BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

CONFIDENTIAL (FR)

March 7, 1973

To: Federal Open Market Committee

From: Robert C. Holland

I am attaching for your information a letter sent by the Joint Treasury-Federal Reserve Staff Committee on the U.S. Government Securities Market to the staff of the Securities and Exchange Commission. The letter embodies the Staff Committee's comments on an SEC proposal to revise their net capital rule and make it apply uniformly to all brokers and dealers subject to SEC regulation (which would include about 10 of the nonbank U.S. Government security dealer firms).

Under this rule, in calculating the ratio of capital to debt, covered brokers and dealers are required to deduct from net worth varying percentages of assets (commonly termed "haircuts"), with the percentage depending on the type of asset. Staff comments focus on the size of "haircuts" that had been proposed for U.S. Government and Federal agency securities and other money market instruments, as well as on certain related issues. We understand the SEC is planning to issue a revised proposal for their net capital rule.

Attachment

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ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

March 6, 1973

Mr. Lee A. Pickard
Associate Director
Division of Market Regulations
Securities and Exchange Commission
500 North Capitol Street, N. W.
Washington, D. C. 20549

Dear Lee:

As you know from our two recent meetings, the Treasury and the Federal Reserve are concerned that the proposed revision of the SEC's net capital rule (15C3-1) not affect adversely the functioning of the Government securities market and, indeed, money and capital markets generally. While we sympathize with the underlying purposes of your proposed regulation, we believe it essential that the Government securities market continue to be able to underwrite and distribute Government debt and to facilitate Federal Reserve open market operations at its current high level of efficiency. Your original proposals, we believe, could significantly impair the efficiency of that market.

Certain revisions of your proposed regulation would tend to relieve or minimize adverse effects on the money market. We would suggest:

1. that no "haircut" be applied to Government securities, Government agency securities, and bankers' acceptances maturing in less than one year;

2. that haircuts on CDs and commercial paper be applied on a scale similar to that used by the New York Stock Exchange, i.e., 1/8 to 1/2 per cent depending on maturity;

3. that haircuts on Government securities and Government agency securities maturing in more than one year be applied at a rate of 1 - 3 per cent depending on maturities; and

4. that the provision that calls for haircutting both the short and long sides of an arbitrage position be amended.

Two main points underlie the above suggestions: first, the smooth and effective functioning of financial markets in the U.S. economy depends on the ability of dealers in Government and agency securities to take, at times, fairly sizable positions in those securities and in other money market instruments; and second, the liquidity of the money market, including the market for Government and agency securities and bankers' acceptances, is such that the risk of significant and dangerous losses in the case of liquidation is relatively small. The United States money market has developed as a highly efficient mechanism for cash adjustments for both financial and nonfinancial corporations. The money market also plays a major role in Treasury and agency debt management and in the effectuation of Federal Reserve monetary policy. It would be unfortunate if the benefits now flowing from our highly efficient money market were impaired because of the unnecessary application to this area of rules that had their chief relevance in other sectors of the financial market.

In the case of hedged (arbitrage) positions, risks are minimized by the offset of long and short positions of comparable maturity since prices of similar maturities of Government and Government agency securities would tend to move in parallel fashion. It might be feasible to let dealer-brokers offset short against long positions for the purpose of haircutting in the following maturity ranges:

1 - 3 years
3 - 5 years
5 - 10 years
10 - 20 years
over 20 years

The Treasury is especially, and understandably, concerned that haircut provisions on awards made to dealers in its financings not inhibit the ability of primary dealers to underwrite new Treasury issues. In a typical Treasury auction of securities, awards are made a week or more in advance of payment date, and a substantial amount of distribution to final investors is made by the dealers during that period. Since the Treasury relies on the dealers to underwrite new issues (in a recent financing the 24 primary dealers took over 75 per cent of the issue), it is essential that their ability to underwrite not be impaired. Perhaps there is some way that the SEC could introduce a measure of flexibility in applying its haircut rules during periods of underwriting Treasury issues.

We have read with some interest a copy of the letter to you from the Association of Primary Dealers in U. S. Government Securities, requesting that your proposed net capital rule not apply to activities in making a primary market for Treasury and Agency securities. As you know this group of dealers reports daily to the Federal Reserve Bank of

New York on their positions, transactions, and borrowings in U. S. Treasury and Federal agency securities, bankers' acceptances and CDs. In addition they submit a financial report annually and we have close market contacts with the group on a daily basis. The group is made up of diverse elements including banks and dealers who trade only in exempt securities and who would presumably not be subject to your regulation. We are concerned about the prospect that various elements of a single unified market will be subject to different rules and regulations. For this reason, and in light of the considerations raised by the dealer group, we feel it extremely important that inappropriately severe capital rules not be applied to those dealers subject to regulation.

Sincerely,

Joint Treasury-Federal Reserve
Staff Committee on the Government
Securities Market

Jack Bennett

Jack Bennett, Deputy Under Secretary
for Monetary Affairs,
Treasury Department

Stephen Axilrod

Stephen Axilrod, Associate Director,
Board of Governors of the Federal
Reserve System

Alan R. Holmes (ccg)

Alan R. Holmes, Senior Vice President,
Federal Reserve Bank of New York