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(III)
IMPACT ON MONEY AND CREDIT POLICY OF FEDERAL DEBT MANAGEMENT

MONDAY, APRIL 25, 1983

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met, pursuant to call, at 1 p.m., in room 2128, Rayburn House Office Building; Hon. Walter E. Fauntroy (chairman of the subcommittee), presiding.

Present: Representatives Fauntroy, Patman, and Hiler.

Chairman FAUNTROY. The subcommittee will come to order.

Slightly more than 1 year ago this month, this subcommittee began to assess the management of the national debt and the impact of Treasury borrowings on general credit conditions. This oversight hearing continues within that general framework but with the more specific focus on the safety, soundness, structure and function of domestic institutions which are engaged in the purchase and sale of U.S. Government debt instruments.

The markets in Government securities are largely unregulated. Relying on oral agreements, informal understandings and mutual trust, a relatively small number of securities dealers trade billions of dollars worth of Government securities each day. A large part of these transactions take the form of repurchase agreements in which the securities serve as collateral.

These transactions rest on the ultimate soundness of the Government securities, but the extent to which such collateral will be stretched to finance speculation has been limited only by the fear of loss, not by affirmative regulation. As the volume of trading has increased and new dealers have entered the secondary market, the marketplace’s restraints against excessive underfinanced dealings have become attenuated. The collapse last summer of Drysdale Government securities, Lombard-Wall, and Comark demonstrated the risks in this situation from overextended dealers with hundreds of millions of dollars in short-term liabilities.

The failure of Drysdale and Lombard-Wall weakened the confidence in the soundness of the Government securities market and raised questions about one of the most common transactions; the repurchase agreement. If there are new failures, there will be new questions and new problems which will severely affect our present system for the marketing of Treasury securities.

The Federal Government is expected to borrow an additional $200 billion this year. Its refinancing operations will be even more.
substantial. If we do not have an efficient and smoothly functioning Government securities market, that volume of borrowing will overwhelm the financial community, raising interest rates and choking off the economic recovery. This is why this subcommittee has been interested in this issue.

I understand that in the aftermath of last summer’s failures, the Federal Reserve System, acting through the Federal Reserve Bank in New York, has increased its surveillance of the market. I also understand there are a number of regulatory schemes currently under discussion which would enhance the safety and soundness of the major security dealers. This subcommittee wants to know precisely what new regulatory efforts and oversight have been undertaken. We also want to know what is contemplated.

Specifically, we on this subcommittee want to hear from our witnesses today on the following issues:

First, what concerns do you hold with respect to the financial and operating conditions of various Government security firms?

Second, will the size of the pending Government deficit have an adverse effect on the ability of the market to absorb the deficit without undue upward pressures on interest rates and the safety and soundness of the Government security firms?

Third, should there be a specific effort made to expand the number of primary dealers? How would this be done?

Fourth, should there be more direct regulation of all Government security dealers?

Fifth, what about possible new capital rules? I am particularly interested in the discussions which are being held about the imposition of capital ratio rules. How would you propose to attract capital to a firm? What would be the advantages of such a rule and would there be any lessening of the number of qualified dealers?

Here to testify on these issues today is the Hon. Anthony M. Solomon, president of the Federal Reserve Bank of New York. Accompanying President Solomon are Edward J. Geng, senior vice president of the New York Federal Reserve Bank, who has been monitoring the Government securities market and preparing new regulations to deal with this problem, and Peter D. Sternlight, executive vice president of the Federal Reserve Bank of New York, who supervises its trading in Government securities on behalf of the Federal Open Market Committee.

[The full text of Chairman Fauntroy’s opening statement follows:]
OVERSIGHT HEARINGS ON THE SAFETY, SOUNDNESS, STRUCTURE AND FUNCTION OF DOMESTIC INSTITUTIONS ENGAGED IN THE PURCHASE AND SALE OF UNITED STATES GOVERNMENT DEBT INSTRUMENTS

OPENING STATEMENT OF THE HONORABLE WALTER E. FAUNTROY CHAIRMAN, SUBCOMMITTEE ON DOMESTIC MONETARY POLICY COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Monday, April 25, 1983 -- 1:00 P.M.,
The Rayburn House Office Building, Washington, D.C.

The Subcommittee will come to order.

Slightly more than one year ago this month, this Subcommittee began to assess the management of the national debt and the impact of Treasury borrowings on general credit conditions. This oversight hearing continues within that general framework but with the more specific focus on the safety, soundness, structure, and function of domestic institutions which are engaged in the purchase and sale of United States Government debt instruments.

The markets in government securities are largely unregulated. Relying on oral agreements, informal understandings, and mutual trust, a relatively small number of securities dealers trade billions of dollars worth of government securities each day. A large part of these transactions take the form of repurchase agreements in which the securities serve as collateral. These transactions rest on the ultimate soundness of the government securities, but the extent to which such collateral will be stretched to finance speculation has been limited only by the fear of loss, not by affirmative regulation. As the volume of trading has increased and new dealers have entered the secondary market, the marketplace's restraints against excessive underfinanced dealings have become attenuated. The collapse last summer of Drysdale Government Securities, Lombard-Wall, and Comark demonstrated the risks in this situation from overextended dealers with hundreds of millions of dollars in short-term liabilities.

The failures of Drysdale and Lombard-Wall weakened the confidence in the soundness of the government securities market and raised questions about one of the most common transactions—the repurchase agreement. If there are new failures, there will be new questions and new problems which will severely affect our present system for the marketing of Treasury securities. The Federal government is expected to borrow an additional $200 billion this year. Its refinancing operations will even more substantial. If we do not have an efficient and smoothly functioning government-securities market, that volume of borrowing will overwhelm the financial community, raising interest rates and choking off the economic recovery. This is why this Subcommittee has been interested in this issue.

I understand that in the aftermath of last summer's failures, the Federal Reserve System, acting through the Federal Reserve Bank of New York, has increased its surveillance of the market. I also understand there are a number of regulatory schemes currently under discussion which would enhance the safety and soundness of the major security dealers. This Subcommittee wants to know precisely what new regulatory efforts and oversight have been undertaken. We also want to know what is contemplated.
Specifically, we on this Subcommittee want to hear from our witnesses today on the following issues:

1. What concerns do you hold with respect to the financial and operating conditions of various government security firms?

2. Will the size of the pending government deficit have an adverse effect on the ability of the market to absorb the deficit without undue upward pressures on interest rates and the safety and soundness of the government security firms?

3. Should there be a specific effort made to expand the number of primary dealers? How would this be done?

4. Should there be more direct regulation of all government security dealers?

5. What about possible new capital rules? I am particularly interested in the discussions which are being held about the imposition of capital ratio rules. How would you propose to attract capital to a firm? What would be the advantages of such a rule and would there be any lessening of the number of qualified dealers?

Chairman Fauntroy. Gentlemen, we are happy and pleased to have you respond to our request to come for this hearing. I am pleased you have submitted your testimony in advance and we have studied it carefully. We also are pleased to have a new member of the committee, Mr. Hiler, here.

We are ready now to proceed, Mr. Solomon, with your testimony in whatever manner you may choose to offer it.

STATEMENT OF ANTHONY M. SOLOMON, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. Solomon. Thank you, Mr. Chairman.

Since the statement that we presented was rather lengthy, I have prepared a shorter statement which I would like to read. I think it will give the subcommittee a sense of the main issues. And then my colleagues and I of course, are pleased to answer any questions you have.

We are here in response to your invitation to Chairman Volcker to discuss the recent efforts of the Federal Reserve System to increase its surveillance of the Government Securities market and thereby contribute to the orderly and effective operation of that market. The New York Reserve Bank serves as the operating arm of the System in the conduct of open market operations, primarily through transactions involving U.S. Government securities.

Mr. Chairman, nearly 1 year has elapsed since the Drysdale Government Securities firm sent shock waves through the Government securities market when it proved unable to pass on to counterparties interest on securities purchased under repurchase agreements, or repos. The Drysdale default also contributed to the collapse of two other Government securities dealers, Comark and Lombard-
Wall. While none of these three firms were eligible to transact business with the Federal Reserve, their failures were a cause of concern to us in terms of the threat they posed to the orderly functioning of the market as a whole.

With this in mind, in my statement last May 25 before the Subcommittee on Securities of the Senate Banking Committee, I indicated that the New York Reserve Bank would reexamine its traditional informal surveillance role and would work with the dealer community in seeking remedies for the practices that led to these failures.

I am pleased to report today that while much remains to be done, considerable progress has been made since that time. I will begin with a brief overview of the Government securities market and a review of the past year's developments before turning to address the specific questions you have raised. My written statement which I have submitted for the record today contains additional background material, including some of the details behind the three failures last year.

Chairman FAUNTLEROY. Without objection, that entire statement will be entered into the record, in addition to the statement which you now give.

Mr. SOLOMON. Thank you, sir.

The market for U.S. Government securities, which comprises trading in Treasury bills, notes, and bonds, is the most active capital market in the world. Although hundreds of firms participate to some extent, the core of the market is comprised of 36 dealers at the present time, including 12 commercial banks and 24 nonbanks, which submit to the Federal Reserve Bank of New York, daily position and volume reports as well as periodic financial statements. We refer to these dealers as the reporting or primary dealers. In addition to making active secondary markets in Treasury securities, the reporting dealers typically purchase and distribute from 35 to 75 percent of the total amount sold by the Treasury at each auction.

This market has functioned quite well over the years as an unregulated market subject only to informal surveillance by the Federal Reserve. Historically, the lack of a perceived need for a more formal regulatory structure probably was due primarily to the essentially riskiness nature of Government securities from a credit standpoint, and limited participation by unsophisticated investors.

Another reason is that many of the dealers already are subject to formal regulation in some form, either as banks or subsidiaries of bank holding companies or because they also operate in regulated markets. Additional measures of protection include the general antifraud provisions of the Federal securities laws and the self-regulatory constraints implicit in the interrelationships among market participants.

The Federal Reserve also plays an important role in this respect. In order for a firm to qualify as a primary dealer, we require that it submit to us daily transaction and position reports, as well as monthly financial statements; be actively engaged in the distribution of Treasury securities; have adequate capital and capable management; and stand ready to make markets in Treasury issues. All
of these requirements must be met over a period of time before we will consider adding a firm to our reporting list, and firms that have failed to maintain these standards have been dropped from the list from time to time.

The failures of Drysdale, Comark and Lombard-Wall, who were not reporting dealers, differed in some respects, but the common thread running through all three cases was that the firms were able to exploit opportunities to circumvent the self-regulating mechanisms of the market. They were thus able to support levels of activity far beyond what would have been prudent given their own resources by raising capital from careless or unwitting customers. From the Fed’s standpoint, these events drove home two essential lessons: First, that it was incumbent upon us to exercise leadership in working with market participants to correct the practices that led to these breakdowns in the market’s functioning; second, that a stepped-up level of surveillance was called for, encompassing a broader spectrum of market participants than just the 36 firms that report to us and trade with us on a daily basis.

Since that time, we have moved forward actively on both of these fronts. Last August, the New York Reserve Bank announced the appointment of a senior officer, Mr. Geng, with broad public and private experience to head a new unit within our open market function devoted exclusively to market surveillance and related issues. We have since completed what we see as the necessary initial staffing of the new area, with an additional officer, five professional employees with experience in financial analysis, dealer operations and law, and support personnel. The surveillance effort also draws upon the bank’s other professional resources and we are, of course, prepared to expand the staff if necessary in light of new developments. The basic ongoing work of this surveillance unit includes reviewing the financial condition and daily position reports of the reporting dealers. The primary objective of this review, aided by computer programs and other analytical tools, is to identify incipient undesirable trends and abnormal dealer behavior. The impressions we form from these analyses are supplemented by regular telephone calls and visits to the reporting dealer firms.

One significant change in market practices that has already been accomplished by the dealer community with the strong encouragement of the Fed is the inclusion of accrued interest in accounting for repurchase transactions. Failure in the past to include interest in determining the value of a security in a repurchase transaction enabled Drysdale to raise additional capital that it was then able to use in its own activities.

Through repurchase agreements it would borrow securities that had a considerable amount of accrued interest, paying only the principal amount. Then it would sell the securities for their full value including the accrued interest. Drysdale used the extra funds raised in this fashion to finance its own activities. But when it incurred losses, it lacked the resources to honor its commitments to make the interest payments when due on the securities.

In the wake of the Drysdale failure, the way to prevent a recurrence was clear; simply require that accrued interest be included in repurchase accounting. The Primary Dealer Association endorsed this change, and I addressed a letter to the head of each primary
dealer firm informing them that we would adopt the new accounting procedure for our own transactions beginning last August. We had had earlier meetings in June, starting shortly after Drysdale, in June and July, and there have been communications by letter as well. By October 4, 1982, all of the reporting dealer firms had completed the changeover in their accounting procedures for repurchase transactions with other customers as well.

One other practice that contributed to the Drysdale failure and in which significant improvement has been seen is that of “blind brokering.” In the Drysdale case, major New York banks had acted as brokers, bringing together the parties in repurchase transactions, but neither party knew who its counterparty was. In effect, this practice would permit a weak dealer firm to hide its identity behind that of the bank acting as broker, and thus to build up its positions with counterparties to a level that the counterparties’ credit review procedures might not have allowed it they had realized with whom they were dealing. But since the Drysdale failure we have seen a new atmosphere of caution and attention to one’s counterparties, and consistent with this the practice of blind brokering of repos has diminished substantially.

Turning to current issues, Mr. Chairman, and the specific questions raised in your letter to Chairman Volcker, the number of primary reporting dealers has grown over the years as the size of the market has expanded—from around 20 in the 1960’s to the present level of 36. The door is always open to additional firms that meet our criteria and who are prepared to comply with our reporting requirements. Although the present reporting list is adequate for our trading needs in conducting open market operations, we have concluded that it is not sufficient for monitoring purposes in light of last year’s developments, even though we believe these firms actually account for the bulk of trading activity in government securities.

While our plans are still in a formative stage, we plan to seek submission of data from a sizable number of nonreporting dealers in addition to the primary dealers. This information would not be as detailed or frequent as it is from the primary dealers. Moreover, since banks are already under close regulatory scrutiny and the purpose here is market surveillance and the financial viability of dealers, this additional data collection effort would be directed only to the nonbank dealers. As with the present reporting group, the submission of reports by the second group would be entirely voluntary. However, we see this group as forming a logical pool of candidates from which future primary dealers might emerge, thus giving them an incentive to comply with our request. I also believe that a sizable market participant would not want to be in a position of declining to disclose information in confidence to the Federal Reserve.

Mr. Chairman, you have asked whether imposing more demanding standards on the dealers could reduce the number of firms available to handle the forthcoming heavy volume of Treasury financings. I do not see any of our plans as posing a problem in this regard. I think a moderately stepped-up program of disclosure is a rather small price to pay for a firm which has the resources and the desire to be a significant market participant. You also have ex-
pressed some concern regarding the market's ability to absorb the expected volume of Treasury financing without compromising the soundness of the dealer firms or causing undue upward pressure on interest rates. As for the primary dealers, their capital has increased substantially during recent years and particularly last year, and I am confident that they are up to the underwriting tasks that lie ahead.

With the economy just beginning to recover from a deep recession, I do not regard the current year's Federal deficit as a significant problem from the standpoint of undue interest rate pressures. As in past recessions, weak private credit demands have allowed the Government to increase its demands on the credit market, and in fact as you know, rates have fallen substantially in the last 10 months or so. To be sure, this could change as the Treasury begins to compete on a massive scale with rising private credit demands during recovery, and this could affect interest rates and the recovery itself adversely, but this would be attributable not to the current structure of the market but simply to the outsize Federal deficits at a time when a much more nearly balanced Federal fiscal posture is called for.

While the economy just beginning to recover from a deep recession, I do not regard the current year's Federal deficit as a significant problem from the standpoint of undue interest rate pressures. As in past recessions, weak private credit demands have allowed the Government to increase its demands on the credit market, and in fact as you know, rates have fallen substantially in the last 10 months or so. To be sure, this could change as the Treasury begins to compete on a massive scale with rising private credit demands during recovery, and this could affect interest rates and the recovery itself adversely, but this would be attributable not to the current structure of the market but simply to the outsize Federal deficits at a time when a much more nearly balanced Federal fiscal posture is called for.

While the issue of accrued interest accounting in repurchase agreements has been dealt with to our satisfaction, there is another issue concerning repos about which we have some concern; namely, the treatment of repos in a bankruptcy proceeding. When Lombard-Wall failed last summer, the bankruptcy court determined that its repos should be treated as secured loans, rather than purchase and sale transactions; thus making them subject to the automatic stay provisions under the Bankruptcy Code. This ruling caused a significant deterioration in market confidence in repos, since it meant in effect that the purchaser of securities, or lender of funds, could see his funds tied up for a protracted period if his counterparty went bankrupt. Furthermore, if the securities were to decline in value he could lose money in what he had thought of as a riskless transaction.

While the repo market has shown some adverse effects from these events, it has held up reasonably well to date—in part, I believe, due to the expectation by market participants that the repo legislation pending in the Congress as part of a package of Bankruptcy Code reforms will be ultimately enacted. That legislation would exempt repo transactions in Treasury securities and certain other money market instruments from the automatic stay provisions, without taking a position as to whether they are secured loans or purchases and sales. Chairman Volcker has recommended that the Congress enact this legislation in letters to Chairman Dole of the subcommittee on courts, Senate Judiciary Committee, and to Chairman Rodino of the House Judiciary Committee. I certainly endorse that recommendation and urge the Congress to move forward in this area.

While I cannot state with certainty to what further extent the market would deteriorate if this legislation does not pass, at the least we would likely see a decline in liquidity and higher rates in the repo market, which would hamper to some degree both the Treasury's ability to market its offerings and the Fed's ability to conduct open market operations. In the wake of the failures of
Drysdale, Comark, and Lombard-Wall, all of which were thinly capitalized in relation to their activities, we have recognized capital adequacy as the single most basic issue to be addressed in our surveillance efforts. Unfortunately, developing objective criteria on any basis that attempts to give weight to different circumstances in a fair and realistic manner can be enormously complex.

In the past, we have looked at capital adequacy on a case-by-case basis, and have cautioned reporting dealers from time to time when their position risks or balance sheet totals seemed excessive in relation to their capital. But since our ultimate objective is to create a model of capital adequacy which may be used not only by the Fed but also by dealers and customers, we feel that more specific and objective criteria that can be applied across the board must be developed. Our surveillance staff is presently developing statistical measures and computer programs that look toward a systematic analysis of both sides of the equation—how to measure capital in a meaningful way and also how to measure whether the risks a firm is taking in its operations are within prudent limits in relation to that capital. Ultimately we expect to have objective criteria of capital adequacy that we can apply to the primary reporting dealers—and we would also suggest and expect voluntary compliance with these standards by the large or active secondary dealers as well. In effect, we expect the guidelines developed by the Fed to become the generally accepted standards to which lending banks and customers would look for guidance.

But I must emphasize that no purely mechanical approach is adequate in a market where the rapidity of developments could lead to serious difficulties for a poorly managed firm even if its capital appears to be adequate. Thus, we intend to continue our case-by-case approach to assessing individual firms in a more subjective way, as well as applying the objective criteria we are developing. In our discussions with dealers following the Drysdale failure, “when issued” trading was often identified as an area of potential danger. In effect, this involves a transaction in which the parties agree to trade a security prior to its actual issue date—perhaps 2 or 3 weeks ahead—with actual settlement to take place on the issue date. Since no money changes hands until the securities are actually issued and delivered, it is possible for a market participant to trade in very large volume without employing any capital at all. Indeed, the volume of this type of forward trading has reached very high levels in recent years.

In addition to the lack of margin or some other form of capital to support these transactions, a significant problem area is that a single market participant could enter into numerous transactions with many different counterparties, none of whom would have reason to know the extent of that participant’s total commitments. Thus, normal standards of prudence, such as credit limits between firms, are not sufficient to prevent the dangers we see in this type of trading. We are actively discussing a number of possible solutions with market participants, most of whom share our concern with this practice, at least to some extent. While we are prepared to insist on a Federal Reserve solution if necessary, we would much prefer, and indeed expect, that a satisfactory system for limiting risk will be agreed upon on a voluntary basis, as the dealers per-
ceive their own long-term interest will be best served by having adequate safeguards.

Turning to the question: Should the Federal Reserve have a formal regulatory role, in the wake of last year's failures? I have heard some sentiment expressed that the Federal Reserve's regulatory role should be made more formal and explicit. Whether such a move is necessary or desirable in the public interest at the present time is not a question that should be answered in the abstract or by ideological preference, and my judgment is that a change in the existing structure is not necessary at the present time. The principal consideration on which I base this conclusion, and which I believe should guide the Congress, is the efficacy of any particular approach in containing the shock waves that could spread through the market from an event such as the failure of a single firm. As last year's experience shows, the present structure affords us the means and the flexibility to act promptly and decisively through several avenues—the open market desk, the discount window, and not least in importance the exercise of moral leadership, such as we displayed in the accrued interest question.

To put the discussion in perspective, between the extremes of direct and detailed Government regulation on the one hand and total absence of an official oversight presence on the other hand—which I would regard as imprudent given the importance of the Government securities market—there are two viable approaches to regulating this market. First, one could rely on the self-regulating mechanisms inherent in the market, fortified by informal monitoring by the Federal Reserve—essentially the present structure. Second, a more formalized and structured self-regulatory organization could be established, under which the market participants would set and enforce rules governing such matters as trading practices and capital adequacy, under the oversight of a governmental body such as the Fed with explicit legislative authority to enforce those rules. This is essentially the case with such self-regulatory organizations as the New York Stock Exchange and the National Association of Securities Dealers.

On balance, I conclude that the more formal structure is not necessary or desirable at the present time. I think we should keep in mind that the losses incurred in last year's failures—unpleasant and undesirable though they were—fell entirely on large and sophisticated market participants, rather than on small individual investors. In such cases we usually see these participants take the lead in promoting necessary reforms, which they may have somewhat less incentive to do under a more formal structure. In the final analysis, this is a market that has generally functioned quite well in a self-regulatory environment, and no degree of regulation will guarantee that accidents won't happen from time to time. The existence of the Securities Investor Protection Corp. is, after all, a tacit recognition that even those securities firms that operate in regulated markets with strict capital ratios are not immune from failure. Much the same could be said of deposit insurance for banks and thrift institutions. But while I conclude that formal regulatory authority is not the best way to go, let me emphasize that our minds remain open on this score. At times I have sensed that a measure of complacency may be returning now that the immediate
threat is over. If this attitude became more widespread and could not be overcome by us in our intensified surveillance capacity, I would become concerned that the momentum of self-regulatory reform could be lost. If that were to happen, we would not hesitate to ask the Congress for more formal regulatory authority.

Thank you.

[The prepared statement of Mr. Solomon, on behalf of the Federal Reserve Bank of New York, follows:]
Statement by

Anthony M. Solomon

President, Federal Reserve Bank of New York

before the

Subcommittee on Domestic Monetary Policy

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

Washington, D.C.

April 25, 1983
Introduction

Good afternoon, Mr. Chairman. I am Anthony Solomon, President of the Federal Reserve Bank of New York. With your permission, I am here today in response to your invitation to Chairman Volcker to review the recent efforts of the Federal Reserve System in its surveillance of the Government securities market, in order to contribute to the orderly and effective operation of that market.

The Federal Reserve Bank of New York, acting on behalf of the Federal Open Market Committee (FOMC), conducts open market operations to implement the FOMC's monetary policy directives, mainly through transactions involving U.S. Government Securities. Most dealers in such securities are located in New York City, and many of the nation's largest banks are also headquartered there. Additionally, in common with the other eleven Federal Reserve Banks the New York Reserve Bank acts as fiscal agent for the United States Treasury in the sale of new Treasury debt issues. Altogether, more than half of the Treasury's securities are sold through New York financial institutions.

Mr. Chairman, nearly one year has elapsed since a dealer in Government securities, Drysdale Government Securities, Inc. (Drysdale) was unable to pass on to counterparties interest on securities purchased under repurchase agreements. In addition to causing two major banks to absorb significant losses, Drysdale's default sent shock waves through the market which contributed to the...
subsequent failure of two additional firms—Comark and Lombard-Wall. These events led to a heightened degree of awareness among all the participants in the market regarding the risks inherent in certain market practices and the need to be more cognizant of the financial conditions of one's counterparties in conducting market transactions.

None of the three firms that failed was a primary dealer conducting Government securities transactions with the Federal Reserve Bank of New York. However, the Federal Reserve had previously transacted business in bankers' acceptances with Lombard-Wall. In November 1981, the Federal Reserve discontinued dealing in bankers' acceptances with Lombard-Wall because of dissatisfaction over its financial condition. Comark and Drysdale had approached the Federal Reserve to establish formal reporting relationships in Government securities but Comark failed to qualify and Drysdale applied only days before its collapse. Nonetheless, their failures were a cause of concern to us in that such events tend to affect the functioning of the market as a whole. In my statement before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs on May 25 of last year, I expressed this concern, and indicated that the Federal Reserve would reexamine its traditional informal surveillance role and work with the dealer community in seeking to remedy the practices that led to these difficulties.

Much progress has been made in the ensuing eleven months. With the active encouragement of the New York Reserve Bank, dealers have effectively eliminated one of the market practices that enabled Drysdale to overextend itself—the failure to include accrued
interest in valuing securities for repurchase transactions--and are at present considering a number of proposals to address other market practices where a need for change has been recognized. For our part, the New York Fed's surveillance efforts have shifted into high gear with the increase in our professional staff devoted to this effort.

In my remarks today, I would like to begin with a brief overview of the Government securities market and a review of the developments of the past year. I will then discuss in some detail the specific areas of concern that we see at the present time with respect to financial and operational matters affecting the dealers and the market. I will address the question you raised, whether the market will be able to absorb the Treasury's financing needs resulting from the next few years' projected deficits without undue upward pressure on interest rates. Finally, I will turn to the issues that remain to be resolved, including the questions you posed regarding the number of dealers with whom the Federal Reserve has a direct relationship; whether the Federal Reserve should be directly empowered to regulate the Government securities dealers; the treatment of repurchase transactions in Government securities and certain other instruments for purposes of the bankruptcy law; and your questions regarding the level of capital needed to support a given level of operations for a dealer firm and whether specific capital ratios should be imposed on the firms.

Overview of the Government Securities Market

The market for United States Government securities, which comprises trading in Treasury bills, notes, and bonds, is the most active capital market in the world. While hundreds of firms
participate in the market, it centers chiefly on some 36 primary
dealer firms which submit to the Federal Reserve Bank of New York
daily and periodic supplemental position and volume reports as well
as regular financial statements. Most of these primary dealers are
located in New York, although several are in Chicago, Los Angeles,
and San Francisco. This primary dealer group presently includes 12
bank dealers, which are among the nation’s largest commercial
banks. There are also 24 nonbank dealers, which range from
comparatively small specialty firms confining their activities to
this market to several of the largest diversified investment banking
firms.

Some measure of the importance of the 36 primary dealers is
provided by their participation in the market for new Treasury
issues. While the amounts vary, these dealers usually purchase from
35 to 75 percent of the total amount sold by the Treasury at each
auction. In addition, they make secondary markets in these issues,
standing ready to bid or offer outstanding Treasury obligations to
customers and to each other. By and large, this market functions
quite well, with the result that over the years the Treasury's huge
financing requirements have been met efficiently. Investor
confidence in Treasury issues is fortified by the knowledge of their
extraordinary liquidity in the secondary market.

Although the Federal Reserve has for decades exercised
informal surveillance of the market, primarily through its
monitoring of reports submitted by dealers with which it does
business, there has never been any formal regulation of the market.
Historically, the lack of a perceived need for formal regulation was
due in part to the essentially riskless nature of Government securities from a credit standpoint. Several other factors are relevant here as well.

--First, many of the dealers are subject to formal regulation in some form, either as banks or subsidiaries of bank holding companies or because they are part of nonbank securities firms that operate in regulated markets.

--Second, although the purchase and sale of Government securities is not regulated as such, it remains subject to the general anti-fraud provisions of the Federal securities laws, thus affording protection to the individual investor in those respects.

--Third, in the usual case the ability of any market participant to carry excessive security positions or engage in other imprudent practices is constrained by its relationships with the other participants, including the degree of credit risk exposure they are willing to assume toward that participant.

The role of the Fed as a key participant in the market has also served as an important deterrent to abusive practices. In order to qualify as a primary dealer that may transact business with the Fed, we require that a firm be actively engaged in the distribution of Treasury securities among investors, have adequate capital and capable management, make markets, and have a "track record" manifesting a long-term commitment to the market. In addition, the dealer must submit periodic audited financial statements to us, as well as daily reports of its market positions. Not until all of these requirements are met, over a period of time,
will a dealer be added to the "reporting list." From time to time, dealers that have not maintained these standards—for reasons such as insufficient activity, inadequate capital, or a business decision to reduce their level of participation in the Government securities market—have been dropped from the list.

It might be noted that inclusion in the reporting list does not ensure a trading relationship; at any given time, one or more of the firms on the reporting list may not actually have a trading relationship with the Fed. A firm in this position may have been added to the reporting list while we are still evaluating its ability to meet our somewhat more stringent criteria for a trading relationship. Alternatively, it might be a firm which has been suspended from a trading relationship while a reporting relationship continues. In effect, we do what other participants in the market should be doing—constantly review the soundness of the firms with whom we do business. We do not, however, represent that a trading or reporting relationship with the Fed is a guarantee of a firm's soundness.

**Developments over the past year**

The most significant development in the Government securities market in the past year was, of course, the Drysdale failure and the subsequent problems of Comark and Lombard-Wall. On September 15, 1982, the Federal Reserve Bank of New York submitted to the Congress a report on these developments. To review briefly, the common thread running through the three cases was that the firms were able to circumvent in some fashion the self-regulating mechanisms of the market, thereby raising working capital from
careless or unwitting customers, which capital they then used in their own activities.

In the Drysdale case, the firm essentially raised funds by borrowing securities, typically securities with large amounts of accrued interest, and then selling them to realize principal and accrued interest in excess of the cash margin it provided when it borrowed the securities. It was able to engage in this activity on a large scale by exploiting two market practices—the failure to include accrued interest in the value of securities used in repurchase transactions in determining how much cash should be posted, and the practice of "blind brokering" which enabled Drysdale to conceal its identity from its counterparty—in effect hiding behind the banks that acted as brokers in arranging the transactions.

In the Comark situation, some of the firm's customers apparently allowed Comark to retain custody of securities they had purchased from it. The firm's accounting system had fallen into disarray, and it is alleged that it posted the securities as collateral to secure borrowings that allowed it to continue functioning, even though its capital had been depleted. It eventually proved unable to meet its customers' demands for their securities.

In the Lombard-Wall situation, some customers advanced funds in excess of the value of the securities they received under repurchase agreements. Others received funds from Lombard-Wall of lesser value than the securities they provided. Again, the firm was able to employ these excess funds to support activities well beyond the level warranted by its own capital.
In the wake of these developments, the Federal Reserve moved to take the lead in working with dealers and other market participants to improve procedures and eliminate the practices that were identified as having caused or contributed to these breakdowns in the market's normal self-corrective mechanisms. At the same time, the dealers began moving toward needed changes in some areas without the Fed being actively involved.

In the immediate aftermath of the disclosure that Drysdale could not honor its commitment on some $160 million of accrued securities interest payments due to Chase Manhattan Bank last May 17, our primary concern at the Federal Reserve was to preserve the orderly functioning of the market until the situation could be resolved. We recognized some risk that failure to make these payments could cause a widespread "seizing up" of the market in which normally major participants would be reluctant to undertake new commitments or perhaps even to perform on their existing commitments.

As the major intermediary between Drysdale and its counterparties in these transactions, the Chase Manhattan Bank contacted the New York Federal Reserve Bank and arranged for a meeting at our offices with the dealer firms that were involved. The key issue was who should bear the loss resulting from Drysdale's default. The firms which had provided the securities through Chase expected that bank to honor the interest payments due, while Chase was looking to Drysdale as the responsible party. The immediate crisis was resolved two days later on May 19, with the announcement by Chase and Manufacturers Hanover, which was involved to a lesser
extent, that they would make the interest payments in question and would undertake to unwind Drysdale’s securities positions.

During these difficult two days, the New York Federal Reserve Bank took a number of actions aimed at facilitating a resolution of the crisis and making sure to the extent possible that the market continued to function smoothly. On May 18 we informed the 12 New York Clearing House banks and all of the primary dealers that we were closely monitoring the situation and stood ready to assist any bank facing an unusual liquidity problem with a loan at our discount window. In addition, we extended normal deadlines for our securities and funds transfer systems to make sure that the day’s transactions could be completed.

The Open Market Desk also helped by acting a bit earlier than usual in meeting projected reserve needs on May 18, and in the period immediately thereafter we tended to resolve any doubts as to the timing of our actions on the side of meeting anticipated needs more promptly and fully. But I should emphasize that the reserve objectives themselves were shaped by monetary policy considerations and were not affected by Drysdale-related factors.

Following the commitment of Chase and Manufacturers Hanover to unwind Drysdale’s position, the Federal Reserve also helped out by alerting the dealers that we would temporarily liberalize our rules for making short-term loans of Government securities from our portfolio. As a result, the volume of Fed-owned securities out on loan, normally in the vicinity of about $200 million, briefly reached a high of about $2 billion on May 25, before dropping back by early June as dealers found other sources for the securities they needed.
Beyond helping to contain the effects of the immediate situation last spring and summer, the Federal Reserve has moved to strengthen its own commitment to overseeing the market. Last August, we announced the appointment of a Senior Vice President to head a new unit within our Open Market Function devoted exclusively to market surveillance. This individual, Edward Geng, has had broad prior experience in Government securities at several private firms, as well as a previous stint at the Federal Reserve and at the U.S. Treasury. Early this year we filled out, for the time being, the staffing of this new area, which presently includes two officers; five professional employees with experience in financial analysis, dealer operations and law; and a few support personnel. We anticipate that this staff will be adequate to meet our present needs, although we are prepared to expand it if warranted by new developments—such as, for example, a significant increase in the number of dealers reporting data to us. In addition, our surveillance effort draws upon the Bank's other professional resources as necessary for legal, analytical, and operating support.

The basic ongoing work of the surveillance unit consists of receiving and reviewing the regular daily and weekly reports of securities positions and transactions submitted by the reporting dealers, as well as their monthly and annual reports of financial condition. With the aid of computer programs and other analytical tools, this review is aimed at identifying abnormal dealer behavior and incipient undesirable trends. The inferences and opinions formed by our analytical team from examining these statistical reports are supplemented by regular telephone calls and visits to the reporting dealer firms. While we have traditionally made
On-site surveillance visits to the reporting dealers, now the procedure for conducting such visits is more systematic, and they have been expanded in both scope and frequency. Essentially, every reporting dealer will be visited at least once annually, and more often as necessary if areas of concern have been identified. As I mentioned earlier, we would be prepared to suspend a trading relationship with a reporting dealer, or if necessary to remove the dealer from the reporting list, if our surveillance efforts reveal that it is not complying with our standards and it does not take appropriate steps to alleviate our concerns.

A little further on I will address some of the specific issues of concern currently being examined by our surveillance staff. To bring you up-to-date, however, I would like to mention briefly several issues that already have been dealt with successfully.

First, the Drysdale situation made clear that the failure to include accrued interest in valuing securities for repurchase transactions carried a potential for abuse that was inconsistent with the sound functioning of the markets. The Association of Primary Dealers in Government Securities put itself on record as favoring inclusion of accrued interest for evaluation purposes, and we in the Fed strongly endorsed this change as well. In a letter dated July 29, 1982 addressed to the head of each dealer firm I expressed the New York Reserve Bank’s support for this change and informed the dealers that we would make the change in August with respect to our own repurchase transactions. I should add that this change was not necessary to protect our own position; rather, we
undertook it with a view to providing leadership and encouragement to the rest of the market.

A bit later we became concerned that the initial momentum in the dealer community toward making this practice more general had bogged down as dealers considered the time and expense to make changes, for example, to their computer systems. In individual consultations with reporting dealers, we concluded that it would be feasible for market participants to make the change in accrued interest accounting with customers other than the Fed by early October. Accordingly, in late August we wrote to each reporting dealer once again, indicating that we expected the changeover to be completed by October 4, 1982—-as it eventually was with few problems.

The self-corrective mechanisms of the market have also contributed to inhibit some of the practices that led to last year's problems. In general, market participants became much more cautious about with whom they were willing to deal and in what amounts. As a result, the total of reported repurchase agreements fell from some $100 billion on May 12, just before the Drysdale incident, to about $87 billion by mid-June. Subsequently, as confidence has returned to the market the volume of repurchase transactions has recovered in the aggregate. But for a while thereafter those dealers regarded as less creditworthy continued to experience some difficulty securing repurchase financing, or found they had to pay higher interest rates. Consistent with this atmosphere of renewed caution and attention to one's counterparties, the practice of blind brokering of repurchase agreements has diminished substantially. Moreover, market participants are giving closer attention to the role of intermediaries in all types of transactions.
Current Issues

Let me turn now to more current issues. By and large, these are the matters identified in your letter, Mr. Chairman: whether the number of reporting dealers should be expanded and how this might be accomplished; the development and implementation of more explicit capital adequacy standards for the dealer firms; and the treatment of repurchase agreements under the bankruptcy laws.

In addition, I will touch upon another area to which we have been devoting considerable thought and effort, "when-issued" trading--transactions in new issues between announcement and settlement date.

Number of dealers

As I have mentioned, there are currently 36 dealers on the Fed's reporting list, including 12 commercial banks and 24 nonbanks. Although this number has been fairly stable in recent years, it has grown considerably from the level that prevailed historically. Through the 1960's the number of dealers remained stable at around 20, including 12-14 nonbanks and 5-8 banks. In the 1970's, however, the number of dealers increased as the Treasury's financing needs grew and the market expanded in depth and breadth. The present level was reached in the latter part of the 1970's.

From the standpoint of conducting open market operations competitively and flexibly, the present number of reporting dealers appears to be satisfactory. We do not believe that a large expansion in the number of firms with reporting or trading relationships would significantly improve our ability to operate in the market. Indeed, a sizable expansion in trading relationships could be an encumbrance to speedy and flexible operations.
Nevertheless, the door is open to additional firms, if they meet our criteria and are prepared to comply with our reporting requirements. As noted, a dozen or so firms have been added to the primary dealer reporting list over the past decade and we continue to look at the possibility of some further additions on a case-by-case basis. The addition of new firms has tended to benefit the market not only by providing a broadened base of participation and increased capital, but also by keeping the older established firms on their toes through enhanced competition.

However, while our present reporting list is adequate to meet our foreseeable trading needs, we have concluded that it is not sufficient for monitoring purposes— even though we believe these firms account for the bulk of trading activity in Government securities. The experience of last year has shown that problems among the non-reporting dealers can cause shock waves that affect the entire market, including the reporting dealers. With this in mind, we have been giving considerable thought in recent months to the question whether there should be some more systematic surveillance of presently non-reporting firms that are relatively active in the Government securities market. We have concluded that effective surveillance of the Government securities market calls for our getting acquainted with a greater number of firms on a more regular basis, and we plan to do so.

Our plans are still in a formative stage, but our present intention is to request cooperation in terms of data submission from a group of dealers that are less sizable and active than the primary reporting dealers. This group would include only nonbank firms, as the chief focus here is on the financial viability of the firms, and
Bank dealers are already under close regulatory scrutiny that we would not seek to duplicate in our market surveillance. We are thinking in terms of a substantial number of additional dealer firms that would be invited to submit regular reports to the New York Reserve Bank—on a considerably less frequent and detailed basis than the primary reporting dealers.

As with the existing reporting group, the submission of reports from a second dealer group will be entirely voluntary. This second reporting group would form a logical pool of candidates from which future primary reporting firms might emerge, which furnishes an incentive for the firms to comply with our requests. I also believe that as a matter of policy any sizable participant in the Government securities market would not want to be in the position of declining to disclose information in confidence to the Federal Reserve.

We are not suggesting a detailed and comprehensive reporting system such as would be entailed in a formal regulatory relationship with all dealers in Government securities. At this point, it is our judgment that a fully comprehensive and mandatory reporting system is not justified on the basis of likely costs and benefits. We do believe, though, that there is enough activity in Government securities beyond the current primary reporting dealer group to warrant a more systematic effort to receive some information from the more active and sizable nonreporting dealers. This would serve the purposes of helping to provide leads on which follow-up inquiries can be pursued, and additionally foster a greater awareness of standards in regard to good market practice and capital adequacy across a broader spectrum of market participants.
In your letter to Chairman Volcker, Mr. Chairman, you asked whether we had any concern that imposing additional standards on the Government securities dealers could reduce the number of firms available to handle the forthcoming heavy volume of Treasury financings. I do not see either our present reporting requirements or our plans for the foreseeable future as posing any problem in this regard. It seems to me that as long as our standards are reasonable and geared to the legitimate business practices of the dealer firms, a firm which has the resources and the desire to be a significant market participant is not likely to withdraw from this market—which is, after all, a large and profitable source of business.

As a related matter, you have expressed some concern regarding the budget deficit and the market's ability to absorb the expected volume of Treasury financing without compromising the soundness of the dealer firms or causing undue upward pressure on interest rates. With the economy just beginning to recover from a deep recession, I do not regard the current year's Federal deficit as a significant problem. As in past recessions, weak private credit demands have allowed the government to increase its demands on the credit market without exerting undue pressure on rates. In fact, as you know, rates have fallen substantially in the last ten months or so in reflection of weakened private credit demands and a growing perception that inflation has slowed substantially. As recovery proceeds, however, there is a real danger that still-excessive Federal deficits would mean that the Treasury is competing on a massive scale with the rising private credit demands that are the natural accompaniment to a reviving economy. This
would inevitably have an effect on interest rates, and pose the potential danger of inhibiting orderly economic recovery.

Such an outcome would not be a function of the current structure of the Government securities market, however, but simply of the outsize Federal deficits at a time when a much more nearly balanced Federal fiscal posture is called for. The Government securities dealers that report to the Federal Reserve are in a position to withstand the possible strains that the deficit and resulting large public sector borrowing requirements could generate in the market. The capital positions of these dealers have strengthened in recent years. Despite the difficulties of predicting market movements, most dealers have ably weathered periods of market volatility, in part due to their increasingly sophisticated trading techniques and ability to adapt to shifting market environments. During periods of favorable market conditions they have added significantly to their capital base, which I believe is adequate to the tasks ahead—provided, as always, that attention is paid to market and credit risks. This does not mean, of course, that heavy treasury deficits will not present problems for the overall economy, but only that the dealers should be able to perform their underwriting task.

**Repurchase Agreements**

As I have noted, one major area of concern involving repurchase agreements—the inclusion of accrued interest in repurchase accounting—has largely been dealt with to our satisfaction. There is another issue involving "repos" that has arisen in the past year, however, specifically as an outgrowth of
the Lombard-Wall bankruptcy. I refer to the question of how repurchase agreements may be treated in a bankruptcy proceeding.

On August 12 of last year, Lombard-Wall filed a voluntary bankruptcy petition under Chapter 11 of the Bankruptcy Code. Most of its customers, who had entered into repurchase or reverse repurchase agreements with the firm, found that their transactions were frozen pending a decision by the court on how to deal with these transactions. The inability of these customers to use either their funds or their securities weakened confidence in the repo market. The underlying legal issue was whether these transactions should be characterized as secured loans or as purchases and sales.

The principal problem with the former characterization is that if a repo is treated as a loan, the "lender" of funds (purchaser of securities) runs the risk that his funds could be tied up for a protracted period of time if the counterparty were to enter bankruptcy proceedings before the repurchase portion of the transaction were completed. In addition to tying up his funds, this could place the "lender" in the position of unsecured creditor with respect to any portion of his loan not covered by the value of the securities. Thus, if the securities were to decline in value, he could lose money in what he had thought to be an essentially riskless transaction.

While I cannot define precisely the extent to which the Government securities market would be impaired if the secured loan characterization of repos were to prevail, I am confident that some deterioration would result. Indeed, there has already been some deterioration, which might well have gone further but for the anticipation by many market participants that the legal questions
overhanging the status of repos will be favorably resolved. At the least, the market would lose a significant measure of liquidity as some risk-averse participants withdrew or reduced their exposure; the interest rate paid on such transactions would rise to reflect the greater risk and lessened willingness of temporary investors to participate; and market participants with less-established track records would experience some loss of business and higher financing costs. In turn, I would foresee these factors hampering to some degree the Treasury’s ability to market its offerings as well as increasing its financing costs.

Repurchase agreements have emerged over the years as a particularly useful tool in conducting Federal Reserve open market operations, since they allow us to adjust reserves for short periods of time. Thus, a diminution in the liquidity of the repo market could also hamper the conduct of monetary policy.

In letters dated September 29, 1982 to Chairman Dole of the Subcommittee on Courts, Senate Judiciary Committee, and January 20, 1983 to Chairman Rodino of the House Judiciary Committee, Chairman Volcker recommended that the Congress enact proposed legislation that would exempt repos in Government and Federal agency securities and certain other instruments from the automatic stay provisions of the Bankruptcy Code, which would otherwise operate to prevent the orderly liquidation of these transactions. I certainly endorse these recommendations and urge the Congress to move forward in this area. Earlier, because of our concern about potentially significant effects on the repo market, and thus on the Federal Reserve’s ability to conduct monetary policy, the Federal Reserve Bank of New York had filed an amicus curiae brief in the Lombard-Wall case. We
took the position that public policy would be better served if repurchase agreements in Government securities were not characterized as secured loans.

Capital Adequacy

The question of whether a particular dealer's capital is adequate to support its level of operations is perhaps the single most basic issue of concern in our surveillance efforts. The three firms that failed last year—Drysdale, Comark, and Lombard-Wall—were all thinly-capitalized in relation to their volume of business. Thus, the importance of capital adequacy guidelines lies not only in monitoring the reporting dealers, but also in furnishing objective criteria for dealers and others to use in appraising their trading counterparties.

Unfortunately, the evaluation of capital adequacy on any basis that attempts to give weight to different circumstances in a fair and realistic manner can be enormously complex. The vast changes in market practices and trading vehicles in recent years, including the development of forward, future and option transactions, as well as the increasingly intricate use of repos and reverse repos, have all complicated the task.

Up to now, our surveillance staff has looked at capital adequacy on a case-by-case basis. Reporting dealers have from time to time been cautioned when position risks have seemed excessive in relation to capital or when they have financed certain transactions that have swollen balance sheet totals excessively. In light of these increasing complexities and the desire to create a model of capital adequacy which may be used also by dealers and customers to
evaluate their trading counterparties, it is our feeling that more specific and objective criteria must be developed that apply across the board.

The surveillance staff has assigned this project top priority and efforts are underway to develop objective criteria for measuring dealer capital and its usage. Clearly the starting point is a concept of available or liquid capital. To measure the adequacy of such capital an evaluation system should encompass several broad considerations. First, a dealer's portfolio positions, both gross and net, must be measured and risk evaluated for each maturity and type of instrument, taking account of acceptable hedging techniques which may be employed to limit exposure. Second, the risk entailed in financing transactions, especially in "matched books" (offsetting repurchase and reverse repurchase agreements), should be analyzed as part of any such system. The surveillance staff is presently developing a variety of statistical measures and computer programs that look toward systematic analysis of dealer positions and risk exposure.

It is our expectation that when developed, such objective criteria of capital adequacy will be applied in the first instance to the primary reporting dealers. We would suggest and expect voluntary compliance with such standards of capital adequacy by the large or active nonreporting dealers as well, on the assumption that clearing and lending banks as well as customers would look for such compliance with generally accepted standards of capital adequacy.

It would of course be essential that any evaluation system also continue to take into account more subjective measures of risk such as the type of customers, internal controls and credit and
margin monitoring procedures, as well as management's overall business philosophy, capacity and experience. For our part, I know of no way to assess these factors other than through a case-by-case approach including the surveillance visits and individual firm contacts we have been pursuing. Even a firm with apparently adequate or conservative capital could nonetheless find itself in serious difficulty in a short period of time if it is poorly managed. Obviously, a purely mechanical approach to the capital adequacy question can not guarantee the elimination of such problems.

**When-Issued Trading**

In the aftermath of the Drysdale situation, we discussed with dealers other areas in which future problems might arise. One area mentioned frequently involves "when-issued" trading. This refers to transactions in which the parties commit to trade a security which has not yet been issued but will be issued in the near future, with the transactions to be completed when the security is issued. The volume of this type of forward trading has reached very high levels in recent years.

Under current market practice no money changes hands until the securities are actually issued and delivered. It is, therefore, possible for a market participant to trade in very large volume on a when-issued basis without employing any capital at all. Additionally, while prudent practices might lead an individual firm to limit its exposure to a particular counterparty in this type of trade, nothing in the present system would prevent a market participant from entering into a large number of such trades with many different firms--each of which would be unaware of the extent...
of that participant's total commitments. Since these transactions can remain open for up to three weeks before the security is issued, the possibility exists that an adverse market move could render such a trader unable to honor his commitments when the security is issued.

At the present time, we are actively discussing a variety of proposals regarding when-issued trading with market participants, most of whom share our concern about this practice in varying degrees. The most comprehensive proposal would set up a central facility to clear when-issued trading and to maintain margins on transactions. The organized futures exchanges typically deal with this problem through a "mark to market" mechanism run by the exchange itself. We are continuing to have discussions with the dealers as we seek a generally acceptable solution that will deal with potential excessive exposure from when-issued trading. While we are prepared to insist on a "Federal Reserve" solution if necessary, we would much prefer--and indeed, expect--to reach a satisfactory agreement with the dealers on a voluntary basis, as they perceive that their own long-term interests are best served by adequate safeguards on when-issued trading.

Should the Federal Reserve Have a Formal Regulatory Role?

The final question I would like to address this afternoon is whether the surveillance role of the Federal Reserve should be made formal and expanded through a legislative mandate. At the present time, I continue to believe that the failure of a handful of nonreporting dealers does not in itself justify a move to a more encompassing regulatory structure--any more than the absence of such failures for a number of years before that should have been cause
for complacency. Certainly, these recent events indicated a need for more active and forceful market monitoring and surveillance, and as my remarks here have indicated we at the New York Reserve Bank have taken responsive actions along these lines.

But in the final analysis, whether it is necessary or desirable to impose a more formal regulatory structure in the public interest is not a question that can be answered in the abstract or by ideological preference, but only on the basis of carefully evaluated experience. In my judgment, the principal consideration that should guide the Congress should be an assessment of the efficacy of any particular approach in containing the "shock waves" caused by occurrences such as these three failures—in other words, preventing a single firm's failure, which in itself may not be a serious or even an undesirable event, from becoming a systemic failure. In this context, I think the events of last year, and the Federal Reserve response to those events I alluded to earlier, show that the present structure affords us the means and the flexibility to act promptly and decisively through several avenues—the open market Desk, the discount window, and not least in importance, by exercising moral leadership as we did in the accrued interest question.

As a second consideration, the Congress might also want to consider the likelihood that members of the public participating in this market might suffer losses resulting from the types of abuses we have discussed—balanced against the costs associated with the establishment of a formal regulatory structure. In considering the costs, I would include not just the "out-of-pocket" expense, but...
also the potential costs that could result from hampering the market's flexibility and responsiveness.

To put the discussion in perspective, there are essentially three general approaches to regulating a market such as the Government securities market. First, one could rely in the first instance on the self-regulating mechanisms inherent in the market itself, fortified by informal oversight by the Federal Reserve. This, of course, is essentially the structure in effect at the present time. Second, a more formalized and structured self-regulatory organization could be established, with market participants setting and enforcing rules governing such matters as trading practices and capital adequacy, under the oversight of a governmental body with explicit authority to enforce those rules. This is essentially the approach followed with respect to such organizations as the New York Stock Exchange and the National Association of Securities Dealers. Third, the governmental authority in question could directly regulate the market, imposing rules pursuant to a legislative mandate and taking disciplinary action as necessary to enforce those rules.

Based on the considerations I have outlined, I can see no justification for the third approach, direct regulation. In my judgment, it would be inconsistent with the objective sought, that of preventing a recurrence of lapses of proper practices or overcommitments in relation to capital that led to the failures of the three dealer firms last year. As you know, the Congress has moved affirmatively to reduce the level of regulation in banking, as it has in other industries, and I think it would be
counterproductive to start thinking at this time about direct
regulation of a market which traditionally has functioned quite well
without it.

The next question is whether the current self-regulatory
structure should be made more formal than it has been, and whether
the Federal Reserve's oversight role should be made more explicit
through the legislative process. On balance, I conclude that those
steps are not necessary at this time. I think we should keep in
mind that the losses incurred in last year's three
failures--unpleasant and undesirable though they were--fell almost
entirely on large and sophisticated market participants, rather than
on small individual investors. Logic and experience tell us that
where significant market participants incur losses of this type they
are likely thereafter to take the lead in promoting the necessary
reforms and insuring that the market's normal self-corrective
mechanisms come into play. I have some concern that there is less
incentive for them to do so under a more formal structure.

It is sometimes tempting, in the wake of market
disturbances such as those of last year, to jump to the conclusion
that more formal regulation would have prevented the problem, but I
seriously doubt that such a conclusion is warranted at this time.
This is a market that has generally functioned quite well in a
self-regulatory environment--and no degree of regulation can
guarantee that accidents won't happen from time to time. The
existence of the Securities Investor Protection Corporation (SIPC)
is, after all, a tacit recognition that even those securities firms
that operate in regulated markets with strict capital ratio
requirements are not immune from failure. The same could be said of deposit insurance for banks and thrift institutions.

So at this time I conclude that formal regulatory authority for the Federal Reserve is not the best way to go. But I would emphasize that our minds remain open on this score. At times it appears that some of the dealers have permitted a measure of complacency to return now that the immediate threat of market disruption is over. To the extent that this attitude becomes more widespread and cannot be overcome by us in our surveillance role, I would have some concern that the momentum of self-regulatory reform could be lost as the events of last year recede into the past. If this were to happen, the time may yet come when formal regulation imposed by Congress will be necessary. And in closing, let me emphasize that we would have no hesitation in recommending such an action if we were to reach that conclusion.

Chairman FAUNTROY. I thank you, Mr. Solomon.

I have a number of questions as I am sure my colleagues do.

As you know, the short-term interest rates for Treasury securities have remained relatively high compared to inflation—around 8 percent, compared with the 3- to 4-percent inflation we have recently had. In your view, has the aftereffect of the Drysdale and the Lombard-Wall collapses contributed to these high real short-term rates by creating uncertainties in the Government securities market at a time of high Federal borrowing demand?

Mr. SOLOMON. I think I can answer that pretty unequivocally, Mr. Chairman, that the immediate impact of the Drysdale shock was what we call a flight to quality. Actually, there was a reduction in interest rates of Treasury securities—particularly short-term Treasury securities. But that has long since evaporated. I would say that there is no causal connection or sequence that I can see that those events of last year are affecting the level of interest rates of Government securities today. I think the transitory effect was there, but it was the other direction, actually lowering them, because there was a flight to the greater quality of Treasury securities at the expense of some other short-term instruments—at least the spread between them widened. But today there is no effect.

Chairman FAUNTROY. What would be the impact on the credit markets in your view and on interest rates if there were another Drysdale type failure?

Mr. SOLOMON. What would be the effect on credit markets and interest rates?

Chairman FAUNTROY. And interest rates, yes.

Mr. SOLOMON. Well, I would assume that the scenario that you have posed might not be very different than what we saw last time. It is a matter, of course, of degree. Drysdale had a big effect,
Comark and Lombard-Wall had a much, much smaller effect. But I would suppose that the direction of the impact would be similar—namely, that you might have a small movement in interest rates, probably on the down side. You would have some greater questioning of the creditworthiness of other market participants, some drying up of liquidity, temporarily at least, in the market, some greater sense of caution in whom you were dealing with, some contracting of outstanding credit lines. We saw all of this. And it may very well be that my colleagues here who are closer to the details of the market than I am might want to add something.

Peter?

Mr. Sternlight. I have no further comment.

Mr. Geng. I would agree completely with Mr. Solomon on that.

Chairman Fauntroy. Mr. Solomon, you explained in some detail the problems arising out of bankruptcy in the treatment of a repo, if it is treated as a loan rather than a sale. Would you further clarify precisely the problem as you understand it, and would you also make available to us the amicus brief which was filed in the Lombard-Wall case?

Mr. Solomon. Yes, we would be pleased to do so, make that brief available. It is quite simple, sir. If there is an unexpected bankruptcy by a counterparty with whom one has an RP transaction, then there normally is an automatic stay, preventing a holder from disposing of any collateral and liquidating anyone's position for as much as 2 months and maybe much longer. The whole point of the RP is that it is 100 percent liquid and riskless, because it is based on Government securities. Since the markets believe that this situation—the legal precedent that has been established by the Lombard-Wall case should continue—then an element of risk enters, that is that the money will be tied up during the working out of a bankruptcy proceeding. Since this is considered liquid money, it can force some major disruptions for the institution that is deprived of that liquidity. Also, there is a danger of actual loss even at the end of that long delay, because interest rates may change in the meantime. Therefore, from both points of view we are concerned that the shrinkage of liquidity in the RP market will adversely affect our open market operations and the market for Treasury securities.

Now, I would not want to go so far as to say that this will result in a rise in interest rates on the debt, because I don't know how far this shrinkage in liquidity will go. But we have seen some shrinkage, and we think the markets are standing still, waiting to see whether the Congress will pass as expected this exemption from the automatic stay provisions of the Bankruptcy Code. But I would hope, sir, that you would see fit to support this, given your interest in monetary policy operations.

Chairman Fauntroy. You indicated that you have had some discussions with Chairman Rodino and apparently with Mr. Dole as well, for the enactment of legislation. Has a bill been introduced?

Mr. Solomon. My understanding of it, sir, is that on the House side there have been no hearings on this question of the RP's, the narrow question, although there have been hearings on other aspects of modifying the Bankruptcy Code. However, on the Senate side there have been hearings and there is a separate bill being
marked up, or already reported out of committee, which addresses this question as recommended by the Federal Reserve. So I presume it would be a matter of this being resolved in Congress, if Chairman Rodino's bill on other aspects of modifying the Bankruptcy Code goes forward without this particular point.

I think the provision is a relatively noncontroversial one. I don't know whether there is anything further on the present legislative status of that.

Do you have anything you want to add, Mr. Sternlight?

Mr. Sternlight. I think it is as you described, Mr. Solomon.

Chairman Fauntroy. As you indicated, we do have an interest in it. I would appreciate if you could provide us a copy of any correspondence you provided either committee, and any draft legislation or any report language which may have been developed thus far.

Mr. Solomon. We certainly will do so.

Chairman Fauntroy. Last year after Drysdale you told the Senate Banking Committee that the private market was itself capable of undertaking the changes needed to prevent another such crisis. Later after the failure of Lombard-Wall, you indicated to the press that the failure of Drysdale itself was not an immediate reason to impose a regulatory structure on the government market. How do you view the situation now, and if there are any changes, what are the reasons?

Mr. Solomon. Well, the minute that we had the Drysdale failure, we began a series of investigations and meetings, with the whole spectrum of dealers, and I participated in some of those. Most of those were handled by Mr. Sternlight. Mr. Geng was still not with us at that point. We came to the conclusion that even though it was not a unanimous view among the dealers, that we had to make this change in the accrued interest that I have described. And we insisted on it, even though we do not have formal regulatory authority, and we insisted on it through a dialog, and a process of logic and reason, and the consensus of the dealer association was that this was a correct decision. We then moved that step along even faster by starting the practice ourselves. And then when we still saw some foot dragging, we advised them by letter that we expected them all to do this by October 4, and everybody complied.

Now in a certain sense that is a kind of illustration of the approach we are using under this intensified surveillance approach. We believe that you get a two-way dialog with the industry, pointing out to them the situation of the possible defects as we see it. Then they in turn point out to us all the technical problems—there are enormously complex technical problems with every so-called solution. So that it is a two-way dialog that goes on. We believe that if we can continue with this, and we are making progress now—we certainly are making progress on monitoring capital in relation to the risk. If we can continue this whole process, this will be a better outcome for the Government securities markets and for us as a Nation in a sense, because you are getting the ideal advantages of both the regulatory input in a nonformalistic way, and you are getting the two-way dialog from the people who are most technically expert and know the situation better than any possible Government regulator can.
Now, if we find—and I am putting it very crudely—that the competing views and the self-centered views of different dealers prevents them from coming to a consensus of action with us after a sufficient dialog, then we would have no recourse in our view but to say to you, the Congress: This is the situation as we found it—and we can be wrong and some of those dealers who resisted may be right—but we think we are right that this does need action. And since this has not moved along now, we would recommend that we be given the formal regulatory oversight authority.

That is the situation quite honestly as I see it. We have made enough progress that we are encouraged to continue this process. But if we find that that progress does not continue, then we certainly will be back.

Chairman Fauntroy. Thank you.

Mr. Hiler. Thank you, Mr. Chairman.

Mr. Solomon, what I would like to do here, so I can better understand some of the changes that you have proposed—if we were to go back in time several years ago, how would the changes that you have made in terms of reporting requirements and accrued interest and blind brokering and those type of things how would they have affected Drysdale?

Mr. Solomon. Well, just the accrued interest change alone would mean that Drysdale would not have been able to accumulate the working capital to take speculative positions on interest rates, and therefore there is a good chance that they would not have gone down this road at all or that their volume of operations would have been much, much smaller. In addition, Drysdale was not a primary reporting dealer. If we had in place the new reporting system that we are developing for nonprimary dealers—even if Drysdale were still able to use the accrued interest and all the other things—I can say to you that we would have detected somewhat earlier, with a smaller volume of operations of Drysdale, a problem that was potentially brewing. We probably would not have been able to avert a failure—when a firm takes enormous speculative risks with thin capital and guesses wrong—those things will happen. But we probably would have caught it earlier and therefore it would have had less of a ripple effect.

We are interested in the system and the soundness of the market. We are not interested in the question of whether an individual firm fails from time to time in the normal course of business. So that would be my best answer to those two questions.

Mr. Hiler. So in terms of the accrued interest that affects everyone who is in the business, and in terms of some of the reporting requirements, the new requirements that you are developing would affect Drysdale.

Now, you mentioned that Lombard-Wall was a much smaller operation than Drysdale. Would the reporting requirements affect Lombard-Wall as well?

Mr. Solomon. Yes; they were not that small that they would not be required to report. I don’t remember the numbers on the volume of operations. Do you?

Mr. Sternlight. I don’t think their volume of trading activity was exceptionally large, but they had taken some sizable positions.
Thus, while we have not yet formulated in detail just what level we want to reach to in this secondary group of dealers, I suspect we would want to have reached a firm the size of Lombard in its Government securities operations.

Mr. Hiler. There are 36 primary dealers and I think you mentioned—or did you mention there are another 20 or so——

Mr. Solomon. No, sir. I simply said it had grown from 22 to 36.

Mr. Hiler. OK. And then how many in the secondary area that you are looking at with reporting requirements? How large would that universe become?

Mr. Solomon. I would like to ask Mr. Geng, head of that surveillance unit.

Mr. Geng. It is my guess at this time, Mr. Hiler, that something in the neighborhood of 50 to 75 additional firms might be included. We have not obtained enough detailed information yet to actually pinpoint the exact number, but there are, in fact, perhaps 100 or 200 firms that do business in Government securities in some manner or another.

Mr. Hiler. How many?

Mr. Geng. My estimate would be that in the neighborhood of 100 or 200 nonbank firms trade in Government securities in some degree. However, I would suspect the number that deal in meaningful sizes, such as could cause a problem for the market, would be probably no more than 50 to 75.

Mr. Hiler. In terms of the computer programing that you are setting up for analysis, I think you mentioned that at the tail end of your statement, would that affect the secondary tier as well?

Would you try to get the people there to use that type of analysis for capital requirements?

Mr. Geng. I think we would, to some extent. Our proposal at this point—it is still in the formative stage—would be for somewhat less elaborate reporting. However, I think what we perceive to be needed would be sufficient to enable us to do some critical evaluation of their impact on the market and the risk exposure they might be taking in relation to their capital.

Mr. Hiler. Would they be obligated to perform this type of analysis?

Mr. Geng. Our proposal essentially would be for a total voluntary system. However, those that would be included in this reporting list would certainly be expected to conform with the broad framework of capital adequacy that we would propose. In fact, we would hope and expect that this system that we are proposing will be accepted by other participants in the market as a model of capital adequacy. Then customers and banks and others who deal with any dealer will look upon this as a guide to whom they might do business with, just as methods of evaluation in other industry studies give people guidance as to what kind of firms they will do business with in any area.

Mr. Solomon. I would like to add to that. We are trying to be very careful in drawing this up so as not to impose an undue burden in terms of reporting. Once they report to us, it will go into our computers, but we will not expect them to have to go through elaborate computer programs in order to meet these relatively modest reporting requirements.
Mr. Hiler. Mr. Chairman, I just have one final question, if I could beg your indulgence.

In terms of the blind brokering, Mr. Solomon, you mentioned that there appears to be a greater interest on the part of dealers to look at who they are doing business with. But blind brokering still exists, it is still going on. Is that correct?

Mr. Solomon. Well, blind brokering among the primary dealers, reporting dealers is, of course, less risky by far than the Drysdale type of blind brokering. There is blind brokering still going on among the primary dealers. I think you have to make a distinction between the outright Government securities and the RP’s.

Mr. Sternlight. You have now, as Mr. Solomon referred to, a degree of blind brokering that goes on in outright transactions as distinct from repurchase type transactions among the group of 36 primary dealers. However, while party A doesn’t know precisely who party B is on the other side, he knows that it is a firm among the group of 36. Contrast to that the Drysdale case, where the counterparties did not know precisely that Drysdale was the other party.

The other distinction is that there is a difference in doing a repurchase type transaction. When you do that, you are dependent on someone performing at some future date that might be several days later. It might be months later, and a lot can happen in the market in that interval of time.

The blind brokering that still exists in the intradealer market among the primary dealers is mostly for same-day or next-day settlement. And while the market can move in a day, it typically doesn’t move so much as to create great vulnerability.

I will, however, footnote my remarks and say we do have some concern about the blind brokering in the primary-dealer market where it concerns when-issued trading, because there you do have a delivery that might be delayed for 1 week or 2 or possibly even 3. And that is why President Solomon referred to our concerns about potential vulnerability in that when-issued trading market. Thus, we have certain proposals that we are discussing with the dealer market to address that.

Mr. Hiler. You think, then, that the risky aspects of the blind brokering, with the exception of the last part that you mentioned, that the market essentially is taking care of that itself by no longer tolerating blind brokering for the repos and for the nonprimary remarket area?

Mr. Sternlight. That would be my impression, Congressman Hiler.

Mr. Hiler. I yield back, Mr. Chairman.

Chairman Fauntroy. I thank you.

Mr. Solomon, did not the Fed have word of Drysdale’s problems in advance, and did you not choose to sort of ignore it at that point?

Mr. Solomon. What we had word of was a few rumors in the market that Drysdale was being unusually aggressive in his operations. There is one point further I think would be appropriate to add, that in one case on an auction bid by a primary dealer it seemed when we learned that he was bidding for a very large amount on behalf of Drysdale, Mr. Sternlight and the operations
people raised a question with that primary dealer as to whether he
was sure of the firm he was dealing with to justify such a large
order. I don't know whether there is anything more that we knew
before the direction of this action. Let me ask Mr. Sternlight.

Mr. Sternlight. To elaborate, we did hear market reports to
suggest that this was a relatively active trading operation. The in-
formation we received did not, it seemed to us, convey any sense of
the losses and vulnerabilities that were building. I think that given
the kind of surveillance intensity that we engage in now, we would
have been in a position to follow up much more pointedly on the
kind of scraps of information that we had received shortly prior to
Drysdale's collapse. So I think we are in a better position now to
deal with that kind of hearsay information.

Mr. Solomon. You know, there is always a certain amount of
competitive gossip in the streets and a certain amount at times of
bad-mouthing which is inevitable, particularly on a newcomer firm.
And it is hard to move in, or at least we used to feel that it was
kind of hard to move in, simply on the basis of rumors. Now that
we have put everybody on notice that we have formalized much
more our surveillance, our monitoring, and our followup, even
though we still have not yet got into the point of systematic report-
ing by the secondary dealers, we feel less inhibited now about a de-
tailed investigatory followup when we hear rumors, even though
most of them are without credence.

Chairman Fauntroy. Thank you.

I want to yield to our distinguished colleague from Texas, Mr.
Patman.

Mr. Patman. Thank you, Mr. Chairman.

Good to see you, Mr. Solomon.

Do you have any regulatory authority over European bonds or
Eurobonds?

Mr. Solomon. No. They have to be registered, if they are sold in
this market, with the SEC and, as far as I know, there is no other
U.S. authority. I am not too familiar with this, but I do not think
there is any U.S. Government authority that has any jurisdiction
over a Eurodollar bond unless, of course, they were being issued
by a U.S. resident; namely, a U.S. corporation.

Mr. Patman. Just for the record, would you describe what a Euro-
bond is? Or one of the two gentlemen with you?

Mr. Solomon. I interpret that as being a bond that is sold out-
side the U.S. market, mainly in Europe, and it could be in any cur-
currency. Normally the bulk of them are Eurodollars. They could be
Euro-Deutsche mark or Eurosterling or what have you. It is, by
definition, an instrument issued outside of the jurisdiction of the
home currency, so to speak. So that in the case of the United
States, it is in an offshore market outside of the United States. In
the case of Germany, it would be outside of Germany.

Mr. Patman. A substantial number of Eurobonds have been
issued backed by U.S. currency; have they not?

Mr. Solomon. There have been a substantial number of Euro-
bonnds issued by both United States and non-U.S. issuers denomi-
nated in dollars. I am trying to answer as accurately as I can.

Mr. Patman. Were they backed by U.S. currency?
Mr. Solomon. I do not know exactly what that means, but if you mean by that that when the bond matures they have to pay it off in dollars, yes, because that is the denomination.

Mr. Patman. Are they competitive as against U.S. bonds backed by the full faith and credit of the United States?

Mr. Solomon. These are all private bonds. The U.S. Treasury has never issued bonds in the Euromarket.

Mr. Patman. But the bonds our country issues are in competition with these, are they not, in the market?

Mr. Solomon. The bonds that those corporations issue are very analogous to the bonds that they issue in the domestic markets. And in that sense you can argue that they raise capital in both markets and only in that sense would they be competitive. However, I am not sure I understand what you are driving at, sir.

Mr. Patman. Is it in the nature of a bond similar to the one issued by the U.S. Government in any way? Does it bear interest? Is it secured by U.S. dollars or promise to pay in U.S. dollars?

Mr. Solomon. The credit rating of the issuer, which in this case is a private corporation, is the key factor. So that only in that sense, to the extent that you would argue that there are private corporate bonds competitive with U.S. Treasury bonds in this market, then you are right. In that same sense there are Eurodollar bonds which are competitive as well with the private bonds here and the U.S. Treasury bonds here, and indeed bonds of foreign governments.

Mr. Patman. Now, do the foreign national companies which own U.S. securities pay the same income taxes on the interest received from that security ownership as U.S. citizens and companies pay or are they exempt?

Mr. Solomon. I don't think I can answer that. I would have to submit that for the record.

Mr. Patman. How about the other two gentlemen?

Mr. Sternlight. I would not have a detailed authoritative answer to give you.

Mr. Geng. I might say it varies from country to country based on legislation, but I, too, do not have available immediately the specific tax regulations for individual countries.

Mr. Patman. You couldn't tell whether or not an English national or a French national who owned U.S. bonds kept in the banks here in the United States has to pay income tax on the interest he receives on those bonds?

Mr. Solomon. Income tax in his own country?

Mr. Patman. No, in this country.

Mr. Solomon. Well, there are a whole series of double tax treaties and in some cases the withholding rate has been reduced. In other cases it is actually at zero—it varies from country to country. There are literally dozens and dozens of those double tax treaties. I don't think that there is a general answer that I can give you, sir, and only if that foreign national were a resident in this country would he have an ultimate income tax responsibility as distinguished from the withholding tax.

Mr. Patman. Now, I don't know if you saw the programs last week by ABC and NBC at 10 o'clock at night eastern time about the critical banking situation we have here.
Mr. Solomon. I read a review of it in the newspaper. I did not see it.

Mr. Patman. I just wondered if the fast action that was shown in at least the latter of those shows was typical of action which occurs in the buying and selling of U.S. Government securities. I assume it is. Is that true? Is it pretty much people standing by telephones, operating phone banks, boiler room-type activities by appearance?

Mr. Solomon. In all the markets—the foreign exchange markets, the government securities market, the municipal bond markets, the stock market—it is a very fast pace with increasing volume.

Mr. Patman. Does that hamper your regulatory authority in any way, the fact that this goes on at such a rapid pace and is mixed in with other transactions?

Mr. Solomon. I think it is always more complicated to do surveillance over a market with larger volume in transactions and which means a faster pace of transactions. Yes, I think in that sense it complicates the surveillance.

Mr. Patman. Now, we hear a lot about the subject of crowding out. The Federal debt is simply crowding out all other possible debt or other creditors, other debtors.

What is the real truth about that? How much does our Federal debt, and how much does our annual deficit impact upon the credit market? What percentage of the total private investment is absorbed by the U.S. Government securities?

Mr. Solomon. Well, I hate to rely on my memory and a lot of these estimates vary among different people but roughly, I think there is a view right now that the current size of the U.S. Treasury requirement in this fiscal year probably absorbs something in the neighborhood of 40 percent of current savings in the country. That has been projected out 2 or 3 years and will go up to somewhere between 60 and 70 percent of all current savings that will be absorbed by the deficit that is envisaged at this time.

Mr. Patman. Does that take into account any other sources perhaps of investment in these bonds or in these securities such as from OPEC nations or persons in foreign countries?

Mr. Solomon. No; that does not assume any change, either new investment or disinvestment in the present foreign holdings of the U.S. Government securities.

Mr. Patman. Well, I guess it is expressed in terms of the amount of capital that is available to private companies and private individuals in this Nation as compared with the amount that has to be absorbed.

Is that how it is calculated?

Mr. Solomon. Well, at the moment since the demand for capital by the private sector is weak, since they are running such low utilization of capacity and we are just beginning to come out of a recession. So far you probably can make a pretty good argument that the heavy U.S. Treasury borrowing is not having a significant impact on rates. But when we reach a point in the recovery where the private sector's credit demands are up substantially, if your Treasury requirements are as large as presently envisaged, there is no question that the combined effect will be very heavy on interest rates.
Mr. Patman. How are the calculations made on the percentages of total U.S. capital in private hands being devoted toward purchasing these Government bonds? Can you tell me about that?

Mr. Solomon. Well, there are different ways of calculating this, including all the way from technical flow of funds analysis to savings and percentage of GNP. I would have to send you a letter explaining the different methodologies that are used in approaching this and why people are concluding that the combination of a strong private sector credit demand and the high U.S. Treasury borrowing levels will, together, have a very major impact on the capital markets.

Mr. Patman. In general, are the assumptions made that other competing purchasers are excluded, such as foreign nationals and investors from outside the United States?

Mr. Solomon. In most of the analyses but not all by any means, one tends to assume a neutral situation as far as the foreign capital flow goes.

Mr. Patman. Let me interject something there. What percentage of the U.S. securities is owned by Americans right now?

Mr. Solomon. What percentage of the U.S. Government securities are owned by Americans?

Mr. Patman. Yes.

Mr. Solomon. I would say about seven-eighths, maybe.

Mr. Patman. Eighty-seven and a half percent?

Mr. Sternlight. Eighty to 90 percent sounds reasonable to me.

Mr. Solomon. Yes. That is about right. When I was Under Secretary of the Treasury I can remember the foreign proportion of the U.S. debt holding going, I think, as high as one-sixth but I think it is lower today. I think it is between a seventh and an eighth.

Mr. Patman. And, of course, that is the percentage that may be dependent upon a treaty for our taxation of the interest, I assume, the one-sixth to one-eighth owned by foreign nationals would be maybe subject to tax and maybe not in the United States depending on the treaties.

Mr. Solomon. Most of the foreign holdings of U.S. Government debt, Mr. Patman, are held by foreign central banks. Very little of it is held by private foreigners abroad. It is just not a worthwhile investment from their point of view. The foreign central banks hold it because it is such a wonderfully liquid market and it gives them liquid dollar reserves to meet their balance of payment needs.

Chairman Fauntroy. If the gentleman would yield? When I raised a similar question at a hearing last year with Mr. Stallecker, he responded that as of the end of the calendar year 1981 private investors held about $695 billion in outstanding debt. Foreign and international investors held a little over $141 billion of that amount which represented 20.4 percent of the debt held by private investors.

Mr. Solomon. That ratio would be lower today, and it is virtually all held by foreign governments or foreign central banks or official institutions. Very little is held by foreign private individuals.

Mr. Patman. Do you undertake to keep a running total of this or running percentage?
Mr. Solomon. We, ourselves, at the New York Federal maintain the accounts of all foreign central banks who have accounts in the United States with the Federal Reserve. We have approximately 140 accounts representing about 130 governments or countries. And we also have the accounts of the International Monetary Fund and the World Bank. These holdings are all Treasury obligation holdings in one form or another, that is what is in those accounts. So I can simply tell by looking at the grand total what that is and why that represents, based on both Treasury data and our data, virtually all of the Treasury obligations that are held by foreigners.

Mr. Patman. You mention your obligations and your responsibilities on the relationships between seller and borrowers and purchases of U.S. Government securities, I believe. Do you have similar obligations and responsibilities in respect to foreign securities bought and sold in the United States?

Mr. Solomon. No, not at all.

Mr. Patman. How about State and local government securities?

Mr. Solomon. No. Aside from our interests in Government securities, because of our open market operations, we also are agents for the Treasury in auctioning off U.S. Treasury obligations. Mr. Sternlight can go into more detail on this if you want, Mr. Patman, that is what he does every day. But that is why we have a special interest in the U.S. Treasury obligations, the Government securities market which we do not have in the others. Now, we have a general interest, as a central bank of the country, in the soundness of all financial markets but we don’t have the kind of monetary surveillance role in other markets that we have in the Government securities market.

Mr. Patman. You get into it through your sales and purchases on the Federal open market committee and you are interested, of course, now in receiving the money that we are due upon the sale of those securities, but how does this extend to what the dealers and brokers do among themselves?

How do you assume responsibility beyond that, once we get paid and once you sell and once you buy and once you receive the security?

Mr. Solomon. We are only interested in the soundness of the market. Therefore, we would want to be sure that a situation would not develop that caused a ripple effect all through the market. Now, there are certain types of practices that are more conducive and others that are less conducive. We are not that interested in whether Mr. x pays Mr. y.

Mr. Patman. But if you start talking about your interest because of the ripple effect that could give you a pretty broad interest, couldn’t it?

Mr. Solomon. You are right. It has to be defined in specifics and we have tried to, by illustrating in my testimony the kinds of issues—the practices—that we are concerned about at the moment, the ones that we feel have been successfully addressed and the ones that we think can cause risk to the system. We are not trying to prevent the failure of any particular firm. We don’t feel that is appropriate for us to be involved in.

Mr. Patman. Thank you, Mr. Chairman.
Chairman FAUNTROY. Mr. Solomon, the when-issued market has expanded greatly, as I understand it. I wonder if you can tell us what you are doing to assure that transactions which rest upon these future securities are being prudently undertaken? Are you establishing limits on when-issued obligations? Should there be limits?

Mr. SOLOMON. Mr. Geng has put to the dealers various proposals on different ways of structuring the question of how to have a more prudent when-issued market and he is engaged in getting differing reactions to that proposal because there is a very wide range of opinion among the dealers. He will go into specifics, if you wish, Mr. Chairman, on these various proposals.

Chairman FAUNTROY. Mr. Geng?

Mr. GENG. Yes, Mr. Chairman. We have addressed this in three proposals to the dealer community. One issue concerns the item Mr. Sternlight referred to earlier, the activity between dealers. During this period of 1 to 3 weeks, when a new issue is first being traded. Trading volume in the dealer community adds up to very large numbers, in the multibillion dollar class on large financing operations by the Treasury. We have suggested that one possible method of dealing with this situation to minimize risk would be to establish a clearing facility where the dealers that were active in the market would clear their own transactions. Every trade between dealers would be netted against each other, and there would not be any broker in between—they would be netted out. That information in that pool would be made available to the Federal Reserve, which would then see the exposure of each individual dealer. We have also suggested that in that kind of an arrangement it would be useful to have a margin payment made by those who have exposure. That is, if one dealer were to have a long position of $x million and the price moved down, that some margin be held in the clearing arrangement to assure that protection of all participants. We have suggested also that that kind of treatment be extended to customer business, and I think this is analogous to the way the current futures market transactions are undertaken. They are done on exchanges where each participant maintains margins against their long and short positions in the futures market. Those are the main elements, Mr. Chairman.

Mr. SOLOMON. They are very complicated, so if you don't understand them, Mr. Chairman, you are in good company because there are a lot of complexities involving the differences between each of these three approaches. Those three don't preempt the entire spectrum either. We are still very much in the dialog stage here.

Chairman FAUNTROY. Mr. Solomon, you touched upon the final question I wanted to ask you and the panel, which stems from the fact that some of these terms and some of these procedures are not very clear to many of us as laymen in the country. Would you provide the subcommittee, for inclusion in the record, further descriptions and diagrams showing, for example, the complete, when-issued transaction, the repurchase agreements, reverse purchase agreements, and so forth. They are all rather confusing to a layman like myself, so if you or your staff could prepare, for inclusion in the hearing record, a brief description, preferably with diagrams, of how a repurchase agreement and a reverse repurchase...
agreement, work, what happens to Treasury securities by using those transactions and how a string of transactions would work. I have had staff to describe this to me, but I would like to see you take your hand at it with a diagram.

Mr. Solomon. Well, it is a real challenge.

[In response to the request of Chairman Fauntroy for additional information, the following response was received from Mr. Solomon for inclusion in the record:]

**WHEN-ISSUED TRADING**

In the process of issuing new Treasury debt there is a period of time between the Treasury's announcement of the terms of the sale, the auction of the securities, and the payment for the securities. During the period between announcement and issuance of the securities a considerable amount of trading of the securities takes place. This trading is referred to as "when-issued" trading because such transactions can only be completed when the new securities are issued. In other words, delivery of the securities is stipulated to take place "when issued".

When-issued periods can vary from about 8 days for a Treasury bill to as much as 3 weeks for a Treasury coupon-bearing security. For example, the sale of regular three- and six-month Treasury bills is announced on a Tuesday. The auction takes place on the following Monday and payment and issuance occurs on Thursday. As a second example, the Treasury announced its quarterly refunding on April 27 but the issuance of the securities will not take place until May 16.

When-issued trading benefits the market because investors can make commitments to take on the new securities before payment is due. Prices would be depressed and the cost to the Treasury would be higher if a large amount of new securities were sold in the market for immediate payment.

A trader's capital ordinarily serves as a restraint on unsound position-taking because most trading in Treasury securities is paid for the same day or the next day. When payment is not made immediately a trader can be tempted to take larger positions than capital would allow. Such a trader is essentially buying with unsecured credit. Market participants realize such trading involves unsecured credit and monitor their exposure carefully. However, an individual trader does not know the total amount of credit extended by the market to any other trader. Consequently a trader could be extending credit on the false assumption that the counterparty has no other when-issued obligations.

**EXAMPLE OF A WHEN-ISSUED PERIOD**

Issue to be sold: An additional $3 3 billion of Treasury bonds due November 15, 2012.

Announcement date of sale: April 27, 1983.

Date of auction: May 5, 1983.


Number of calendar days during when-issued period: 20.

**HYPOTHETICAL SET OF TRANSACTIONS BY ONE TRADER**

Assume that on April 27 a trader buys $4 million of the Treasury bonds at a price of $100 from each of 5 other parties—a total of $20 million. On April 29 assume that the price has declined one-half point and the trader buys an additional $20 million of the bonds at $99%—$4 million from each of 5 other parties. And on May 7, with the price down one-fourth point, he buys $40 million of the bonds, this time $4 million from each of 10 other parties.

This is illustrated in the following table, along with an assumed closing market price each day and a resultant unrealized loss.

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<th>Amount purchased</th>
<th>Number of counterparties</th>
<th>Price</th>
<th>Average price paid to date</th>
<th>Closing price</th>
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<td>98½</td>
<td>98½</td>
<td>800,000</td>
</tr>
</tbody>
</table>
Result: The trader has lost $800 thousand during the when-issued period. The trader has not paid for the securities and, given the size of the loss, may be unable to meet the commitment. Each of the counterparties from whom the securities were purchased stands to lose $40 thousand. Each of the 20 counterparties sold only $4 million of the securities to the trader, an amount they believed was within the capabilities of the trader. They did not know the trader had accumulated commitments totaling $80 million.

REPURCHASE AND REVERSE REPURCHASE AGREEMENTS

A repurchase agreement (RP) is a transaction which obligates the seller of a security to buy it back from the purchaser at a later date. The other party to the transaction has a corresponding obligation to return the security to the seller. The same transaction may also be referred to as a reverse repurchase agreement (reverse RP). That is to say, when a dealer obtains a security under a repurchase agreement the dealer will refer to the transaction as a reverse repurchase agreement. In fact, under the same transaction, a seller is said to put the security out on “RP” and the purchaser, particularly a dealer, is said to “reverse” the security in.

By means of this transaction, the seller obtains funds from the purchaser while simultaneously transferring a security to assure repayment of the funds. Dealers use such transactions to finance their inventories of securities. If dealers use such transactions to obtain securities they are doing the opposite or the “reverse”. Dealers may do a “reverse” to borrow securities which were sold short.

The date set for the repurchase of the security may be as short as overnight or extend for a number of months. Both the price at which the security will be repurchased and an interest rate charge for the funds borrowed are determined at the initiation of the transaction. The amount of funds borrowed is normally less than the security’s money value. This difference exists in order to protect the purchaser from a loss if the seller fails to repurchase the security and its price has fallen. Since the Drysdale failure, the security’s money value is calculated to include any accrued interest due from the issuer of the security as well as the market price at which the security trades. The difference between the security’s money value and the funds borrowed is referred to as the margin. Sufficiently large changes in the market price (up or down) of the security during the life of the repurchase agreement can require adjustments in the margin.

Because each purchaser of a security under a reverse repurchase agreement essentially has the unrestricted use of the security during the life of the contract, the security may change hands a number of times as it is sold outright or used for subsequent repurchase agreements. When the purchaser has used the security for an outright sale to a third party (a short sale), the purchaser may satisfy his obligation under the reverse repurchase agreement by obtaining the equivalent securities from any customer and returning them to the original seller under the agreement.

The following diagram illustrates an example of these transactions which link the movements of a security. In the example, dealer A purchases a security for $100 million and in order to replenish his bank balance before the close of business places the security on repurchase with dealer B. In so doing, dealer A obtains $99 million after margin and uses $1 million of his own capital to complete payment for the original purchase. Dealer B, having done a reverse repurchase with dealer A, then sells the security outright to customer C for $100 million. At the maturity of the contract, dealer B purchases the comparable security outright from customer D for $100 million, returns the security to dealer A and receives repayment of his original $99 million loan. In order to repay dealer B, dealer A must either sell the security outright or enter into a new repurchase agreement.

ILLUSTRATIVE SECURITY TRANSACTIONS USING A REPURCHASE/REVERSE REPURCHASE AGREEMENT

<table>
<thead>
<tr>
<th>Transactions</th>
<th>Dealer A</th>
<th>Dealer B</th>
<th>Customer C</th>
<th>Customer D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds</td>
<td>Securities</td>
<td>Funds</td>
<td>Securities</td>
<td>Funds</td>
</tr>
<tr>
<td>Dealer A purchases security outright</td>
<td>-100</td>
<td>+100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dealer A RP's security with dealer B</td>
<td>+99</td>
<td>-100</td>
<td>-99</td>
<td>+100</td>
</tr>
<tr>
<td>Dealer B sells security outright to customer C</td>
<td>+100</td>
<td>-100</td>
<td>-100</td>
<td>+100</td>
</tr>
</tbody>
</table>
ILLUSTRATIVE SECURITY TRANSACTIONS USING A REPURCHASE/REVERSE REPURCHASE AGREEMENT—Continued

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<tr>
<td></td>
<td>Funds</td>
<td>Securities</td>
<td>Funds</td>
<td>Securities</td>
</tr>
<tr>
<td>Dealer B buys security outright from customer D</td>
<td>-100</td>
<td>+100</td>
<td>+100</td>
<td>-100</td>
</tr>
<tr>
<td>RP and reverse RP matures</td>
<td>-99</td>
<td>+100</td>
<td>+99</td>
<td>-100</td>
</tr>
<tr>
<td>Net change upon maturity of RP contract</td>
<td>-100</td>
<td>+100</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Chairman Fauntroy. Thank you.

I think Mr. Patman has a final question.

Mr. Patman. Really, it involves several concepts, the law of supply and demand and how it affects the interest rates and also the expectations argument that we hear continually. You are right on the ground floor there where people buy these securities or they don’t buy them.

First of all, when a person doesn’t buy U.S. securities because he is not satisfied with the interest rate, what does he do with his money?

Mr. Solomon. Well, he can buy commercial paper, he can buy CD’s, certificates of deposit, from the banks, he can buy various kinds of short-term instruments, he can go long in the non-Government security corporate bond market, he can go to the stock market, he can buy gold and put it under his mattress, he can buy real estate or antiques. There is a whole variety of things. I think you would have to give me a more specific question.

Mr. Patman. Do people generally come in and out of the U.S. Government security market, or do you have a pretty solid list of customers and buyers and sellers that do nothing but that?

Mr. Solomon. I think it is fair to say that many of the institutions in this country are steady buyers and hold those securities in their portfolios at least for some period of time, as distinct from those who would buy in order to take advantage of market opportunities in a very quick turnaround sense.

I don’t know whether you want to get into a lot of detail in this, and my colleagues could probably give you some percentage estimates as to what percentages are currently or customarily bought by, say, the banks as against the other types of financial institutions and as against individuals. What do you say?

Mr. Patman. I will tell you. Could you just give me a percentage of those people who buy Government securities customarily over the last year who are likely to buy gold as an alternative investment or commerce paper or something of that nature?

Mr. Solomon. I don’t think there is any way of giving you that.

For one thing, the Government does not keep track of who buys gold. What percentage are individuals that are flexible in their investments?

Mr. Sternlight. There is such a lot of flexibility, Congressman. There is a sort of hard core, if you will, of buyers, many of them institutional, who are in Government securities all the time. There
is also a fairly sizable group at the margin who will be in or out of Government securities depending on yield relationships.

I am tempted to note that the Treasury, in all of its auctions has some portion of the securities that is sold in a noncompetitive form. They are sold in smaller amounts. In the case of weekly Treasury bills, that averages about three-quarters of a billion to 1 billion out of the weekly issues that now average about 6 billion. But that would be an extremely crude proxy for individual participation because many small institutions also use that noncompetitive route.

Mr. Patman. Let me ask you, we have had these huge deficits projected. I think I read the other day in the Heritage Foundation paper that they put out that the estimates have gone up 2,500 percent.

Chairman Fauntroy. You read the Heritage Foundation’s publications?

Mr. Patman. Oh, yes.

Chairman Fauntroy. Oh, I see, thank you.

Mr. Patman. From March 1981, to, I guess, February 1983. Why hasn’t the market reacted by causing interest rates to go up in the last few months by simply depreciating the value of the Government securities that are on the market? Is it because the amount of money supply has been integrated to compensate for that?

Mr. Solomon. No, that is not it at all. In fact, if you increased the money supply, you would probably get a reverse reaction in the longer end of the market—that is, interest rates would rise.

Mr. Patman. Excuse me. Would you explain why if we inflated the money supply we would get a reverse effect, as long as you brought it up?

Mr. Solomon. Well, it is that old business that the attitudes of buyers and sellers do determine, of course, the equilibrium price in those markets.

Mr. Patman. How about the supply-and-demand equation?

Mr. Solomon. Right, that also.

Mr. Patman. Well, if you have more money buying the same bonds, you would probably have more money chasing after the same goods and have a higher price, wouldn’t you?

Mr. Solomon. Except that what happens if people believe, and I am not saying it always happens this way, but if they believe that inflating the money supply is going to mean a significantly higher rate of inflation farther down the road even if it is 18 months or so from now. They will then be very reluctant to lock themselves into longer term securities unless the yield is high. They will stay short, or they will go into anti-inflationary hedges.

Mr. Patman. Right. And staying short for 91 days or 188 days with Treasury bills would mean that the rates of interest on those would drop significantly, wouldn’t they?

Mr. Solomon. That is right.

Mr. Patman. Why haven’t they dropped? The chairman earlier mentioned there is a more direct relationship to inflation?

Mr. Solomon. Well, short-term rates can drop for various reasons. They can drop either because of the particular situation you are talking about, namely, inflating the money supply and, therefore, people being afraid of the long end of the market and staying short. That is one way.
But it could also drop simply because of an increasing realization
that inflation rates are coming down and, therefore, rates both in
the short end and the long end of the market would tend to come
down when and as people are really convinced of that.

Mr. Patman. Can you give us any projections, just based on what
these Government deficits are going to be in the next few years, as
to what effect that is going to have on the interest rates?

Mr. Solomon. No, sir; I can’t. All I know is that if you get a re-
covery, as we assume we are in now, the private sector credit de-
mands will increase, which is only natural as part of a recovery.
Then I am convinced, that if you are running a U.S. Treasury bor-
rowing requirement of roughly 6 or 6½ percent of GNP, or another
way of looking at it, using up 70 percent of the current savings in
the country, and that is combined with a stronger private sector
credit demand, you are clearly going to have major upward pres-
sure on interest rates. How much I don’t know and nobody would
know. There is no way of predicting that. Even if you knew the
exact amount of increase in the private sector demand for credit
and for medium and long-term capital as part of the recovery, you
still would not be able to make a calculation as to how much inter-
est rates will be higher than they otherwise would be without such
a big deficit. But they certainly will be significantly higher, Mr.
Patman, that you can be assured.

Mr. Patman. Regardless of expectations?

Mr. Solomon. Not only that, but the actual demand for money—
for capital for medium and long-term capital—would also be part of
this whole process so that you would get an actual tilting of the
demand/supply balance aside from expectations.

Mr. Patman. Thank you very much.

Chairman Fauntroy. I thank you, Mr. Patman and Mr. Solo-
mon, Mr. Geng, Mr. Sternlight. Your testimony here certainly con-
tributed to our understanding of the impact of these money and
credit policies on Federal debt management and in particular, our
concern on the domestic institutions that are engaged in the pur-
chase and sale of our U.S. Government debt instruments.

We look forward to your continuing counsel with this, particu-
larly with respect to any future legislative initiative that you think
may be necessary, and also with respect to some of the requests we
have made for diagrams and data that should help us to under-
stand better our oversight requirements as a subcommittee. Thank
you so very much, and we look forward to seeing you in the future.
And with that, the subcommittee hearings will come to a close.
[Whereupon, at 2:40 p.m., the subcommittee was adjourned, sub-
ject to the call of the Chair.]
APPENDIXES

ADDITIONAL MATERIAL SUBMITTED FOR INCLUSION IN THE RECORD

APPENDIX A: Notice of subcommittee hearing and miscellaneous material

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
WASHINGTON, D.C. 20515

April 10, 1983

REMARKS OF SUBCOMMITTEE HEARING AND WITNESS LIST

To : Members, Subcommittee on Domestic Monetary Policy
Members, Committee on Banking, Finance and Urban Affairs

From : Walter E. Fauntroy, Subcommittee Chairman

Re : Impact on Money and Credit Policy of Federal Debt Management

MONDAY The Subcommittee on Domestic Monetary Policy will meet on Monday, April 25, 1983, at 1:00 p.m. in Room 2128 Rayburn House Office Building in exercise of its oversight authority on the Impact on APRIL 25 Money and Credit Policy of Federal Debt Management to examine proposals being advanced by the Federal Reserve System relating to the safety, soundness, structure and functions of domestic institutions engaged in the purchase and sale of United States Government debt instruments.

2128 The Federal Reserve System, acting through the Federal Reserve Bank of New York, has increased its regulatory efforts over major government security dealers following the collapse of Drysdale Government Securities, Inc. and Lombard-Wall, Inc. last year.

There are both present regulatory efforts and contemplated regulatory schemes which have been undertaken that are intended to enhance the safety and soundness of the major security dealers. The Subcommittee intends to explore these and possible proposed regulations to ascertain the following:

1. What concerns are held by the System with respect to the conditions of firms engaged in the purchase and sale of government securities included in both financial and operational matters.

2. Whether the size of the pending government deficit will have an adverse effect on the ability of the market to absorb the deficit without undue upward pressures on interest rates and the safety and soundness of the government security firms.

3. Whether the number of dealers with whom the Federal Reserve has a direct relationship should be expanded, how this might be accomplished, and whether there should be changes in the standards governing those who are engaged in the purchase and sale of government securities.

4. Whether direct regulation of all government security firms by the Federal Reserve should be undertaken and what legislative changes are required to implement such a scheme.

5. Exemptions from certain provisions of the bankruptcy laws controlling assets when those assets are repurchase agreements.

WITNESSES The Honorable Anthony M. Solomon, President, The Federal Reserve Bank of New York, will be accompanied by Edward J. Geng, Senior Vice-President, and Peter D. Sternlight, Executive Vice-President.
The Honorable Paul A. Volcker  
Chairman  
Board of Governors  
Federal Reserve System  
20th and Constitution Avenue, N.W.  
Washington, D. C. 20551  

April 6, 1983  

Dear Paul:

On Monday, April 25, 1983 the Subcommittee on Domestic Monetary Policy in exercise of its oversight authority will meet to take testimony on the structure and function of those domestic institutions engaged in the purchase and sale of United States government debt instruments. This has been a matter which has previously been studied by this Subcommittee and this hearing continues my deep interest and concern about the safety, soundness, function, and structure of our debt markets.

I understand that the Federal Reserve Bank of New York has increased its regulatory efforts in this area since the failures of Drysdale Government Securities, Inc. and Lombard-Wall Inc. last year, and that additional regulatory schemes are being contemplated. I also understand that both this regulatory effort and any subsequent schemes would be applied first, and only directly, to the 36 dealers with whom the New York Bank has a specific relationship with the further effectiveness of any regulatory effort occurring through the insistence by this group that the same standards be followed by other dealers with whom they maintain business relationships.

I would like you or your designee to testify on this date on these matters. Specifically, I hope your testimony will address the following questions:

1. What concerns are held by the System with respect to the conditions of firms engaged in the purchase and sale of government securities including both financial and operational matters?

2. Whether the size of the pending government deficit will have an adverse effect on the ability of the market to absorb the deficit without undue upward pressures on interest rates and the safety and soundness of government security firms.
3. Whether the number of dealers with whom the Federal Reserve has a direct relationship should be expanded, how this might be accomplished, and whether there should be changes in the standards governing those who are engaged in the purchase and sale of government securities;

4. Whether direct regulation of all government security firms by the Federal Reserve should be undertaken and what legislative changes might be required to implement such a scheme;

5. Exemptions from certain provisions of the bankruptcy law controlling assets when those assets are repurchase agreements.

I am also very much interested in discussions which have been ongoing at the Federal Reserve Bank of New York related to the possible imposition of capital ratios. I would like a thorough discussion of the issues surrounding this matter which should include the advantages such a rule could conceivably bring and the disadvantages such as a narrowing of the number of qualified dealers.

I realize that the System has not yet finalized any proposal or suggestion. I am not looking for any finalized version of any potential regulatory scheme. Rather, I want to be sure that all of the issues are being fully examined and discussed. Towards that end, I will be holding further hearings on this matter. There will not, however, be any other witnesses at this hearing since I have determined that it would not be useful to engage in any debate before there has been adequate time to assess Federal Reserve System comments or concepts. The industry will be given adequate time to comment on a subsequent date.

The hearing will commence at 1:00 p.m. on Monday, April 25, 1983 in Room 2128 of the Rayburn House Office Building. Committee Rules provide that witnesses should provide 100 copies of their testimony at least 24 hours before the hearing. Witnesses should also bring with them additional copies if they wish to be sure that members of the press and the public who may be in attendance are to be provided with copies of their testimony.

Any questions concerning this oversight hearing should be directed to the Staff Director of the Subcommittee, Howard Lee, who may be reached at 226-7315.

Sincerely yours,

Walter E. Fauntroy
Chairman

Paul, I understand that Tony Solomon has been designated by you to testify on this matter and that he will be accompanied by other officials of the New York Fed. That is an acceptable arrangement and I am most pleased to extend to him my welcome.
April 7, 1983

The Honorable Walter E. Fauntroy
Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Chairman Fauntroy:

Thank you for your letter of April 6 concerning your Subcommittee's hearings on the structure and function of domestic institutions engaged in the purchase and sale of United States government debt instruments.

As you are aware, I have asked Mr. Anthony M. Solomon, President of the Federal Reserve Bank of New York, to appear before your Subcommittee on behalf of the Board on Monday, April 25.

Sincerely,

[signature]
NEW YORK—The Federal Reserve Bank of New York is considering establishing capital requirements for major government-securities dealers, as part of a stepped-up regulatory effort following last summer’s collapse of Drysdale Government Securities Inc. and Lombard-Wall Inc., two relatively small houses.

Edward J. Geng, a New York Fed senior vice president hired to do market surveillance in the wake of the failures, told a news conference yesterday that the bank may set up a formula under which dealers would be required to have fixed amounts of capital to support particular levels of exposure in the government-securities market.

Mr. Geng disclosed that “there have been occasions” during the past six months when the New York Fed was concerned that certain dealers didn’t have enough capital to support their trading positions. As a result, the bank had the dealers pare their positions. He didn’t identify the dealers involved.

Mr. Geng also said the bank is thinking about restricting “when-issued” trading of government securities. In such trading, which has burgeoned in recent years, dealers trade securities that are going to be offered but that haven’t yet actually been issued. He explained that often there can be three weeks between the time an issue is announced and offered. Dealers are at risk if, for any reason, other dealers fail to make good on delivery of cash or securities once a security is issued.

Mr. Geng suggested that the bank may require margin payments among dealers as a means of minimizing such risks. Margin is the amount of cash that must be put up in a purchase of securities.

Any new rules in the government-securities area would take the form of standards set for the 36 dealers with which the Federal Reserve Bank deals. Smaller dealers outside this group—such as Drysdale and Lombard-Wall—wouldn’t be affected directly.

Mr. Geng said he hopes that once new regulations are applied to the 36 dealers, this group will insist on the same standards at smaller firms with which they trade.

Mr. Geng also called for enactment of a U.S. legislative amendment that would exempt repurchase agreements from bankruptcy-law provisions that automatically freeze assets and obligations of a company filing under the Bankruptcy Code. The amendment, which industry officials support strongly, would allow dealers to unwind repurchase agreements after entering bankruptcy proceedings.

Questions over how repurchase agreements were to be treated in the bankruptcy courts brought additional confusion to the Lombard-Wall collapse last August.

Drysdale’s collapse last summer sent shock waves through the financial community, which had generally played down the risk underlying the massive government-securities market, where about $30 billion of trades occur daily. Diysdale folded after building a multibillion-dollar portfolio of repurchase agreements, far out of proportion to its capitalization. These contracts, generally known as “repos,” allow dealers to make cash by selling securities under an agreement to buy them back later.

Since joining the Fed last September, Mr. Geng has set up a staff of seven people to monitor the government-securities market. But this group been in place a year ago, Mr. Geng said, it would probably have detected problems in Drysdale’s ballooning repurchase agreements.

He said the surveillance team reviews data provided by the 36 major dealers and often follows up with visits to dealers.

Mr. Geng warned that dealers shouldn’t grow complacent because last summer’s failures didn’t create the industry-wide damage some feared they would. Improved market conditions “tend to let the events of last year fade,” he said.

Mr. Geng cited plans for enactment of a U.S. legislative amendment that would exempt repurchase agreements from bankruptcy-law provisions that automatically freeze assets and obligations of a company filing under the Bankruptcy Code. The amendment, which industry officials support strongly, would allow dealers to unwind repurchase agreements after entering bankruptcy proceedings.

Questions over how repurchase agreements were to be treated in the bankruptcy courts brought additional confusion to the Lombard-Wall collapse last August.
U.S. Debt Dealers Face Antitrust Probe
On Use of Closed-Circuit Trading System

WASHINGTON—A large and profitable segment of the market for Treasury securities has come under U.S. antitrust scrutiny because it is in the hands of a limited number of companies that can have access to closed-circuit systems for making anonymous trades in Treasury securities.

The Department of Justice has begun a preliminary inquiry into whether the companies with access to the limited systems are able to use their influence to restrict access to the systems. The department's officials said the civil inquiry has been going on "for some time."

Currently, the four companies that serve as brokers in this segment of the securities market allow access only to 36 brokers who are approved by the Federal Reserve Bank of New York as a primary or reporting dealer. To qualify, these brokers lose most, among other things, make a market in all Treasury issues, handle more than about 1% of trading in Treasury securities, maintain an adequate balance sheet, and report daily to the Fed on their trading. The brokers also give access to the system to a few other companies among those that have applied to the Fed to become reporting dealers.

The brokers operate a closed-circuit network of interconnects carrying information on amounts asked or offered for specific Treasury securities, thereby identifying the companies involved. The network works so that almost in orders to the brokers, who flash "hit" next to the offers that are accepted.

Volume of trading among these large dealers in Treasury securities could be as large as $15 billion to $20 billion a day, according to federal regulators. And because the volume is so large, the prices carried on these systems' users can then phone in orders to the companies with which they trade anonymously are able to execute their agreements without violating antitrust laws.

The brokers maintain a list of customers, maintain an adequate balance sheet, and report daily to the Fed on their trading. The brokers also give access to the system to a few other companies among those that have applied to the Fed to become reporting dealers.

Each of the brokers operates a closed-circuit network of interconnects carrying information on amounts asked or offered for specific Treasury securities, thereby identifying the companies involved. The network works so that almost in orders to the brokers, who flash "hit" next to the offers that are accepted.

The brokers also give access to the system to a few other companies among those that have applied to the Fed to become reporting dealers.

The Justice Department investigation highlights a distressing conflict among securities dealers and brokers. If they keep the current system, they run the risk of antitrust charges. But if they remove all barriers, they fear that they expose themselves to the risk of trading with financially unsound companies.

The issue is especially fresh in the minds of securities dealers because of the collapse last summer of Dreyper Government Securities Inc. and Lombard-Wall Inc. Since the failure of the two small concerns, many securities dealers have tightened their credit-checking procedures, and some have also shortened the list of companies they do business with.

Still, some brokers and federal regulators point out that the securities industry hasn't done enough to protect itself against more such incidents. As a result, some brokers and securities dealers feel as though they are being pulled in opposite directions by two government branches. On one hand, they note that the Federal Reserve System has been encouraging them to be more careful of whom they trade with, while on the other hand, the Justice Department is pushing them toward antitrust violations.

Before we go about making major structural changes in this marketplace, we should consider the potential disruptive effects on the efficient functioning of the market," said Larry F. Clyde, an executive vice president of Chase National Bank in San Francisco.

This system, Mr. Clyde has served as a consultant to various financial institutions, has been encouraging dealers to tighten credit-checking procedures, and some have also shortened the list of companies they do business with. If they keep the current system, they run the risk of antitrust charges. But if they remove all barriers, they fear that they expose themselves to the risk of trading with financially unsound companies.

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re

LOMBARD-WALL INCORPORATED,

Debtor.

LOMBARD-WALL INCORPORATED,

Plaintiff,

-COLUMBUS BANK AND TRUST COMPANY;
MERCANTILE-SAFE DEPOSIT AND TRUST
COMPANY: THE FIRST BOSTON CORPORATION;
A.G. BECKER INCORPORATED;
and others similarly situated,

Defendants.

MEMORANDUM OF LAW IN
SUPPORT OF FEDERAL RESERVE'S
MOTION TO INTERVENE AS AMICUS CURIAE
AND
BRIEF AS AMICUS CURIAE
PRELIMINARY STATEMENT

This document is respectfully submitted on behalf of the Federal Reserve Bank of New York ("Reserve Bank") so that it may make its views known to the Court on an important principle of commercial law: namely, whether in a bankruptcy proceeding, a repurchase agreement should be characterized as a purchase and sale transaction or as a secured loan. The Reserve Bank submits, as a matter of public policy, that a repurchase agreement should be characterized as a purchase and sale transaction. If the Court characterizes a repurchase agreement as a secured loan, this characterization could have an adverse impact on the Federal Reserve's ability to conduct domestic monetary policy effectively and to invest dollar deposits of foreign central banks efficiently. Moreover, such a characterization could also increase the cost of financing the public debt of the United States.

STATEMENT OF FACTS

The defendants in this motion are involved in contractual agreements with Lombard-Wall Incorporated ("Debtor"). Pursuant to these agreements, the Debtor sold securities to the defendants and also agreed to repurchase securities from the defendants at a future date. After the Debtor filed its petition for reorganization relief under Chapter 11 of the Bankruptcy Code on August 12, 1982, the Debtor breached its contractual obligation to repurchase securities from the defendants. Defendants are contemplating, and may have already effected, sales of the securities to third
parties. The Debtor has moved the Court for a preliminary injunc-
tion enjoining the defendants from liquidating the securities in
this manner and the Court has scheduled a hearing on the Debtor's
Motion for August 23, 1982. The central legal issue to be decided
at this hearing is whether a repurchase agreement should be char-
acterized as a purchase and sale transaction or as a secured loan.

POINT 1: THE MOTION
TO INTERVENE AS AMICUS
CURIAE SHOULD BE GRANTED.

A. The Federal Reserve Uses The Repurchase Agreement As A Vehicle
For Carrying Out Certain Of Its Public Responsibilities.

A repurchase agreement ("Repo") is used by the seller of
securities as a means to acquire funds, and by the buyer of securi-
ties as a means to invest funds, over a short period of time. As
part of the terms of sale, there is included a simultaneous agree-
ment between the parties that the seller will repurchase the securi-
ties at a later date.

The Federal Reserve uses the Repo in two ways. First,
it is used as a tool of monetary policy. The objective of Federal
Reserve monetary policy is the achievement of a steady and sus-
tained growth in the economy, along with reasonably stable prices.\1/
Achievement of this objective is sought through encouraging the
nation's money supply to grow within ranges deemed appropriate and

\1/ In fact, the FOMC is required by the Full Employment and
establish objectives for national monetary growth and to report
on these objectives periodically to appropriate committees of
the Congress.
desirable by the Federal Open Market Committee ("FOMC"). In turn, the FOMC instructs the Reserve Bank to achieve the FOMC's monetary growth objectives by controlling the supply of reserves available to commercial banks. These reserves are controlled through open market purchases and sales, which are described more extensively in Point 2(c) below. A purchase of securities by the Federal Reserve will increase reserves, whereas a sale of securities will decrease reserves.

Because the supply of reserves tends to fluctuate widely over short periods of time, the Federal Reserve often uses the short-term Repo to buy and sell securities. Accordingly, the Repo has become an important tool used by the Federal Reserve to control the nation's monetary growth over the short term. The Reserve Bank, therefore, has a substantial interest in the Repo remaining an efficient and readily usable instrument of the money market.

Second, the Reserve Bank provides a variety of banking services to about 140 foreign central banks, monetary authorities, and international institutions such as the International Monetary Fund. As of September 1980, the Reserve Bank held over $100 billion in dollar-denominated assets and $249 billion of gold for these entities. Among the banking services provided these entities are investment services, and the Repo is an important vehicle used by Reserve Bank to provide these investment services. Consequently, the viability of the Repo is an issue that has not only domestic monetary policy implications, but international financial implications as well.

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B. The Court Can And Should Permit the Reserve Bank To Intervene As Amicus Curiae.

Rule 724 of the Bankruptcy Rules incorporates by reference Rule 24 of the Federal Rules of Civil Procedure. Rule 24 of the Federal Rules of Civil Procedure authorizes intervention by permission and as of right. The Reserve Bank acknowledges that it has no right to intervene in the subject proceeding, but asks the Court to exercise its discretionary authority and permit it to intervene as amicus curiae.

Although no policy or regulation of the Reserve Bank is directly involved in the subject proceeding, there is case law supporting the principle that the court has the power to permit a party to intervene as amicus curiae (and not as a party plaintiff or defendant), if the party can show a substantial interest in an issue involved in the litigation.

The leading case is Brewer v. Republic Steel Corporation, 513 F.2d 1222 (6th Cir. 1975). In Brewer, the Ohio Civil Rights Commission moved to intervene in a private employment discrimination suit brought under 42 U.S.C. § 1981 and Title VII of the Civil Rights Act of 1964. After finding that the movant was not entitled to intervene as of right, and after refusing to exercise its discretion to allow permissive intervention, the Court ruled that the movant could participate by filing an amicus curiae brief. Movant appealed.

On appeal, the Sixth Circuit affirmed the ruling of the district court, and supported the trial court's resolution of the dispute through the amicus curiae device.
We believe that movant can make its views known if the Commission accepts the District Court's invitation to participate in the litigation as amicus curiae. Surely this role will afford the Commission ample opportunity to give the court the benefit of its expertise. Moreover, the District Court apparently will receive and consider any admissible evidence that the Commission chooses to offer.

513 F.2d at 1225. Several district courts in other jurisdictions have followed this procedural innovation of the Sixth Circuit, and have permitted parties that are not authorized to intervene under a literal reading of Rule 24 to intervene as amicus curiae. National Association for Neighborhood Schools of Pittsburgh, Inc. v. Board of Public Education of the School District of Pittsburgh, Pennsylvania, 90 F.R.D. 398, 405 (W.D. Pa. 1981); United States v. Massachusetts Merchant Marine Academy, 76 F.R.D. 595, 598 (D. Mass. 1977).

The Reserve Bank has been involved with Repo transactions since 1917 and wishes to give the court the benefit of its expertise. The Reserve Bank does not wish to become involved in the litigation as a party plaintiff or defendant, nor does it wish to become involved in details of specific proceedings. Instead, the Reserve Bank desires to intervene in the litigation and brief the court as amicus curiae on the single issue of whether a Repo should be characterized as a purchase and sale transaction or as a secured loan. The Reserve Bank believes that the court has the power to permit such participation under the above-cited case law, and respectfully requests the court to grant its motion to intervene as amicus curiae. See also SEC v. U.S. Realty Co., 310 U.S. 434, 459-60 (1940) (agencies representing public interest should be allowed to intervene and be heard).

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POINT 2: ASSUMING THAT THE COURT GRANTS THE RESERVE BANK'S MOTION TO INTERVENE AS AMICUS CURIAE, THEN IT ALSO ASKS THAT THE COURT TREAT THE REPO AS A PURCHASE AND SALE TRANSACTION.

A. There Is No Case Law Controlling This Issue In The Southern District of New York.

One court in the Southern District of New York has impliedly held, in a nonbankruptcy context, that repurchase agreements involve the purchase and sale of securities. In SEC v. Miller, 495 F. Supp. 465 (S.D.N.Y. 1980), the SEC sued for an injunction alleging that the principal of a bankrupt government securities dealer engaged in deceptive conduct in connection with repurchase agreements. The SEC alleged that the failure to keep proper accounting records and the failure to disclose that fact constituted violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Both Section 10(b) and Rule 10b-5 apply only to deceptive conduct in connection with the purchase or sale of a security. Implicit in the court's analysis of whether the defendant had violated Section 10(b) and Rule 10b-5, is the court's tacit determination that the repurchase agreements involved purchase and sales of securities. The court's general statements that "from a purely economic perspective . . . a repo is essentially a short-term collateralised loan . . . ," (495 F. Supp. at 467, 469) were offered merely to indicate the
general nature of a repurchase agreement and were not intended as conclusions of law. Furthermore, the general statements did not affect the court's analysis. In making such statements, the court was merely drawing attention to the economic purpose of repurchase agreements. For example, the court also pointed out that the Reserve Bank treats federal funds transactions, which "resemble considerably" repurchase agreements (495 F. Supp. at 468), differently from ordinary loans because of their economic purpose (495 F. Supp. at 468).

B. Case Law From Other Jurisdictions Indicates That The Court May Characterize Repurchase Agreements As Purchase and Sale Transactions.

The characterization of Repos either as secured loans or as independent contracts for the sale and purchase of securities "is the subject of conflicting precedent." Letter dated July 20, 1982 to the Chairman of the House Commerce, Consumer and Monetary Affairs Subcommittee from Debtor's counsel.2/ The recent amendments to the Bankruptcy Reform Act of 1978 "do not resolve the central issue under the Code concerning repos, which is whether they will be treated as secured loans or as involving executory contracts." Letter dated August 6, 1982 to Chief Economist of the House Commerce, Consumer, and Monetary Affairs Subcommittee from Debtor's counsel.3/ Case law confirms "the equivocal status of

2/ Attached as Exhibit A.
3/ Attached as Exhibit B.
repo transactions." Letter dated August 9, 1982 to General Counsel of the Board of Governors of the Federal Reserve System from Debtor's counsel.4/

There are no cases characterizing Repos in the context of bankruptcy proceedings. Furthermore, the few reported cases characterizing repurchase agreements in other contexts appear to turn on the particular legal context in which they arise. For example, in cases arising under the income tax law, courts have generally characterized a securities repurchase transaction as a secured loan. First Am. Nat'l Bank of Nashville v. United States, 467 F.2d 1098 (6th Cir. 1972); Union Planters Nat'l Bank of Memphis v. United States, 426 F.2d 115 (6th Cir.), cert. denied, 400 U.S. 827 (1970); American Nat'l Bank of Austin v. United States, 421 F.2d 442 (5th Cir.), cert. denied, 400 U.S. 819 (1970). However, these characterizations were made for the purposes of determining the tax treatment of the income earned on securities which were tax-free State, county, or municipal obligations.

In the context of Federal securities law, there has been considerable controversy over the characterization of a Repo for the purpose of determining whether it is an "offer or sale" or "purchase or sale" of securities within the meanings of the Securities Act of 1933 or the Securities Exchange Act of 1934, respectively. Generally, courts have held that such transactions

4/ Attached as Exhibit C.

There are two cases that directly address the rights of a buyer in a Repo transaction when the seller is unable to perform the repurchase. These cases do not appear to reach the same conclusions regarding either the nature of a Repo transaction or the consequences that follow from the seller's default on his obligation to repurchase. Compare *Financial Corp. v. Occidental Petroleum Corp.*, No. 75-1623 W, 4 (W.D. Mo. May 7, 1979) aff'd, 1 B.R. 522 (W.D. Mo. 1979), aff'd, 634 F.2d 404 (8th Cir. 1980) (Repos treated sui generis) with *Gilmore v. State Bd. of Administration of Fla.*, No. 78-1794 (Fla. Cir. Ct. July 24, 1979), aff'd, 382 So.2d 861 (Fla. Dist. Ct. App. 1980) (Repos treated as a purchase and sale transaction).

In conclusion, what little case law exists is split; some cases characterize Repos as secured loans and some characterize them as purchase and sale transactions. Accordingly, the Court is free to decide the key issue in this litigation in whatever way it feels appropriate.

C. The Court Should Find Repos To Be Purchase And Sale Transactions.

The Reserve Bank uses Repos involving U.S. Government and agency securities ("Government securities") to supply funds to the banking system, in execution of monetary policy, because Repos are a highly flexible and effective short-term device for doing so. In
addition, wide public and private sector participation in the Repo market enhances the attractiveness of Government securities as investments; such broad-based participation permits the Treasury and other Federal agencies to finance the country's public debt at rates of interest lower than would otherwise exist. Moreover, smooth functioning Repo markets provide additional incentive for foreign central banks and other foreign holders of U.S. dollar reserves to participate in financing the nation's public debt.

The Federal Reserve System establishes monetary policy through the FOMC and executes policy through the Domestic Trading Desk at the Reserve Bank. The Trading Desk regularly engages in purchases and sales in the Government securities market. The Federal Reserve Systems Open Market Account contains approximately $142 billion of Government securities as of August 18, 1982. Federal Reserve Open Market transactions are the principal means by which the Federal Reserve implements monetary policy. For example, when the Desk purchases $1 million worth of Treasury securities in the open market, this adds $1 million to the reserves of the banking system when payment is made to the seller. While outright purchases and sales are used extensively in the Federal Reserve's open market operations, experience has shown that Repos are often a far preferable alternative. The Repo can be a superior instrument of monetary policy because it permits the Desk to affect reserve supplies in large volume for a few days at a time without exerting a large and possibly undesirable impact on interest rates.
For example, if attainment of reserve objectives required the Desk to add funds, say, $3 billion to bank reserves for just three days -- not an unusual occurrence -- and the Desk sought to do this by outright purchases and sales, it would purchase Government securities at market price on the first day and sell them, again at market, three days later. Outright purchases and sales of this size could have an appreciable and possibly undesirable impact on interest rates that can be avoided if the Repo instrument is used instead. Indeed, it is not unusual for the Desk to have to add as much as $7 billion to bank reserves through one-day Repos, an amount that probably could not be accomplished via outright transactions without causing significant market disruption.

Moreover, use of Repos permits the Desk, and the market participants, to undertake large short-term transactions without being exposed to the impact of short-run changes in market interest rate. If the Federal Reserve bought a large amount of securities, on an outright basis, and sold them out a few days later, and if market rates had risen in the meantime, the Fed could incur a substantial capital loss. Alternatively, if rates had fallen sharply then dealers or other market participants could suffer a large loss, probably making them less willing to participate in operations with the Desk, underwritings of Treasury issues, or market-making for other customers.

In 1981, the Desk entered into $111 billion of Repo transactions for Federal Reserve monetary policy purposes, and $88 billion on behalf of official foreign accounts. To conduct
operations at this level, the Repo market must attract a variety of responsible participants. Such participants are likely to be much less willing to undertake Repo transactions if, upon failure of a counterparty to repurchase securities, the participant would not be free to liquidate its holdings to minimize potential loss from price movements in securities, or to meet pressing liquidity needs.

Currently, a wide variety of institutional investors and public entities participate in the Repo market. Both the United States Treasury and the public benefit from this broad involvement and from the efficient operation of this market.

From the standpoint of those who purchase securities, the Repo transaction permits them to invest funds for precisely the period desired. Of course, an investor wishing to invest funds for a period of a few days could purchase a security outright and then resell it in the market at the end of the period, but this would subject him to a risk of capital loss in the event that prevailing interest rates rose, and the value of the security declined, between the date of purchase and sale. Alternatively, the investor could seek out securities with maturities matching his own unique liquidity needs. However, such securities may not be available, especially if the investor sought Treasury or Federal Agency securities.

In addition to flexibility, Repos involving Government securities attract investors because they are secure. The investor views the Government security as a virtually riskless
asset to be realized upon in the event that the seller breaches his agreement to repurchase.

From the standpoint of those dealers who sell Government securities, the ability to attract investors in the Repo market is essential to the efficient financing of their positions. This, in turn, benefits the United States Treasury and other agencies in financing the public debt. A Government securities dealer who takes a position in a particular new issue of Government securities may need to finance a portion of his position until purchasers are found. The Repo is an excellent means of financing. Also, a dealer may finance his own portfolio through Repos. It is through the larger, more active dealers in Government securities that the Federal Reserve is able to conduct its open market operations, including Repos.

As previously mentioned, the Reserve Bank maintains accounts for approximately 140 foreign central banks, monetary authorities, and international institutions. The dollar is the principal reserve currency in the world. With such large international holdings of the dollar, it has become important to the orderly financing of the public debt that these institutions purchase Government securities. In 1979, for example, the dollar volume of investment activity for these foreign accounts at the Reserve Bank exceeded $1.4 trillion, most of which involved purchases and sales of Government securities. A substantial amount of this activity was in Repos. A decision by this Court characterizing the Repo as a secured loan...
may well decrease the amount of participation in the Repo market by foreign investors. Such a decrease would have an adverse impact of indeterminate proportion on direct financing of the public debt.

From the foregoing discussion, the Court will appreciate that the Repo is an essential tool for conducting monetary policy and financing the national debt. From the buyer's perspective, the purpose of purchasing the security is cash management: the purchaser desires to maximize the return on his assets over a short period through the use of a secure investment vehicle. In most cases, assuming astute cash management on the part of the purchaser, the purchaser will require funds on the date repurchase is to occur. If repurchase does not occur because the seller of the securities is unable to perform, then the purchaser must be able to meet his liquidity needs by selling the security to some third party. The purchaser can have assurance of meeting this need only if the Court treats the Repo as a purchase and sale transaction. If purchasers believe that their need for liquidity might be unsatisfied, then the attractiveness of the Repo as an investment instrument will diminish. Such a result would hinder the conduct of domestic monetary policy by the Federal Reserve, and would make dollar investment by the Reserve Bank on behalf of foreign institutions more difficult. Moreover, it would increase the cost to the Treasury of financing the public debt. Therefore, considerations of public policy favor characterizing the Repo as a purchase and sale transaction.
CONCLUSION

For the reasons stated, movant should be permitted to intervene as amicus curiae, and the Court should characterize the Repos in the subject litigation as purchase and sale transactions.5/

Respectfully submitted,

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By: _______________________
Don N. Ringsmuth

Thomas C. Baxter, Jr.

5/ The Reserve Bank assumes in reaching this conclusion, that to the extent proceeds of the sale of the securities held under agreement to repurchase exceed the consideration stated in the agreement to repurchase, these "excess" proceeds will eventually become a part of the estate of the debtor.

5/ Julie S. Fox and David Kroop, both law clerks in the General Counsel's office, assisted in preparing this document.
Hearings Needed to Settle Repo Market Uncertainties

Congress has been urged to hold comprehensive hearings on the implications of the Drysdale affair, with particular attention to the application of the bankruptcy code to the market for repurchase agreements. In the view of Thomas A. Russo, a member of the New York-Washington-Palm Beach law firm of Cadwalader, Wickersham & Taft, the most important legal uncertainty concerning repos is whether in an insolvency they will be characterized as secured loans or independent contracts for the sale and repurchase of securities. The consequences of this characterization are substantial, he says, and the issue is not likely to be settled soon in the courts. Mr. Russo set forth his views in a letter requested by Rep. Benjamin S. Rosenthal, D-N.Y., chairman of the commerce, consumer and monetary affairs subcommittee of the House Government Operations Committee.

In a letter dated June 23, 1982, you asked me to provide the commerce, consumer, and monetary affairs subcommittee with additional analysis concerning the potential risks and legal ambiguities involved in the use of repos and reverse repos. I continue to believe that there are problems in the repo markets which deserve the most serious and careful attention, and I hope that the views expressed in this letter will be of assistance to the subcommittee.

As has been extensively described in the 1980 Report of the Joint Treasury-SEC-Federal Reserve Study of the Government-Related Securities Markets and elsewhere, the market for repos and reverse repos has grown dramatically in recent years and has become one of the principal means by which dealers and other participants in the government-related securities market finance their positions.

Moreover, by providing liquidity to the market for Treasury securities as a means for the Federal Reserve to conduct open market operations, an orderly functioning repo market has come to have substantial and growing significance for the implementation of national economic policy. As a result, it has become increasingly apparent that a major disruption of the repo market could have a serious adverse impact on that policy.

The much discussed Drysdale affair and the recent financial problems of Comark have given rise to uncertainties and concerns among participants in the repo market about the possible failure of additional firms and about the future of the market as a whole. These concerns have already been reflected to some extent in the news media, as is exemplified by the June 27, 1982, article from The New York Times and July 6, 1982, article from The Wall
ceedings involving such entities might average of the code and insolvency pro-
and insurance companies, for example, prevent entity.
participants and, in the case of the Insolvency of a repo market which might apply in the event
different insolvency laws would apply be able to rely on the code for explicit guidance in those areas.
However, since the code's current
itself. Notwithstanding the broad coverage of
coverage, there is substantial
a participant in the repo market is the
important to note than upon filing of a bankruptcy petition under the code a creditor is automatically
stay in effect for security of the collateral the debtor had been delivered to the debtor to the
of the filing of a petition. As a result, mark-to-market procedures might not provide the protection anticipated by the
may be punishable as being in contempt of the bankruptcy court.
and from liquidating any property
likely to be resolved in the courts in the near future.
- relates to the usual practice of dealers
required of the code. In effect, the dealer receives
or when the motion would be granted.
the delinquent books by balancing their commitments of repos and reverse repos and, accordingly, assuring that they generally have very low ins-
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If a repo to the debtor was treated as a secured loan from a lender to the debtor for which securities had been delivered to the debtor to the leader as collateral, the leader would be automatically stayed by the filing of a petition from setting off the reverse repo against other obligations of the debtor to the leader and from liquidating the securities held as collateral.
Although the leader could make a motion in the bankruptcy court to have the stay lifted, it is uncertain whether or when the motion would be granted.
On the other hand, the debtor or trustee could commence a so-called turnover proceeding to require the lender to transfer to the debtor or trustee the securities held as collateral in exchange for "adequate protection" provided to the leader.
Two issues concerning the reverse repo lender's security are worthy of note. First, the debtor or trustee might successfully attack as a preference the transfer by the debtor of additional collateral to the leader within 90 days of the filing of a petition. As a result, mark-to-market procedures might not provide the protection anticipated by the
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the dealer would have a secured claim against the securities which the dealer had agreed to sell. In addition, if the dealer had made any payments or transferred any funds to the borrower, it would appear that the secured claim of the dealer would be an unsecured claim for damages. If the dealer had made any payments to the debtor, it would appear that the secured claim of the dealer would be a preference claim, which is generally not a claim for damages. In addition, if the dealer had transferred any funds to the borrower, it would appear that the secured claim of the dealer would be a preference claim, which is generally not a claim for damages. In addition, if the dealer had transferred any funds to the borrower, it would appear that the secured claim of the dealer would be a preference claim, which is generally not a claim for damages.

The possibility that a bankrupt dealer's secured claim might be eligible for a preference reorganization plan that would avoid the secured creditor's claim is that the secured creditor's claim was not secured. In the proceeding, the secured creditor's claim was not secured. In the proceeding, the secured creditor's claim was not secured. In the proceeding, the secured creditor's claim was not secured.

The second possible characterization of a dealer's reverse repo transactions is that they involve, for purposes of the code, completed sales or purchases of securities, respectively, and independent executory contracts to repurchase or resell the securities. Under the code, the dealer or trustee would have the right to decide which of these executory contracts were, to assume and perform with respect to a repo, and without the possibility of a bankruptcy proceeding, the possibility that a dealer's secured claim might be entitled to any interest after the date of the petition and the funds owed to the dealer could be invested as described above.

The code's treatment of post-petition interest creates the possibility that a reorganizing dealer could fund the reorganization plan, in part, through investment of funds owed to secured creditors or parties to executory contracts which would ultimately be assumed. Even if the creditors were required to be paid the legal rate of interest, the spread between that rate and current market rates would present very attractive funding opportunities and would create a strong incentive to protect the proceeding.

The manifold uncertainties concerning the treatment of repurchase agreements in a bankruptcy context provides a strong incentive to reorganize market participants who would avoid entering into, or attempting to extricate themselves from, commitments with firms who have or are rumored to have financial difficulties. In light of Drysdale and Comark, and of rumors of difficulties at a variety of other firms, market participants view the uncertainties as daunting and inducing the problems they are so concerned to avoid.

Cooperation and Recommendations

In my view the legal uncertainties concerning repurchase agreements have added substantially to the concerns of market participants. Although some of these participants view the uncertainties as desirable in providing a set of available "options," for others to consider, I find that this view is shortsighted for at least three reasons.

First, due to the uncertainties involved, the results obtained in a given proceeding might be completely contrary to the objectives of the particular "options" employed. Second, the diversity of available strategic options for all participants makes it very difficult for any market participant to predict the behavior of other participants.

Third, the existence of a "hair trigger" mentality among at least some participants leads to the possibility that bankruptcies might be induced which otherwise would not have occurred and which might lead to financial problems for previously solvent counterparts of the bankrupt firms. It is crucial that a process be established, in the immediate future which will result in resolution of the legal uncertainties in the repo market. I believe that the best approach to this stage is for Congress to hold comprehensive hearings on the implications of the Drysdale affair and, in particular, on the application of the code and related laws to the repo market.

The hearings would provide a public forum for consideration of various approaches to the problem, including amendments to the bankruptcy code, amendments to state uniform commercial codes, adoption of preemptive federal regulations along the lines of the federal bank entry securities regulations, modifications of the bankruptcy code, and formation of a regulatory organization for dealers. I also believe that the Federal Reserve should form a broad-based advisory committee to consider the issues raised at the hearings as they might affect the rational economic policy objectives of the Federal Reserve. The advisory committee would provide an ongoing framework for solving the
various proposed approaches into a coherent solution consistent with those policy objectives. Congressional hearings and the advisory committee would establish a firm basis for resolving the issues raised by Drysdale. Unless action on these issues is taken soon, it is likely that all of the intensive and valuable effort which has recently been expended by market participants and regulators will be wasted and that nothing of real value will be done until the next and quite possible far more serious crisis occurs.
Mr. Donald P. Tucker  
Chief Economist  
Commerce, Consumer and Monetary  
Affairs Subcommittee  
B377 Rayburn Building  
Washington, D.C. 20515  

Dear Don:

The technical amendments to the Bankruptcy Code (the "Code") which were signed into law on July 27, 1982 (the "Amendments") are of considerable value in reducing the likelihood that a "ripple effect" would follow an insolvency in the securities or commodities industries. The Amendments clarify the treatment of repo and reverse repo transactions, however, only to a limited extent. As you suggested during our recent discussion, in this letter I will briefly describe the major effects of the Amendments on the matters discussed in Tom Russo's July 20, 1982 letter to Representative Rosenthal (the "Russo Letter").

Bills containing provisions substantially similar to the Amendments were passed by both Houses in the last Congress, but failed to become law due to differences between the two Houses concerning the retirement system for bankruptcy judges. Although H.R. 4935, the bill which became the Amendments, was resurrected and passed in response to concerns over such matters as the Drysdale failure, the Amendments do not reflect specific consideration of the treatment of repos.
No Change in Loan or Executory Contract

The Amendments do not resolve the central issue under the Code concerning repos, which is whether they will be treated as secured loans or as involving executory contracts. The Amendments add to the Code the significant new term "securities contract," which is defined as follows:

"Securities contract" means contract for the purchase sale or loan of a security, including an option for the purchase or sale of a security or the guarantee of any settlement of cash of securities by or to a securities clearing agency. (Emphasis supplied)

If repos and reverse repos are characterized, for purposes of the Code, as completed sales or purchases of securities, respectively, and independent executory contracts to resell the securities, then these executory contracts would be "securities contracts," as defined above.

On the other hand, if repo transactions are characterized, for purposes of the Code, as secured loans, they will not be securities contracts, since they involve loans of funds and not loans of securities. A repo from a dealer to a bank, for example, is a loan of funds from the bank to the dealer on which the dealer pays interest, not a loan of securities from the dealer to the bank on which the bank pays interest. The securities in repo and reverse repo transactions thus are not themselves loaned, but rather serve as collateral security for obligations to repay loans of funds.

Setoff, Liquidation and Margin

The major changes made by the Amendments which concern repos relate to setoff, liquidation of securities contracts and protection of margin payments, but these provisions probably will be of substantial importance to repo market participants only if repos are characterized as involving executory "securities contracts." If repos are so
characterized, the provisions in the Amendments concerning setoff and liquidation will be helpful to commodity brokers, forward contract merchants, stockbrokers and securities clearing agencies (collectively, "Covered Firms"), but not to government securities dealers which are not "stockbrokers" or "forward contract merchants," or to banks, money market funds or other market participants (collectively, "Uncovered Firms"). If repos are characterized as secured loans, the provisions concerning setoff and liquidation will not apply since no securities contracts will be involved. Regardless of which characterization of repos is adopted, the provisions in the Amendments concerning margin will be helpful to Covered Firms, and possibly to Uncovered Firms.

The new setoff provision revises an exception to the automatic stay and expands the actions which a Covered Firm may take after the filing of a petition. The new provision generally permits a Covered Firm to set off a claim against a debtor for a margin payment under a commodity contract, forward contract or securities contract (collectively, a "Covered Contract") against property of the debtor held by the Covered Firm to margin, guarantee or secure a Covered Contract. If repos were characterized as involving executory securities contracts, the setoff provision would be helpful to a Covered Firm which had made a margin call prior to the filing of a petition by a debtor. The setoff provision in effect before passage of the Amendments probably would not have been available in the repo context.

The Amendments include new provisions expressly preserving the ability of Covered Firms to liquidate open Covered Contracts of a debtor pursuant to contractual rights, which are, in general, triggered by the insolvency of the debtor. The exercise of such contractual rights was not specifically allowed under pre-existing law, and the new provision would be very helpful to Covered Firms if repos are determined to involve executory contracts. Moreover, the new provision preserving contractual rights to liquidate open positions will probably have practical significance for repo market participants even though the characterization of repos as loans or
executory contracts remains unclear. Since at least some courts and governmental agencies have concluded that repos involve executory contracts, it is likely that many repo market participants will conclude that in most or all cases they should exercise their contractual rights to liquidate the open repo positions of a debtor immediately upon the filing of a petition by the debtor in an attempt to forestall additional losses on the positions. This strategy would be risky, however, if the law became clear that repos were secured loans for purposes of the Code.

The Amendments include provisions which protect a margin payment on a Covered Contract made by or to a Covered Firm from being set aside by a trustee except where the recipient of the payment did not take it in good faith. These provisions would benefit Covered Firms and also Uncovered Firms, which might receive margin payments from or make margin payments to Covered Firms, if repos were determined to involve executory securities contracts.

The margin provisions might be helpful to repo market participants even if repos were characterized as loans. The term "margin payment" is defined as follows:

"Margin payment" means payment or deposit of cash, a security, or other property, that is commonly known to the securities trade as original margin, or variation margin, or as a mark-to-market payment, or that secures an obligation of a participant in a securities clearing agency.

This definition does not depend on the existence of a securities contract and should include the securities and any additional collateral given to secure performance in a repo characterized as a secured loan. Thus the trustee should not be able to set aside the margin payments except where they were not taken in good faith.
The other matters raised in the Russo Letter are largely unaffected by the Amendments. Thus, a variety of laws other than the Code, as amended, may apply to the insolvency of a market participant, repo dealers may be eligible to reorganize and may attempt to take advantage of the Code's provisions concerning post-petition interest, the security position of dealers running "matched books" is unclear, and there is in general a strong incentive for market participants to take pre-petition action against troubled firms. In light of these uncertainties, and those discussed above relating to the Amendments, there continues to be a substantial need for clarification of the legal status of repos.

Very truly yours,

John W. Osborn

JWO:st
August 9, 1982

Michael Bradfield, Esq.
General Counsel
Board of Governors,
Federal Reserve System
Washington, D.C. 20551

Dear Mr. Bradfield:

As he mentioned in his August 6, 1982 letter, Tom Russo is out of the office on vacation and he has asked me to assemble and furnish to you and Robert Plotkin cases confirming the equivocal status of repo transactions. Enclosed please find copies of the following cases:

3. In re Financial Corporation, Bankrupt, Case Nos. 79-0544 (U.S.D.C. W.D. Mo. 1979) and 80-1050, 634 F.2d 404 (8th Cir. 1980).
4. Gilmore v. State Board of Administration of Florida, Case Nos. 78-2179 (including a portion of the defendant's brief) (Circuit Court of the Second Judicial District, Florida 1979) and FR-134 (District Court of Appeals, First District, Florida 1980).
Michael Bradfield, Esq.  
August 9, 1982


Cases 1 and 2 consider repos to be loans and cases 3 and 4 consider them to be sales and repurchases. Case 5 is one of a number of cases considering certain municipal bond transactions involving repurchases to be loans, and cases 6 and 7 discuss repos and appear to assume that they are sales and repurchases.

The enclosed cases are not an exhaustive collection of the cases which discuss repos, but I think they are a fair indication of the uncertainty which exists concerning the characterization of repos. Moreover, various administrative positions of the SEC, the Comptroller of the Currency, the Federal Reserve, the IRS and the state agencies active in the repo market, although not binding in the bankruptcy context, serve to confirm this uncertainty.

I hope that the enclosed cases are helpful, and that you will not hesitate to contact Tom (when he returns) or me if we may be of any further assistance.

Very truly yours,

JNO/hlw

John W. Osborn

Enclosures
### Appendix C: Daily report of dealers

**DAILY REPORT OF DEALER POSITIONS**

*Par value; in millions of dollars to one decimal*

<table>
<thead>
<tr>
<th>SECURITY TYPE</th>
<th>IMMEDIATE POSITION</th>
<th>NET POSITION</th>
<th>NET FORWARD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GROSS LONG</td>
<td>GROSS SHORT</td>
<td>NET</td>
</tr>
<tr>
<td>U.S. GOVERNMENT SECURITIES</td>
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<tr>
<td>FEDERAL AGENCY SECURITIES</td>
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<tr>
<td>OTHER MONEY MARKET SECURITIES</td>
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</table>

**TOTAL** (sum of above) | | | |

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*Includes the following securities that were sold after having been obtained under reverse repurchase agreements which reoffered on this same day as the securities.*

<table>
<thead>
<tr>
<th>SECURITY TYPE</th>
<th>IMMEDIATE POSITION</th>
<th>NET POSITION</th>
<th>NET FORWARD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GROSS LONG</td>
<td>GROSS SHORT</td>
<td>NET</td>
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<tr>
<td><strong>TOTAL</strong> (sum of above)</td>
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</tr>
</tbody>
</table>

*Digitized for FRASER*

Federal Reserve Bank of St. Louis

A. POSITIONS

SPECIFIC INSTRUCTIONS

1. Memorandum and option positions should report only positions of all accounts of the firm, including the individual bank department. Nonbank dealers should report on the basis of all accounts of the firm. Aims when the positions are netted against each other, not by individual bank department. All positions should be netted against each other, not by individual bank department.

2. Figures should be reported in terms of par value expressed in millions of dollars rounded to one decimal. For example, $20,756,500 should be reported as $20.8M.

3. The report should be submitted as soon as the Market Services Division at the Federal Reserve Bank of New York by 10 A.M. of the following business day.

GENERAL INSTRUCTIONS

1. Memo. to the FLS New York Division:

   1. The Federal Reserve System regards the individual dealer information provided by each respondent as confidential. If it should be determined subsequently that any information collected on this form must be authorized by law (12 U.S.C. 248a and 12 U.S.C. 248e), your voluntary cooperation in submitting and reporting, for the purpose of this report, is needed to make the results comprehensive, accurate, and timely.

2. Options for the purpose of this report are call options, i.e., the owner of the option has the right to purchase a security at a specified time in the future at a specified price (i.e., the strike price). A dealer who has sold an option under which a customer may purchase securities is in the money if the strike price is lower than the market price of the security. When immediate positions reflect sales of securities obtained under reverse repurchase agreements which mature on the same day as the reporting date, the amount of securities should be deducted in the income statement. However, the positions should be included in the net forward positions of the dealer.

3. Options on mortgage-backed securities on which the owner has the right to purchase securities at a specified price (i.e., the strike price) before the maturity date of the security. These positions should be reflected in the immediate position.
**Daily Report of Dealer Transactions**

*(Par value; in millions of dollars to one decimal)*

**FR 2004B**

OMB NO. 055-R-0205

Approved by Federal Reserve Board and OMB February 1980

Approval Expires June 1983

**MARKET REPORT**

MARKET REPORT DIVISION, NEW YORK, FEDERAL RESERVE BANK OF NEW YORK, WITHIN TWO BUSINESS DAYS AFTER THE TRADING DAY.

**REPORTING DEALERS**

TRANSACTIONS FOR IMMEDIATE DELIVERY

ALL OTHERS

**TREASURY BILLS**

15

**MARKET REPORT**

MARKET REPORT DIVISION, NEW YORK, FEDERAL RESERVE BANK OF NEW YORK, WITHIN TWO BUSINESS DAYS AFTER THE TRADING DAY.

**REPORTING DEALERS**

TRANSACTIONS FOR IMMEDIATE DELIVERY

ALL OTHERS

**TREASURY BILLS**

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**REPORTING DEALERS**

TRANSACTIONS FOR IMMEDIATE DELIVERY

ALL OTHERS

**TREASURY BILLS**

15
"THIS REPORT IS AUTHORIZED BY LAW (12 U. S. C. 248 (A) AND 12 U. S. C. 248 (I). YOUR VOLUNTARY COOPERATION IN SUBMITTING THIS REPORT IS NEEDED TO MAKE THE RESULTS COMPREHENSIVE, ACCURATE, AND TIMELY."

"THE FEDERAL RESERVE SYSTEM REGARDS THE INDIVIDUAL DEALER INFORMATION PROVIDED BY EACH RESPONDENT AS CONFIDENTIAL. IF IT SHOULD BE DETERMINED SUBSEQUENTLY THAT ANY INFORMATION COLLECTED ON THIS FORM MUST BE RELEASED, RESPONDENTS WILL BE NOTIFIED."

General Instructions
1. Nonbank dealers should report all market transactions of the entire firm. Bank dealers should report only transactions of the dealer department, which may include dealer department transactions with nondealer accounts of the bank, such as investment and trust accounts.
2. Figures should be reported in par value in millions of dollars rounded to one decimal. For example, $20,693,000 should be reported as $20.7.
3. This report should be delivered to the Domestic Reports Division, Federal Reserve Bank of New York, within two business days after the reporting date.

Specific Instructions
A. DELIVERY BASIS:
1. Immediate:
   All purchases and sales of securities (other than mortgage-backed agency securities) for which delivery is scheduled for five business days or less should be reported as transactions for immediate delivery. "When-issued" trades in U.S. Government securities which occur between an announcement and issue date should also be reported, even though delivery is scheduled for more than five business days from the date of the trade. Report as immediate transactions purchases and sales of mortgage-backed agency securities if the transaction is scheduled to settle in 30 days or less.
2. Forward:
   Forward transactions should reflect agreements arranged in the over-the-counter market in which securities other than mortgage-backed agency securities are purchased or sold for delivery after five business days from the date of the trade. Securities purchased (sold) on a "when-issued" basis prior to the date on which the offering is anticipated should also be reported as forward transactions. (However, "when-issued" trades in U.S. Government securities that occur between announcement and issue date should not be reported as forward transactions, since delivery is scheduled for more than five business days from the date of trade.) Forward transactions in mortgage-backed securities are those which call for delivery in 31 or more days.
3. Futures:
   Futures transactions should include standardized agreements that are arranged on an organized exchange in which parties commit to purchase or sell securities for delivery on a future date. All transactions in futures contracts should be reported in the futures column even if the delivery is scheduled for less than five business days.

B. REPORTING CATEGORIES:
1. Dealers in U.S. Government Securities. Report trades with other dealers (including the dealer departments of banks) that report to the Domestic Reports Division of the Federal Reserve Bank of New York. If the dealer is a department of a bank, report in this column only transactions with the dealer department. A list of the reporting dealers may be obtained from the Division.
3. All Other. Report trades with all customers (including the Federal Reserve) other than those in B.1 and B.2 above.

C. MISCELLANEOUS:
1. Domestic Certificates of Deposit are dollar-denominated obligations of banks and banking offices payable in the United States.
2. Foreign Certificates of Deposit are dollar-denominated obligations of banks and banking offices payable outside the United States.
3. Transactions should be reported gross. Do not net.
4. Exclude all transactions under repurchase agreements and reverse repurchase agreements.
5. Do not record allotments, redemptions, exchanges, or securities purchased from the Treasury for customers.
6. Cancellations and corrections. Purchase and sale tickets written to cancel or correct prior trades should be reported on Schedule B only to the extent they affect the par amounts of previously reported transactions. For example, the correction of a previously reported sale of $1.0 million to $0.1 million should reduce today's sales by $0.9 million. Do not correct by reporting a purchase of $0.9 million. Similarly, a $1.0 million sale previously reported as a purchase should reduce today's purchases by $1.0 million and increase today's sales by the same amount. (Negative sales or purchases on any day may thereby be reported.)
7. Odd-lot transactions. Transactions of less than $25,000 may be included either with "Other" customers or in their proper customer category.
**WEEKLY REPORT OF DEALER FINANCING**

This report is held by law (12 U.S.C. 248 (A) and 12 U.S.C. 248 (I)). Your voluntary cooperation in submitting this report is needed to make the results comprehensive, accurate, and timely.

The Federal Reserve System regards the individual dealer information provided by each respondent as confidential. If it should be determined subsequently that any information collected on this form must be released, respondents will be notified.

**SCHEDULE C**

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<tr>
<th>Type of Financing</th>
<th>Overnight and Continuing Contracts</th>
<th>Reverses Repurchase Agreements</th>
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<td>WITH ALL OTHERS</td>
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<td>COLLABORATIVE LOANS</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**INSTRUCTIONS**

**I - SCOPE**

This report covers the outstanding balance of borrowings and lendings of reporting government securities dealers as of the close of business each Wednesday. All financings involving U.S. Government and Federal agency securities, negotiable certificates of deposit, bankers' acceptances, and commercial paper should be included. Bank dealers should only report those financings of the dealer department of the bank, including those arranged with nondealer accounts of the bank, such as investment and trust accounts.

**II - HOW AND WHEN TO REPORT**

All data should be reported on a "gross" basis - that is, borrowings should not be netted against loans made by the dealer, and loans should not be netted against borrowings. Amounts reported on this schedule should be in terms of "principal" value, i.e., actual funds, paid or received. All amounts should be reported in millions of dollars to one decimal as of the close of business each Wednesday (or the preceding business day if Wednesday is a holiday) and delivered to the Domestic Reports Division of the Federal Reserve Bank of New York on the first business day of the following calendar week.

**A - MATURITY**

Borrowings and loans are to be reported by maturity category. Those items reported in Column 1 have an original maturity of one business day or continuing contract (as defined below), and those reported in Columns 2 and 3 have an original maturity greater than one day, as defined below:

- **Overnight** - Overnight borrowings are defined as:
  - Those made on one business day and maturing on the next business day, or
  - Those made on Friday to mature on Monday, or
  - Those made on the last business day prior to a holiday for either or both parties to the transaction that mature on the first business day after the holiday.

- **Continuing Contract** - A continuing contract is defined as an agreement that:
  - Requires a cash deposit in excess of the original maturity of the business day but has no specific maturity, and
  - Does not require advance notice by the lender or the borrower.
INSTRUCTIONS (continued)

Lines 3 & 4: Collateralized loans are borrowings secured by pledging U.S. Government and Federal agency securities (including obligations that are fully guaranteed as to principal and interest by the U.S. Government or a Federal agency), negotiable certificates of deposit, bankers' acceptances and commercial paper entered into with any entity, whenever issued. Include those reverse repurchase agreements that are matched, i.e., in which the dealer agrees to buy back the securities at a later date (i.e., R/P due bills). Include R/P due bills in the "Overnight or Continuing Contract" maturity category; others should be included in the "Term Agreements" maturity category.

Lines 8 & 9: Include due bills which the dealer agrees to buy back on a specified future date (or within a specified time). Report all reverse repurchase agreements involving U.S. Government and Federal agency securities (including obligations that are fully guaranteed as to principal and interest by the U.S. Government or a Federal agency), negotiable certificates of deposit, bankers' acceptances and commercial paper entered into with any entity, whenever issued. Include those transactions arranged in most cases to profit from the difference between the price at which the dealer purchased the securities and the price at which the dealer agrees to buy them back on a later date (i.e., R/P due bills). Include R/P due bills in the "Overnight or Continuing Contract" maturity category; others should be included in the "Term Agreements" maturity category.

Lines 10, 11: Matched book primarily includes transactions in which a dealer acquires a security on a reverse repurchase agreement specifically to place it with a customer including the Federal Reserve with the agreement to buy back on a specified future date (or within a specified time). Report all reverse repurchase agreements involving U.S. Government and Federal agency securities (including obligations that are fully guaranteed as to principal and interest by the U.S. Government or a Federal agency), negotiable certificates of deposit, bankers' acceptances and commercial paper entered into with any entity, whenever issued. Include those transactions arranged in most cases to profit from the difference between the price at which the dealer purchased the securities and the price at which the dealer agrees to buy them back on a later date (i.e., R/P due bills). Include R/P due bills in the "Overnight or Continuing Contract" maturity category; others should be included in the "Term Agreements" maturity category.

Report in line 8 the principal value of reverse repurchase agreements, due bills or collateralized loans in which a dealer acquires a security on a reverse repurchase agreement specifically to place it with a customer including the Federal Reserve with the agreement to buy back on a specified future date (or within a specified time). Report all reverse repurchase agreements involving U.S. Government and Federal agency securities (including obligations that are fully guaranteed as to principal and interest by the U.S. Government or a Federal agency), negotiable certificates of deposit, bankers' acceptances and commercial paper entered into with any entity, whenever issued. Include those transactions arranged in most cases to profit from the difference between the price at which the dealer purchased the securities and the price at which the dealer agrees to buy them back on a later date (i.e., R/P due bills). Include R/P due bills in the "Overnight or Continuing Contract" maturity category; others should be included in the "Term Agreements" maturity category.
THE FEDERAL RESERVE SYSTEM REGARDS THE INDIVIDUAL DEALER INFORMATION RESPONDENT AS CONFIDENTIAL. IF IT SHOULD BE DETERMINED SUBSEQUENTLY THAT DATA COLLECTED ON THIS FORM MUST BE RELEASED, RESPONDENTS WILL BE NOTIFIED.

Domestic Reports Division, Federal Reserve Bank of New York. This report should be submitted semi-monthly, to reflect positions on the second Wednesday of each month (or the previous day if a holiday) and the last business day of each month. It should be returned within two business days after the trading date.

<table>
<thead>
<tr>
<th>TYPE OF SECURITY</th>
<th>DUE 30 DAYS OR LESS</th>
<th>DUE IN 31-120 DAYS</th>
<th>DUE AFTER 120 DAYS</th>
<th>TOTAL</th>
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<td>TOTAL</td>
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</table>

| TOTAL            |                      |                     |                   |       |

<table>
<thead>
<tr>
<th>TYPE OF SECURITY</th>
<th>DUE 30 DAYS OR LESS</th>
<th>DUE IN 31-120 DAYS</th>
<th>DUE AFTER 120 DAYS</th>
<th>TOTAL</th>
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<td>OUT OF THE MONEY</td>
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<td>FORWARDS</td>
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<tr>
<td>OUT OF THE MONEY</td>
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</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
SCHEDULE D
Instructions

1. Futures contracts are standardized agreements arranged on an organized exchange in which parties commit to purchase (sell) securities for delivery at a future date. All positions in futures contracts should be reported on this schedule, even if a contract is acquired that calls for delivery of securities within five business days from the date of acquisition. The maturity of the contract, and not the underlying security, should be reported in this schedule. Contracts should be netted only in the case in which they specify delivery of the same securities on the same date and have been obtained on the same exchange. When futures contracts are settled by actual delivery of securities, the delivery should be reflected in positions on Schedule A.

2. Forward contracts are agreements arranged in the over-the-counter market in which securities are purchased (sold) for delivery after five business days from the date of the transaction. Do not report mortgage-backed securities if settlement was scheduled to occur in 30 days or less. “When-issued” trading after an offering is announced is not considered a forward contract for the purpose of this report. The maturity of the commitment, and not of the underlying security, should be reported in this schedule. A forward contract to purchase a given amount of a security should not be netted against a forward contract to sell the same amount of the security, except in the case when both contracts are with the same customer and have the same delivery date. Forward commitments should continue to be reported on Schedule D until the settlement day.

3. Standbys for the purpose of this report are put options, i.e., the purchaser of the standby has the right to sell a security at a specified time and price. A dealer who is obligated to buy a security under a standby contract, for which he has received a fee, should report a standby to purchase (long position). A dealer who has paid a customer for the right to sell securities under a standby contract should report a standby to sell (short position).

4. Options for the purpose of this report are call options, i.e., the owner of the option has the right to purchase a security at a specified time and price. A dealer who has acquired an option under which the dealer may purchase a security should report an option to buy (long position). A dealer who has sold an option under which a customer may purchase a security from the dealer should report an option to sell (short position).

5. This report should be submitted semimonthly to reflect positions on the second Wednesday of each month (or the previous day if a holiday) and the last business day of each month. The report should be delivered to the Domestic Reports Division, Federal Reserve Bank of New York within two business days after the trading date.