Exchange Act of 1934, to bring entities directly involved in the government securities market under regulatory control for the first time. The bill, entitled the “Government Securities Rulemaking Board Act of 1985,” would require all government securities dealers to register with the SEC, although the Federal Reserve and the SEC would have authority to exempt certain dealers. Congress apparently believes that registration ultimately would provide a device for enforcement of the bill and would provide tools for keeping government securities dealers from trading if they previously were involved in fraud, or if they violated any other provisions of the bill.

The bill would establish a self-regulatory organization called the Government Securities Rulemaking Board (GSRB), which would fall under Federal Reserve oversight. The GSRB would have only rule-making authority and would have no enforcement powers. Under the bill, the GSRB would have five months to adopt rules in specific areas involved in the recent failures of government securities dealers. The GSRB would adopt rules for capital requirements andrepo transactions, and would improve the transfer and control of securities under repo agreements. However, the GSRB would consider the possible impact that any of its rules might have on the liquidity of the RF market.

In addition, the GSRB would adopt rules for reporting and recordkeeping, including requirements for filing financial statements and for maintaining appropriate accounting standards. No other rules could be submitted until the mandatory rules, mentioned above, were adopted and until there was sufficient experience with the new rules. In addition to the GSRB’s rules, the Federal Reserve would have authority to set rules for margin requirements and for when-issued trading.

The bill was designed to use existing agencies for inspections and enforcement of the GSRB’s rules to minimize the cost of regulation. Primary enforcement authority would be given to the SEC because it already has primary responsibility for enforcing the 1934 Act. The bank regulatory agencies would be given primary inspection and enforcement authority over government securities dealers that are banks. Compliance by nonbank brokers and dealers would be enforced by the self-regulatory organizations (the NASD for nonbank dealers) already in existence.

In addition to the House-passed bill, Senator Alfonse D’Amato (R-NY) introduced a bill in 1985 that is similar to the current legislation. The only substantive difference is the bill would not create a new rule-making authority. Also, the Treasury Department has submitted a proposal to Congress, yet to be introduced, that would give the Treasury rule-making authority without establishing a self-regulatory agency.

Conclusions

Recent proposals to regulate the government securities market seek to prevent some of the problems that led to the failures of secondary government securities dealers. However, such regulation would only provide additional safeguards that prudent investors already can use. No amount of regulation can prevent fraud completely. Many of the losses that resulted from unregulated, undercapitalized dealers were due to investors’ carelessness and to misplaced trust.

The GSRB must complement any legislation that might be passed with their own common sense, and should closely scrutinize the brokers and dealers they trade with in order to make sure their interests are adequately protected.

The failure of several unregulated government securities dealers since 1982 has led to pressure for at least minimum regulation of this market.

According to some estimates, the failure of one of just two government securities firms, E.S.M. Government Securities Inc. (ESM) and Bevill, Bresler and Schulman Asset Management Corp., caused losses of over $500 million to those who dealt directly with the dealers. The losses also were directly related to investors who never transacted business with ESM, including taxpayers of municipalities such as Toledo, Ohio. The failure of ESM also produced a temporary decline in the foreign exchange value of the dollar, led to the temporary closing of 70 privately insured savings and loan associations in Ohio, and contributed to a substantial loss of confidence in private deposit insurance systems in other states.

The issues and problems raised by calls for new laws to regulate the market are worth examining because the government securities market, where an estimated $225 billion worth of transactions occur per day, plays a key role in our economy. The market, for example, provides liquidity to our domestic banking system. Government securities—that is, the bills, notes, and bonds that are IOUs of the Treasury or of other government agencies—can be sold to banks to raise cash. The market is also important to fiscal policy because the federal government uses the sale of securities to finance budget deficits and to meet seasonal shortfalls between receipts and expenditures.

Finally, the market also is used by the Federal Reserve Bank of New York (FRBNY) to implement the Federal Reserve’s monetary policy. The New York bank, through its trading desk, influences the nation’s supply of bank reserves by buying or selling large amounts of government securities.

Proposed legislation would bring the market under closer regulation in an effort to prevent future failures of government securities firms that could have repercussions throughout the financial system and that could inhibit the conduct of domestic monetary and fiscal policies.

This Economic Commentary examines the participants in the government securities market, and discusses the desirability of minimum regulation, the importance of avoiding excessive regulation, and recent proposals to regulate the market.

Participants

Besides investors, participants in the government securities market include the Treasury Department, the Federal Reserve System, and primary and secondary dealers.

The Treasury Department, through its fiscal agent, the Federal Reserve Bank of New York, sells government securities at competitive auctions. Most of the trading in government securities is done by government securities dealers who are individuals or corporations who trade government securities for their own account.

Primary dealers are those with whom the FRBNY is willing to deal when conducting the Federal Reserve’s monetary policy. Currently, there are 36 primary dealers who are so designated if they meet certain criteria outlined by the Federal Reserve Bank of New York.

Despite the lack of express statutory authority, the FRBNY oversees primary dealers, who must submit daily, monthly, and annual reports showing their transactions, positions, and capital.

In addition to the primary dealers, it is estimated that there are 400 to 500 secondary dealers in the market. The exact number is unknown because there is no strict definition of a government securities dealer, and no requirements for federal registration. However, secondary dealers are important to the market’s liquidity—that is, they increase the ability of investors to buy and sell government securities—because they act as a sales force and as financial agents for the primary dealers. Secondary dealers also trade with investors who don’t buy large enough quantities of securities to deal with the primary dealers.

Secondary dealers contact municipal treasurers and other institutions with readily available cash in order to borrow to finance their positions (inventories of securities), and they may act as intermediaries in arranging financing for the primary dealers. Many secondary dealers obtain financing for primary dealers through repurchase agreements (repos or RPs), but never hold

1. For a complete description of the criteria used by the Federal Reserve in designating primary dealers, see Statement of E. Gerald Corrigan, President, Federal Reserve Bank of New York, before the Committee on Banking, Finance and Housing, and Monetary Affairs of the House Committee on Government Operations, May 15, 1985.

9. When-issued trading is the secondary market trading of new Treasury securities between the time of announcement of the new securities by the Treasury and the subsequent day the securities actually are issued.

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James J. Balazsy, Jr. is a research assistant at the Federal Reserve Bank of Cleveland. The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

James J. Balazsy, Jr. is a research assistant at the Federal Reserve Bank of Cleveland. The author would like to thank Walter Todd, Mark Sanderlin, Owen Humphage, Robert Jagay, and James Boughaballah for their helpful comments. The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.
The absence of capital or margin requirements for dealers who trade only government securities eliminates one of the reasons why government securities operations are included within otherwise regulated banking activity. For example, when Drysdale Government Securities Inc. marked to market $65 billion of government securities with a capital base of only $20 million, which reduced the capitalization of the firm to about 720 million in interest payments owed on the borrowed securities.4

The absence of margin requirements permits the firm to build up significant inventories of government securities with collateral that is mostly borrowed funds. This practice may encourage the dealer to take excessive risks because, if losses are sustained, the dealer's creditors have proportionately more to lose than the dealer. Dealers may increase their inventories when they expect interest rates to fall and price risks to rise. However, inventories of government securities cannot be easily sold off because, if losses are sustained, the dealers' creditors have proportionately more to lose than the dealer. Dealers may increase their inventories when they expect interest rates to fall and price risks to rise. However, inventories of government securities cannot be easily sold off because custodians' fees, reflecting actual delivery of collateral, would in some cases be paid by the dealer.

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The absence of capital or margin requirements for dealers who trade only government securities eliminates one of the market's most dangerous risks, namely fraud. In an atmosphere of tight capital market regulations, market participants, including the government, engage in speculative behavior and risk appetites that would not be contained in a market that was not subject to such constraints. When speculative investors enter the market and their liquid capital is exhausted, the market swings to the other extreme. Dealers engage in high-risk transactions, often losing large amounts of capital and causing significant damage to the market. The absence of capital or margin requirements makes it possible for dealers to trade in risky, speculative transactions without losing significant capital. This can result in significant losses for the government and other market participants, as well as for the government's ability to manage its debt.

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