-dealers who also conduct a government securities business currently are protected by SIPA in the event of the default of the broker-dealer. Nevertheless, the Securities Investor Protection Corporation ("SIPC") takes the position that persons engaged in repurchase transactions with SIPC member firms are not customers under SIPA and therefore are not protected by SIPA. In the event that SIPA did apply to the repurchase transactions, would SIPC have adequate funds to satisfy customer claims?

51/ If the property in possession of a failed broker-dealer that is distributed to customers is insufficient to satisfy customer claims, SIPC advances funds up to $500,000 per customer, of which no more than $100,000 can be to satisfy claims for cash.

2. Professional Qualifications

Persons associated with registered broker-dealers must meet professional qualification standards. The Act specifically empowers SROs to ensure the qualifications of persons associated with member firms. 52/ One aspect of professional qualifications is the requirement to pass an examination testing knowledge relevant to particular functions in the industry. 53/ In addition, SROs are empowered, subject to Commission review, to deny membership to a broker-dealer, and bar any person from becoming associated with broker-dealers, who is subject to a statutory disqualification. 54/

52/ See Sections 6(c)(3)(B), 15A(g)(3)(B), and 15B(b)(2)(E) of the Exchange Act.

53/ See NASD By-Laws, Article 1, §§ 1-2 and Schedule C thereunder ("Schedule C"); MSRB rules G-2 and G-3; NYSE Rule 345. For example, registered representatives must pass either: (i) the Series 7 General Securities Representative Examination, Schedule C at III (2)(a), to qualify to conduct a general securities business; or (ii) a more specialized examination or examinations to qualify to conduct specific limited types of business. Specialized examinations include the MSRB's Muncipal Securities Representative Examination, MSRB rule G-3(e), and NASD Limited Representative examinations for direct participation programs, Schedule C at III (2)(c), investment company and variable contracts products, Id. at III (2)(b), and options products, Id. at III (2)(d). Similarly, supervisory personnel must pass the relevant principal examinations. These examinations generally parallel the categories of examinations applicable to registered representatives, with additional examination, such as one for financial and operational principals.

54/ See supra notes 26-27 and accompanying text.

The Commission requests comment on which, if any, of these professional qualifications requirements should be applicable to the government securities markets. In doing so, commentators are requested to address what particular supervisory requirements would be cost-effective in the government securities market and whether persons with particular statutory disqualifications should be restricted from participating in this market.

3. Business Practices

Pursuant to the statutory directive to adopt rules to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trades, to protect investors and to further the public interest, 55/ SROs have adopted a number of rules regulating various business practices of their members. In addition, the Commission, pursuant to the

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55/ *See* Sections 6(b)(5), 15A(b)(6), and 15B(b)(2)(c) of the Exchange Act.

anti-fraud sections of the securities acts, 56/ has adopted various rules and adopted enforcement programs that address the business conduct of broker-dealers.

While some of the business practice rules adopted by the Commission and the SROs had, as their original basis, the objective of assuring that broker-dealers protected themselves against unsound practices, for the most part they have evolved into rules designed to protect investors dealing with those broker-dealers. In considering the appropriateness of applying business practice rules to government securities dealers, it is necessary to understand the nature of the customers with whom they typically do business.

A significant presumption behind a number of provisions of the federal securities laws and Commission rules is that, as the financial resources of an investor increases, his need for protection under the federal securities laws decreases, primarily because the sophistication of the investor, or his ability to

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56/ *See* Sections 10(b), 15(c)(1), and 15(c)(2) of the Exchange Act and 17(a) of the Securities Act.

obtain professional advice or counsel, commensurately increases. 57/ Transactions in the market for government securities generally are substantial in size. Nevertheless, abuses that have come to light in the past in the government securities markets generally have involved entities regarded as "institutional investors," often financial institutions. 58/ Accordingly, a significant question raised by problems encountered in the government securities industry is whether the presumption of sophistication usually attached to investors with significant assets is applicable to investors in the government securities markets, or whether the complexity of transactions or other factors related to this market necessitate additional protection for otherwise sophisticated investors. As a related matter, if it is felt that these customer losses stem from sophisticated investors that have received inadequate management or advice, commentators are asked to consider whether additional regulation of these investors by their regulators, or other approaches such as the FRBNY's educational initiative, would be more cost-effective than, or preferable to, regulation of government securities dealers.

The Commission requests commentators to focus on a number of specific areas where business practice rules have been adopted

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57/ See, e.g., Rule 215 under the Securities Act, defining the term "accredited investor" as used in Section 2(15) of the Securities Act and Rule 215 thereunder; and Section 205 of the Investment Advisers Act of 1940.

58/ See, e.g., Government-Related Securities Report, supra note 4, at 106-117.

in the past. First, those SROs that regulate registered broker-dealers have rules to ensure that members recommend to a customer only securities that are suitable for that customer. 59/ Similarly, these rules also address "churning," or engaging in excessive trading solely to generate commissions. 60/ In the past, the most rigorous suitability rules have been intended to address potential problems involving speculative low-priced securities, securities where market information is unavailable, or potentially risky trading strategies involving options.

Government securities in and of themselves pose virtually no credit risk to investors. Nevertheless, trading vehicles such as repurchase agreements, reverse repurchase agreements, GNMA forwards and standbys, and when-issued trading may pose suitability issues. Hence, the Commission requests comment on whether suitability concerns are raised in the more complex trading strategies involving government securities.

Second, the Commission and the SROs have rules governing disclosure that must be made in confirming trades with customers. 61/

59/ *See* NASD Rules of Fair Practice Article III § 2; MSRB rule G-19.

60/ *See* NASD Policy of the Board of Governors: Fair Dealing With Customers, under Article III § 2 of the NASD's Rules of Fair Practice.

61/ The confirmation rules generally require certain information to be disclosed to customers, including, with respect to debt securities, dollar value and yield information and, where applicable, information concerning possible redemption before maturity. Commission Rule 10b-10; NASD Rules of Fair Practice Article III Section 12; MSRB rule G-15.

The Commission requests comment on whether there should be specific confirmation requirements applicable to the government securities markets, for example, as regards to the general provisions of repurchase agreements.

Third, pursuant to its general investigative and antifraud authority, the Commission investigates, and can take enforcement action, if it believes that customers are being charged excessive mark-ups or commissions, 62/ including transactions in government securities. 63/ The Commission requests comment on whether reliance on the Commission's general antifraud authority is sufficient in this area or whether there should be more specific regulation of commissions and mark-ups of government securities.

Finally, the Commission requests comment on any other business practice regulations that commentators may believe

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62/ In addition, SROs have more specific rules intended to ensure that their members are not charging excessive mark-ups and commissions in non-exempt securities. NASD Rules of Fair Practice Article III § 4; MSRB rule G-30. Those SROs with surveillance and enforcement authority also inspect for violations of the rules, and can take action in appropriate circumstances.

63/ The Commission has used this authority on several occasions to bring enforcement actions with respect to government securities. *See, e.g., SEC v. Winters Government Securities Corporation* (S.D. Fla., No. 77 Civ. 6345), Litigation Rel. No. 8067 (August 15, 1977), 12 SEC Doc. 1560; *SEC v. MV Securities, Inc.* (S.D.N.Y., No. 84 Civ. 1164), Litigation Rels. Nos. 10289 (February 21, 1984) and 10303 (March 5, 1984), 29 SEC Doc. 1454 and 1591.

are appropriate. Areas of possible comment include, but are not limited to, disclosure of possible conflicts of interests, regulations concerning quotation and last sale reporting, and rules regarding employee trading.

III. Conclusion

In preparation of its response to Congress on the need for additional regulation of the government securities markets, the Commission is seeking comment on a wide variety of issues. The Commission requests commentators to address both the specific issues raised in this release and any other issues believed to be relevant to the government securities markets.

LIST OF SUBJECTS IN 17 CFR 240

Reporting and recordkeeping requirements, securities

By the Commission.

John Wheeler
Secretary.

Date: April 19, 1985.

Summary of Comment Letters

In response to its solicitation of comments on the appropriate approach to regulation of the government securities market, the Commission received 79 comment letters, including 23 from primary dealers or organizations representing these dealers, 22 from secondary dealers, and 12 from investors and investor groups. In general, 56 commentators supported at least some form of additional federal regulation for the government and/or agency securities markets, 12 commentators opposed any form of further regulation, and 11 expressed no opinion.

Commentators were uniform in their view that the U.S. government securities market is the world's largest, most efficient and liquid securities market. Most also noted the importance of this market in financing the government's debt as well as permitting the Federal Reserve Board ("FRB") through the Federal Reserve Bank of New York ("FRBNY") to execute domestic monetary policy. Both pro and con commentators stressed the dangers of imposing excessive regulation that would impair the liquidity of the market, raise treasury and dealer costs, and lower yields to investors.

Many commentators responded to specific questions raised by the Commission, including the impact of the ESM/BBS failures on the market, the costs/benefits of regulation, and the structure and coverage of regulatory proposals, particularly relating to repurchase transactions (repos).

I. Impact of the ESM/BBS Failures on the Market

The City of Pompano Beach, Florida, which may lose $11.9 million after the fall of ESM, cites, along with numerous other commentators, an overall loss of investor confidence in the market. The City also perceived the recent Maryland thrift difficulties to be directly related to this loss of confidence. The FDIC indicated that 16 insured state nonmember banks had open transactions with ESM or BBS, which may result in up to $12.4 million in losses (one bank may incur much of this loss).

The Federal Home Loan Bank Board ("FHLBB") indicated it may require its insured savings and loans to deal with regulated dealers (many regulated and unregulated investors are independently reviewing their trading controls and procedures) and might impose a strict mark-to-market policy. Many commentators cite that more market participants are scrutinizing the creditworthiness of those with whom they deal. Many primary and secondary dealers perceive a flight to quality, a shift of business from small regional firms to primary dealers or more capitalized secondary dealers. There is evidence of even a flight from unregulated or smaller capitalized primary dealers to regulated or larger capitalized primary dealers.

The greatest impact has occurred in the repo market. Many dealers indicate that more customers are seeking delivery or at least some form of collateral perfection. Some unsophisticated institutions have left the market (may have been forced into more speculative markets, e.g., commercial paper) resulting in less business for the smaller regional firms. Indeed, the City of Pompano stated that although it had done over 2,000 repos during the past five years, after ESM it has done none. The City indicated that it receives lower yields in its present alternative investments, which may cost the City up to six figures in lost annual interest income.

II. Regulatory Proposals

The vast majority of commentators recommended some form of further federal regulation over government securities market participants. All six investors were strongly in favor of additional regulation. Most proponents of regulation touted the benefits of regulation as restoring public confidence in the market, thereby increasing dealer and investor participation and liquidity, promoting long term market stability which will reduce national debt financing costs, protecting customers, and reducing potential losses and deterring frauds. Other commentators alluded to the failure of voluntary standards with respect to the market's recent problems. While commentators varied widely on the structure and coverage of the regulatory scheme, commentators generally cautioned that the new regulation should be focussed on solving the recent problems with the market.

A. General Rulemaking/Enforcement Proposals

A significant number of commentators, including most primary dealers, supported the regulatory approach extended by the Primary Dealers Committee of the Public Securities Association ("PSA"). The PSA's comment letter tracked the earlier testimony of the Committee's Chairman, Richard Kelly. The PSA advocated that the FRB be vested with rulemaking authority (so long as it consulted with the Treasury and other appropriate regulatory agencies) over all government securities dealers. The FRB should promulgate rules, which would include a registration requirement, capital adequacy standards, inspection and enforcement procedures, and specific measures to prevent fraud in connection with repos. The PSA advocated that the FRB should be given exemptive authority and should account for the unique role of the primary dealers in structuring its rules. The association also believed that it was important that prudent investment standards be established to guide less sophisticated investors. Finally, the PSA opposed any requirement that would mandate delivery of repo collateral, viewing such a requirement as imposing unnecessary costs, especially for non-wireable securities. The association believed that segregation of collateral should be permitted as an alternative to delivery.

While the PSA position only hinted that additional regulation should fall mainly on secondary dealers as opposed to primary dealers, some commentators, including many primary dealers and the U.S. House of Representatives Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs ("House Subcommittee"), directly asserted that new regulations should exclusively cover unregulated dealers (due to the perception that recent problems stemmed from these dealers). Still, many commentators urged the extension of uniform regulation to all dealers. In this connection, the Mortgage Bankers Association of America argued that secondary dealers would be disadvantaged if they were the only dealers subject to the new regulation. 1/

Most commentators who focussed on who should receive rule-making authority chose the FRB as a result of its close and historic nexus to the the government securities market. In this regard, the House Subcommittee, NYSE and Morgan Bank suggested that an advisory board within the FRB be created to advise the FRB in promulgating rules. While three commentators would give the MSRB rulemaking authority, most objected because of the dissimilarities in the markets for municipal and government securities, *e.g.*, different investors, problems, etc. 2/ Three recommended the creation of a new SRO (GSRB) under the aegis of the FRB and made up of federal government participants and/or industry/investor participants (Irving Trust suggested that a new SRO comprised of formerly unregulated dealers should

1/ The law firm of Patton Boggs & Blow, representing Lazard Freres, a secondary dealer, submitted a comment letter arguing the competitive disadvantages of secondary dealers being unable to access primary dealer brokers' brokers screens for trading and pricing securities. The firm advocated alternative credit tests to gain access to the screens and downplaying the importance of primary dealer status.

2/ The Credit Union National Association, Inc., representing over 18,000 credit unions nationwide, suggested that representatives of the Treasury and FRB could be voting members of the MSRB, thus "balancing the federal agencies' responsibilities for the public debt and monetary policy with the self-regulatory approach of the MSRB."

conduct member inspections). Commentators opposed to the latter proposal cited the costs of a new SRO and its potential tendency to over-regulate. Many commentators, however, indicated the benefit of using existing SROs to conduct inspections and to enforce FRB rules.

Several commentators suggested unique regulatory schemes whereby the FRB's rules would be voluntary, but the FRB would be required to disclose those not in compliance with the rules. For instance, Goldome, a market participant, suggested that the FRB disclose those dealers who do not volutarily report their positions. The House Subcommittee suggested that the FRB publish the names of those dealers not complying with the FRBNY's capital adequacy rule and that federally insured depository investors be barred from dealing with these dealers.

Although some primary dealers believed that the FRB should make and enforce its rules for primary dealers, most commentators would permit the FRB to delegate enforcement and inspection functions to others. Most suggested that these functions be undertaken by a particular dealer's current primary regulator, e.g., Commission, NASD, or banking agency, with current unregulated dealers being picked up by the Commission or NASD. Lehman Government Securities suggested that current unregulated secondary dealers should be registered as broker-dealers with the Commission and regulated as existing full service broker-dealers.

There was a fair amount of consensus on the types of rules that the new regulation should encompass. Most favored a registration requirement for firms and professional staff (with a possible grandfathering of the latter), statutory disqualification rules, daily, weekly and monthly position reporting to the FRB or an appropriate agency, auditing and inspection of books and records requirements, financial reporting rules, and a mandatory capital adequacy rule. With respect to a capital adequacy rule, many would simply make the FRBNY's voluntary guidelines in this area mandatory. Three stressed the importance of implementing a new rule sensitive to the government securities market. (Merrill Lynch Capital Markets, Bear Stearns, and Lehman Government Securities.)

Many commentators were against suitability and other business practice rules (they noted that the market was not characterized by innocent individuals), SIPC coverage, and margin requirements. Although most agreed that investor education programs, whose purpose is to raise the level of investor sophistication, by themselves would not be effective, such programs and related rules would be valuable adjuncts to dealer regulation. Metallgesellschaft Trading Corp., a reporting secondary dealer, suggested that investors be required to take exams (Dillon, Read, another secondary dealer suggested that at least money managers be required to take an exam) and sign dealer forms which disclose market risks. Lasater & Co., a secondary dealer, encouraged investors' regulators such as the FHLBB and FDIC to learn more about their regulated investors' market problems and establish appropriate guidelines. 3/ Indeed, the Securities Industry Association ("SIA") recommended that the FRB issue guidelines to govern investors' investment practices. First Boston indicated that certain problem investor groups should be targeted for regulation. Goldman Sachs, a primary dealer, cautioned, however, that regulators should not overly react to the recent problems and limit particular groups of investors to overly restrictive policies such as dealing with only primary dealers or dealers with a huge capital position.

Most commentators specifically discussed regulatory initiatives for repos. While some investors and dealers advocated a mandatory collateral delivery requirement at least for wire eligible securities, most commentators encouraged expansion of

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3/ The State Comptroller of New York indicated that it had already imposed strict investment guidelines upon the state's local governments in December 1984 after losses sustained in the collapses of Lions Capital and RTD. The Comptroller stated that "one state can not do it alone. Positive corrective action should be initiated by the Federal Government to control the market in which its securities are sold." The Comptroller urged that the Commission be given the authority to regulate government securities dealers; absent regulation, the Comptroller is considering prohibiting local governments from trading in the government securities market or at least not with unregulated dealers.

book-entry and wire systems for all government and agency securities, but no mandatory requirement that delivery must be made. These commentators detailed the direct delivery costs 4/ and argued the necessity of maintaining flexibility in structuring repo deals 5/ (delivery may be prohibitively expensive for non-wireable securities or short-term repos, especially those involving many underlying securities as collateral or a odd lot). In addition, many customers do not have facilities to take possession of collateral and must incur bank custodial costs. The City of Pompano Beach cited its problems of arranging with a correspondent bank to transfer its collateral over the Fed wire. Because of its relatively low level of business, no New York money center bank would set up a custodian account for the City of Pompano Beach. In addition, local banking

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4/ Irving Trust's comment letter described the direct and indirect costs of requiring delivery. Along with the $40 to $60 bank delivery charge (depending on the type of security and whether it was wireable, and including both wire and bank charges), most customers require custodial services for which banks charge between $15 to $50 per delivery. Delivery requires re-delivery after termination of the repo, but once the collateral is out of the hands of the dealer, he risks delays in getting it back resulting in a risk of failure to deliver. Bear Stearns noted that a $25 to $35 wire charge translated to 150 basis points lower yield for a customer in a $1 million overnight repo. Mortgage Bankers Association of America stated that a mandatory delivery rule for GNMAs would kill the GNMA repo market.

5/ Similar flexibility was recommended by some commentators with respect to the formulation of parties' margin practices.

institutions did not feel they had sufficient expertise to offer that service. Bankers Trust cautioned that without flexibility in setting up repos, dealers might be forced to seek alternative financing that could cost 10 to 200 basis points more than repo financing. Many commentators recommended alternative methods of allowing a customer to perfect a security interest in the collateral besides delivery (e.g., verifiable segregation rules and third party custodian arrangements. 6/

III. Opposition to Regulation

The Department of Housing and Urban Development ("HUD") and a small number of primary dealers, secondary dealers and other market participants disfavor any mandatory federal regulation. HUD believed that large scale regulation may reduce market liquidity resulting in up to $2 billion in increased Treasury financing costs per year. 7/ HUD and some other commentators stated that actual market losses may pale in comparison to the costs of regulation.

6/ See the comment letters of Goldman Sachs and Irving Trust for detailed descriptions of alternative methods of perfecting a security interest in one's collateral.

7/ The House Subcommittee, although a proponent of comprehensive regulation, cited a similar figure of potential costs of regulation. It noted that total FY-84 debt was $1.576 trillion and new financing and refinancing was $656.7 billion. If regulation raised costs by just 10 basis points (1/10 of 1%), the Treasury would incur between $1 to $2 billion in increased interest expense.

Like many proponents of regulation, opponents of regulation argued that regulation will not prevent fraud, which is already illegal. Some also argued that regulation may lull investors into a false sense that the federal government is protecting them, encouraging them not to exercise prudence on their own behalf. These commentators believe that the market is self-correcting, but most encourage adherence to voluntary industry standards such as the FRBNY's voluntary capital adequacy guidelines. They also support educational programs to enhance the sophistication of investors.

Many pro and con commentators believed that market participants must rely upon themselves to research the creditworthiness of all parties with whom they deal and that the recent ESM/BBS publicity has gone far to encouraging voluntary moves to more sound business practices, including increased monitoring of repo collateral and/or perfection of that collateral.

Dillon Read & Co., a secondary dealer, was particularly concerned about the imposition of a mandatory capital adequacy requirement. The firm argued that such a requirement "would make entry into the marketplace more expensive for small dealers and therefore transfer increased risk to large dealers in the form of reduced liquidity. The increased risk would mandate wider spreads and more costly financing."

Summary of May 21, 1985 Public Forum on Government Securities Market

Summary

The panelists in the Commission's May 21, 1985 Open Meeting on regulation of the government securities market represented a variety of perspectives on the government securities market -- investors, primary dealers, secondary dealers, industry groups, and federal regulators. Given this diversity, the panelists expressed a surprising degree of consensus. With only a few exceptions, the panelists supported a cautious legislative initiative that would grant the Federal Reserve Board limited authority to adopt capital adequacy and selected rules. The panelists felt strongly that such regulation of the government securities markets was necessary to restore confidence in the markets and in dealers, particularly secondary dealers, to prevent dealer firm problems, and to protect less sophisticated institutional investors.

A number of commentators noted a contraction in the repurchase transaction ("repo") market and a tendency among investors to shun secondary dealers in favor of primary dealers as a result of the ESM and BBS collapses. While John Niehenke of the Treasury indicated that this had not yet had a discernible effect on Treasury yields, others said that these trends could reduce the capital dedicated to these markets and thereby impair the liquidity and operation of the market. Commentators cited the unusually wide quotation spreads in GNMAs during the last three weeks as an example of this potential problem.

The most prevalent forms of regulation proposed were registration requirements, some qualifications standards, capital adequacy standards, reporting and recordkeeping requirements, and regular firm inspections. Most panelists favored the Federal Reserve as the most appropriate rule-making body, with inspection and enforcement carried out by the Commission, self-regulatory organizations, and bank

regulatory authorities. Three panelists supported a separate government rulemaking board, or an expansion of the Municipal Securities Rulemaking Board to encompass government securities.

Several panelists -- in particular, Mr. Ralph Peters of Discount Corp. and Mr. Niehenke, questioned the need for additional regulation. They suggested instead that education of investors and more careful regulation of investment practices might suffice to avoid repetitions of earlier dealer failures. Mr. Niehenke feared that regulation, even cautious regulation, could restrict dealer participation in the markets and reduce capital. The investor panel also generally was cautious about implementing broad regulatory changes.

The panelists were divided on the efficacy of requiring delivery of collateral in repos. Although one investor panelist, Mr. Cleveland, suggested a rule approach that in effect would require delivery of collateral in repos at the risk of losing exempt status for these trades, most dealers insisted that mandatory delivery of collateral would be difficult and excessively costly for smaller transactions (under $1 million) in wireable securities, and would be expensive and cause serious operational problems for non-wireable securities such as GNMAs. These panelists advocated relying on segregation rules and inspections to protect customers in repo transactions.

Separate discussions of each panel are provided below.

Investor Panel: (Bruce Cleveland, Government Investors Trust; Harold Boldt, 1/ Columbia Missouri; Betty Dunkerley, 2/ Beaumont, Texas)

Initially, the investor panelists expressed skepticism about the need for regulation in the government securities markets. Instead, they focused on the need for investors to develop sound investment practices. In particular, they

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1/ Mr. Boldt also is Chairman of the Government Finance Officers Association's cash management committee. He appeared in his individual capacity, not as a GFOA representative.

2/ The city of Beaumont lost 62% of its total investments from its dealings with BBS.

emphasized the importance of: 1) taking delivery of collateral on all repurchase transactions; and 2) educating the public investor about the nature and risks of repurchase transactions.

The panelists noted that regulatory measures such as capital adequacy quidelines would not prevent fraud. But they acknowledged that a scheme of regulation including registration, inspections, surprise audits and enforcement authority would certainly deter fraud. Panelists favored such measures if they could be accomplished within the current regulatory environment by either the Federal Reserve Board or the Commission.

Mr. Cleveland estimated that the costs to convert a repurchase transaction from an unsecured loan to a government guaranteed security through taking delivery of the collateral were minimal - from three basis points for the largest investor to perhaps 10 basis points for the average investor. Mr. Cleveland acknowledged, however, that his fund maintained an average repurchase balance of $100 million dollars, making his costs very low. Panelists also noted that taking delivery of collateral is cost effective only for transactions of one million dollars or more, and that small investors often are discouraged by both primary and non-primary dealers from taking delivery of collateral.

Finally, Mr. Cleveland suggested that government securities dealers that fail to deliver collateral on repo transactions should not be exempted from the broker-dealer registration and regulation re quirements of the Securities Exchange Act. Those dealers that deliver collateral would retain exempt status. 3/ The Fed would determine through its book-entry system which dealers were not making collateral delivery and the Commission would exercise its enforcement authority.

3/ Subsequent panels developed the notion of perfecting a security interest in collateral through means other than taking delivery, particularly for the small investor. Those panels explored the possibility of pooled third-party safekeeping arrangements.

Primary Dealer Panel: (Waite Rawls, Chemical Bank; Ralph Peters, Discount Corp; Edward Mahoney, Merrill Lynch GSI; Jon Corzine, Goldman Sachs)

The primary dealer panelists, with the exception of Mr. Peters, believed immediate regulation of the government securities markets is necessary. All the panelists, including Mr. Peters, believed the PSA's proposal -- Federal Reserve rulemaking authority, registration requirements for dealers, capital adequacy standards, audits, and inspections by the NASD and the bank regulators -- is the preferable regulatory approach.

The three panelists supporting regulation argued that there is a continuing problem with marginal government securities dealers dealing with unsophisticated customers, which threatens to destabilize the market and impair investor confidence. They indicated that investors have reacted sharply to these problems by shunning even well-run secondary dealers, possibly forcing some of these firms ultimately from the market and reducing capital and liquidity. These panelists also argued that centralized rulemaking by the Fed was needed to forestall a proliferation of restrictive regulations by other bodies (primarily the regulators of institutions investing in the market) that could impede the government securities market or destroy its fungibility.

The panelists all believed that the Fed was the preferable rulemaking body because of its involvement with the government securities market through open market operations, its experience in regulating banks, its present oversight of the primary dealers, and its control of the book entry system. They opposed expansion of the MSRB to the government securities markets because of the major differences in the government and municipal markets: for instance, the government securities markets have a far lower proportion of individual investors than the municipal securities markets. They also believed that establishing a new GSRB would lead to excessive rulemaking as the GSRB sought to justify its existence, although with the exception of Mr. Peters they viewed a new SRO as preferable to no regulation. They advocated NASD and SEC examination and enforcement authority over government securities affiliates of broker-dealers, bank regulatory authority responsibility for banks, and Fed responsibility over the primary dealers and any remaining firms.

The panelists opposed any direct or indirect collateral delivery requirements for repo transactions. They argued that wire transfer costs for small repo transactions in Treasury securities (under $1 million) would be prohibitively expensive.

They also indicated that the cost of physical delivery of non-wireable securities such as GNMAs far exceeded the delivery costs for Treasuries. For instance, a single transfer of $1 million in GNMAs, consisting of 3 pools, would cost $75 - $100 (resulting in a cost of 54 basis points for a one week repo). In addition, they contended that, at the current level of activity, delivery of collateral for all repos would simply not be feasible. The panelists said that requiring collateral delivery would end smaller repo trades, hurt dealers and banks that relied on smaller trades, reduce liquidity, and widen spreads because of a shortage of financing. Mr. Rawls noted that collateral delivery through pooling arrangements for smaller trades could reduce these costs, but only if mandatory delivery was not required on a transactional basis. The panelists argued that the use of third party arrangements or segregation of collateral on a customer's behalf should continue to be allowed, as under the Commission's Rule 15c3-3, and that audits and inspections would give this segregation of customer collateral added reliability.

Secondary Dealer Panel: (Thomas Kane, Printon Kane; Griffith Clarke, G.X. Clarke; James Ogg, Westcap Corp.; Stephen Barrett, Alex Brown)

The secondary dealer panelists strongly supported regulation of the government securities market, although they differed on what form regulation should take. They uniformly emphasized that any regulation should treat primary and secondary dealers equally to avoid a further tiering of the market.

The panelists said that secondary dealers were suffering from a contraction in the repo market and from a blind "flight to quality" by investors in reaction to BBS and ESM. They said that many investors were choosing to deal only with primary dealers on the assumption that they are regulated by the Fed, even though they believed that secondary dealers that are registered broker-dealers are in fact more highly regulated than many primary dealers. The panelists said that these trends ultimately could eliminate many secondary dealers that add capital to the market and service smaller institutions. They also argued that regulation was needed to bolster confidence in the market generally, although Mr. Clarke thought investor education might suffice in this regard.

Each panelist supported a different regulatory body. Mr. Kane favored regulation by the SEC, the NASD, and the bank regulators. Mr. Clarke favored Fed rulemaking because of the Fed's greater experience in the government securities markets. Mr. Barrett favored expansion of the MSRB to avoid creating a new board. Mr. Ogg favored a separate GSRB because of the differences between the government and municipal securities markets. Their primary emphasis, however, was on the need for additional, uniform regulation rather than its form. They generally advocated giving the selected regulatory body authority to require registration, capital adequacy standards, inspections, and qualification standards. Mr. Ogg also supported fair practice and uniform delivery standards.

The panelists regarded the costs of such regulation as low, particularly in comparison to its value. Mr. Kane said the direct costs of registration requirements and qualifications standards for his firm would be minimal, as would the costs of SIPC contributions, if required.

The panelists indicated that they participated in Treasury auctions on an occasional basis. Their weekly secondary trading ranged from less than $1 billion (Clarke) to over $3 billion (Barrett). Their GNMA and agency security trading ranged from minimal (Kane) to 60% of total firm activity (Ogg). Matched book operations ranged from none (Clarke, Ogg) to $300 million (Barrett). The majority of their individual repo trades exceeded $1 million (80% for Barrett, most or all trades for others), although many of their cash market trades were less than $1 million. (90% for Clarke, 30% for Ogg, 10% for Barrett).

Industry Group Panel: (Richard Kelly, PSA; Robert Shapiro, SIA; Rex Teaney, DBA)

The Public Securities Association ("PSA") stated that, although the government securities market has experienced recent problems that indicate a need for additional regulation, the government securities market is sound overall. In the PSA's view, the recent problems in the government securities market have resulted from careless and illegal actions by isolated dealers and irresponsible practices on the part of investors. The PSA believed that these problems have arisen mainly because of a regulatory gap that permits approximately 150 to 200 government securities dealers to be unregulated.

The PSA argued that regulation was needed to deal with these problems and to restore confidence and maintain capital in this market. The PSA proposed that specific rulemaking authority be granted to the Fed, applicable to all government securities dealers. This rulemaking authority should encompass: registration requirements, capital adequacy standards, inspection and enforcement procedures, and rules or guidelines to prevent fraud in connection with repo transactions. The PSA would vest enforcement and inspection authority in the regulatory authority that has principal oversight responsibility for the institution in question. Presently unregulated dealers would come under Commission and NASD oversight. The proposal would grant the Fed broad exemptive authority and the PSA emphasized that the Fed's rules should take into account the "unique role of the primary dealers."

The PSA supports the Fed as the proper regulatory authority because of its special interest in maintaining a healthy and viable market for government securities, its market knowledge, and its integrity. The PSA opposes the establishment of a separate self-regulatory organization for the government securities market because it believes that an SRO with general rulemaking authority would use its rulemaking authority to go beyond solving the problems that exist in the market.

PSA is opposed to mandating delivery of collateral in the repo market. It stated that delivery of collateral may be costly, unnecessary, and impractical and that alternatives such as segregation of customer securities and third party agreements exist and should continue to be employed.

The PSA also favors the establishment of guidelines for investors in the government securities market and feels that this can be accomplished through the existing regulatory structure. It noted, for example, that ERISA guidelines provided sound guidance for investors.

The Securities Industry Association ("SIA") supported the PSA's proposal on regulation of the government securities market, in order to preserve the efficency and the integrity of the market. The SIA stated that all market participants should be subject to mandatory standards, with oversight authority to monitor compliance. It stated that unregulated government securities dealers are a small segment of the market. The SIA noted the need to balance investor protection against the liquidity needs of the dealers.

The SIA favors the Fed as the regulatory authority for the government securities market because the Fed would be sensitive to the Treasury's interests as the issuer of government securities and the need for efficient markets. The SIA opposed the expansion of the MSRB because it feels the government securities market is different from the municipal securities market and that the problems in the government securities market are easily identified and can be remedied with specific rules.

The SIA opposed mandatory delivery of repo collateral. It supported capital adequacy guidelines, segregation of securities, recordkeeping requirements, and inspections to address the problem. Mr. Minike of Bear Stearns disputed estimates by Mr. Cleveland, stating that requiring delivery of an overnight repo might impose costs in excess of 300 basis points. The SIA noted that in many instances delivery of collateral is not practical and that, if the repo process is encumbered by too many restrictions, the Treasury will be subject to additional costs.

The Dealer Bank Association ("DBA") will not take an official position on the issue of regulation of the government securities market until its board meeting, June 5, 1985. Speaking personally, Mr. Teaney observed that: (1) some regulation of the market is necessary; and (2) the Fed should be given authority to regulate the government securities market.

<u>Regulatory Panel</u>: (Edward Geng, Federal Reserve Bank of N.Y.; John Niehenke, Treasury Department; Eric Hemel, Federal Home Loan Bank Board; Christopher Taylor, Municipal Securities Rulemaking Board)

The regulatory agency panelists emphasized that the flow of capital to the government securities market must be protected. All the panelists agreed that a flight by investors from secondary to primary dealers would adversely affect the liquidity of the government securities market.

Mr. Niehenke said that the Department of Treasury had not yet reached a position regarding regulation of the government securities market. He stated that the market had no inherent problems but was affected by transaction deficiencies. In response to these transaction problems, Mr. Niehenke noted that regulators and the accounting profession had promulgated guidelines concerning control and disclosure of collateralization. As a result, he stated that more investors are taking possession of securities, insisting on third party depositories, and scrutinizing balance sheets of dealers.

Mr. Niehenke also raised concerns about over-inclusiveness in the definition of government securities dealer. He asserted that many of the proposed regulatory schemes would unintentionally include small thrifts, mortgage bankers, and money brokers dealing in government securities transactions. He argued that regulation of these sectors might drive these investors to other securities markets.

Mr. Hemel noted that the Federal Home Loan Bank Board's ("FHLB") constituents were the primary victims of recent failures of government securities dealers. He said that the FHLB was currently looking at means of ensuring that its participating constituents complied with already existing FHLB guidelines concerning government securities transactions, 4/ and that the FHLB is considering adding additional guidelines. 5/

Mr. Geng indicated that the Fed had not yet reached a conclusion regarding the need for additional regulation of the government secuurities markets. He noted that neither collateralization nor third party delivery were complete solutions and that various regulatory opitons pose different problems. Mr. Geng believes that educating the participants in the government security market was a useful approach to the problem.

4/ He listed six such guidelines issued by the FHLB that affect savings & loan associations ("S&Ls"). These guidelines recommend that S&Ls (1) know the dealer before engaging in any government securities transactions, (2) inspect the certified financial statements and other filings required by any agency that regulates the dealer, (3) do a credit analysis of counterparties, (4) use capital adequacy guidelines in choosing dealers, (5) ensure that counter-collateral exists, and (6) review repurchase agreements to see if the market value of collateral exceeds funds received.

5/ Such guidelines will require S&Ls to (1) use a third party depository arrangement, (2) recalculate the value of their collateral on a weekly basis, (3) deal only with dealers who are regulated broker-dealers, (4) ensure that the value of the collateral they receive is at least equal to the value of the loans made, and (5) make payment or purchase goverment securities at the same time they receive confirms by third parties.

Christopher Taylor declined to comment because the MSRB is scheduled to testify at the Energy and Commerce Committee hearings on June 11, 1985 (since postponed).

Impact of Recent Events on Government Securities Markets

Mr. Niehenke indicated that he had seen no evidence of an investor shift from Treasury Bills or repos to other kinds of securities as a result of recent events. He conceded that investors were changing methods of transacting business, but he characterized these changes as merely evolutionary. He therefore concluded that there was no disturbance of the basic government securities market. Mr. Geng disagreed with Mr. Niehenke's view and stated that, while there was no short term problem, he was concerned that investor flight to primary dealers could ultimately result in withdrawal of capital from the market.

Mr. Niehenke noted that, even if repo agreements became less available as other panelists had said was occurring, dealers still could use other means to finance their government securities businesses. He also argued that investors could protect themselves without regulation by either taking possession of securities or perfecting their interest in the securities. Mr. Niehenke argued that regulation could have adverse effects if it identified participants incorrectly or drove some participants out of the market.

Mr. Niehenke stated that the international currency market had responded negatively to the failure of ESM (and the subsequent collapse of the Ohio private bank insurance system). He added that the decline in the value of the dollar reflected the international market's misunderstanding of the effects on the United States banking system of the collapse of a few financial institutions.

Causes of government securities dealer failures

Mr. Geng stated that double collateralization was one of the primary causes of the recent dealer failures. He added that, in both ESM and BBS, investors suffered substantial losses of margin payments made to those firms. In addition, he observed that falsification of records by dealers and false certified financial statements contributed to the problem. Mr. Geng also added that if these problems were resolved, new fraudulent methods could be devised such as abuse of custody or when-issued trading arrangements. He concluded that to avoid fraud one must educate participants in the marketplace, create good internal industry guidelines, and invest prudently.

When-issued Trading

Mr. Geng said that both the Treasury and the Federal Reserve had examined the when-issued market to prevent problems. In response, the Treasury had shortened the when-issued auction period from three weeks to a maximum of two weeks. Also, dealers have improved internal credit checks of counter-parties and taken other steps to reduce their monetary exposure. He noted, however, that credit checks are a problem when multiple parties are involved. He added that the Federal Reserve is collecting data from primary dealers concerning their exposure on when-issued accounts.

Nonetheless, Mr. Geng stated that the when-issued market continues to be an area for possible abuse since an unscrupulous party could build up excessive positions at considerable risk to its counterparties.