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The Government Securities Market and Proposed Regulation

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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 failures in 1985 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 them. Losses also were sustained indirectly by individuals 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 subsequent loss of confidence in private deposit insurance systems in other states.

The problems and issues 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 by 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.[1]

Despite the lack of express statutory authority, the FRBNY oversees the 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

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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 Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations, May 15, 1985.

inventories in the securities covered by the repos.[2] Without the secondary dealers, primary dealers and, hence, the Federal Reserve and the Treasury, would not be able to dispose of large amounts of new securities without disrupting the market.

Despite the importance of the government securities market, it has been one of the least-regulated markets. Brokers and dealers (except for banks) who trade *nonexempt* securities, which now include principally corporate securities and municipal revenue bonds, fall under a system of regulation enforced by the Securities and Exchange Commission (SEC) as provided by the Securities Exchange Act of 1934.[3]

Brokers and dealers registered with the SEC must follow requirements concerning capital, margin, professional qualifications, recordkeeping, reporting, surveillance, and financial responsibility that are designed to safeguard customer funds and securities.

The following securities are currently *exempted* from the 1934 Act: government and agency securities, bankers' acceptances, commercial paper, and certificates of deposit. Thus, whether or not a government securities dealer is regulated by the SEC depends on how the firm is organized. If it trades exempt and nonexempt securities within the same entity, the whole firm, including the government securities operations, is subject to SEC rules.

However, if the firm trades nonexempt and exempt securities via separate subsidiaries or affiliates, then the subsidiary escapes SEC oversight. Thus, brokers and dealers who separate their operations by type of securities dealings have greater flexibility, especially since they are not subject to the SEC's net capital or margin requirements. To illustrate the impact of the margin requirements on the financing of the firm, a dealer who buys corporate securities must deposit at least 50 percent on margin (in cash) when making a purchase because these securities are nonexempt. However, it is not unusual for firms trading exclusively in government securities to finance their positions using only 1 percent cash.

A majority of the estimated 400 to 500 secondary dealers already are subject to some level of regulation by the federal government because their government securities operations are included within otherwise regulated banking organizations, or within SEC-registered dealers. Dealers affiliated with banks, for example, are supervised by one of the three federal commercial banking regulators (the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency). While most government securities dealers are regulated through one of these channels, at least 100 avoid any type of federal regulation.

The Case for Regulation

Critics contend that a system of overall federal regulation would have prevented many of the problems associated with the recent failures of secondary government securities dealers.

One point made by critics is that there is a lack of registration requirements that essentially allows anyone to trade securities, even those who have previously committed fraud. The absence of formal reporting requirements and on-site examinations also has been criticized. Since dealers who specialize in government securities aren't required to file reports with a regulator and, if not publicly owned, don't have to submit to audits and inspections, it has been easy for a few of them to conceal fraud. While no degree of regulation can completely eliminate fraud, on-site examination could make it more difficult to conceal.

Many have argued, however, that additional regulation is not needed, since all securities dealers may be subject to Rule 10b-5 of the SEC, which prohibits fraud in any type of securities activity. However, under penal statutes and regulations, an offending dealer can be brought to justice only after fraud has occurred. Proposed legislation that would provide for reporting requirements and for on-site examinations seeks to reduce both the risk of fraud and the loss of confidence that failures of government securities dealers can cause.

The absence of capital or margin requirements for dealers who trade only government securities eliminates one of the safeguards against excessive risk in the capital markets. For example, when Drysdale Government Securities Inc. failed in 1982, it had borrowed \$6.5 billion of government securities with a capital base of only \$20 million, which was very small compared with the \$270 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 very little cash down, using 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 security prices to rise. However, if they guess wrong, sizable losses can be sustained by the dealers and their creditors. The proposed establishment of minimum capital and margin requirements supposedly would diminish such risks by providing a cushion against unfavorable movements in interest rates.

One of the most common problems in the recent government securities firm bankruptcies was the failure of market participants to adequately secure the government securities used as collateral in a repurchase or reverse repurchase transaction. The absence of a requirement for actual delivery of securities in a repo transaction makes it easy for a dishonest dealer to pledge the same securities as collateral for multiple transactions. While this increases the leverage of the dealer and the potential profits, it also increases the risk and the amount of loss that can be suffered when movements in interest rates don't meet the dealer's expectations.

Despite the possibilities of such abuses, requiring the actual transfer of government securities in a repo transaction would diminish the profitability of arranging some repos in small volume because custodians' fees, reflecting actual delivery of collateral, would increase. Thus, a requirement for actual delivery of collateral ultimately could harm the market by impairing some of

2. A repo is a transaction in which an agent holding securities can temporarily acquire funds by giving the other agent the securities, while simultaneously agreeing to repurchase them at a later date. In a reverse repo, the roles of the agents are reversed, with the first agent providing funds (buying securities), while the second agent sells securities, simultaneously agreeing to repurchase them.

3. The SEC delegates some of its supervisory responsibilities to the various stock exchanges and the National Association of Securities Dealers (NASD). Dealers that trade only municipal securities are regulated by the Municipal Securities Rule-Making Board.

4. See Government Securities Act of 1985, *Federal Banking Law Reports No. 1095,* Commerce Clearing House, Inc., September 27, 1985, p. 16.

its liquidity. In addition, such a requirement might be impractical in many circumstances and always would be time-consuming. Those parts of the government or government agency mortgage-backed securities market that do not yet have access to generally accepted book-entry delivery systems also would be impeded by such requirements.

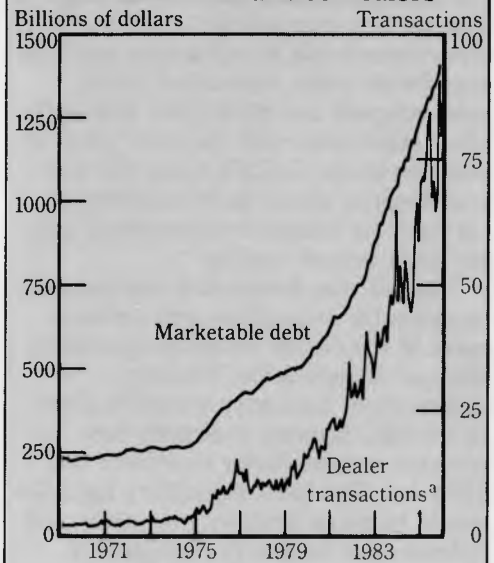
To avoid impairment of market liquidity, many have advocated requirements for segregating and designating the government securities for specific investors on the books of Federal Reserve Banks. Unfortunately, such activity by the Federal Reserve Banks would compete directly with services already offered by the private sector and would conceivably require completely new and greatly expanded computer capacities and telecommunications networks at Federal Reserve Banks, especially at the New York Federal Reserve Bank.

Recent developments have further increased pressures for regulation of the government securities market. The growth of government debt, and advances in communications and technology, have made it possible for hundreds of new government securities brokers and dealers to operate nationwide. The large federal budget deficits have made it necessary to market great amounts of new government debt. Currently about $1.4 trillion of marketable government debt is outstanding, and the Treasury has had to issue almost $200 billion of new marketable issues in the past two years to finance the deficit (see figure 1).

The volume of government securities trading will have to become even larger to accommodate expected future budget deficits. The Congressional Budget Office estimates the cumulative debt will reach $2.5 trillion by 1989.[5]

Another recent phenomenon, the increased variability of interest rates, has increased the market risk government securities dealers face. The risk to the creditors of government securities dealers in particular has increased because dealers can build up sizable inventories of securities without margin requirements, capital requirements, and the actual delivery of collateral in repo transactions.

Figure 1 Total Marketable Treasury Debt Outstanding and Transactions of Government Securities Dealers



a. Averages of daily figures.
SOURCE: Board of Governors of the Federal Reserve System.

Importance of Avoiding Excessive Regulation

Although the lack of regulation of the government securities market has allowed problems to go undetected for a long time, the ease with which new dealers can enter the market adds to the market's efficiency and liquidity. The large number of government securities brokers/dealers has permitted intense competition, allowing customers to trade at the best possible prices. The large amount of competition allows the spread between the price at which a dealer buys securities from a customer (bid) and the price at which the dealer is willing to sell (ask) to remain small. The typical bid-ask spread for a 3-month Treasury bill ranges from 2 to 4 basis points. (1 basis point is one-one hundredth of one percent.) For example, on December 31, 1985 the bid on the three-month Treasury bill was 7.03 percent, while the ask was 7.01 percent.

The market's competitiveness also reduces the Treasury Department's costs of issuing new debt, which ultimately benefits taxpayers. In addition, the large number of firms in the market allows both the Treasury to issue large amounts of securities and the Federal Reserve Bank of New York to conduct large monetary policy operations without significantly disrupting the market.

Care must be taken so that new regulation does not unduly restrict entry or cause firms to reduce their market activity. If overly burdensome regulation reduced market participation, it could increase the Treasury's costs of financing the budget deficit. It has been estimated that, if the Treasury's cost of borrowing increased by as few as 10 basis points as a result of regulation, the cost to the Treasury could be $2.2 billion over the life of the securities issued during the first year of such increased costs.[6]

Proponents of regulation, however, use a similar argument to support their cause. They argue that if activity in the government securities market is reduced, and if interest costs rise because of the lost confidence generated by failures of government securities firms, then there is a cost of not regulating the market. Thus, any regulation must maintain a delicate balance, ensuring that confidence will not be lost, while avoiding overly burdensome requirements.

The absence of formal regulation also permits unimpeded innovation in the government securities market. Market participants have developed many new trading techniques unheard of several years ago, such as development of the reverse market and the specific issues market that have made shorting easier and cheaper.[7] Also, the opening of futures and options trading has created many new strategies for investing and speculating in government securities (including increased arbitrage) that has attracted many new participants into the market. Any regulatory structure that is developed for the government securities market must take care not to inhibit useful market innovation.

Regulatory Proposals

On September 17, 1985, the U.S. House of Representatives passed a bill that would amend the Securities and

5. See Statement of Richard M. Kelly, Chairman of the Primary Dealers Committee of the Public Securities Association, before the Committee on Energy and Commerce, Subcommittee on Telecommunications, Consumer Protection and Finance of the U.S. House of Representatives, June 11, 1985, p. 5.

6. See Statement of Richard M. Kelly, p. 15.

7. When a dealer shorts the market, he makes a contract to sell a security he does not own for a certain price on some future date. To cover the short position when the contract expires, the dealer must either borrow the security or "reverse them in." In a reverse, the dealer obtains the shorted securities by purchasing them from an investor with an agreement by the investor to repurchase. The market for reverses

Exchange Act of 1934, to bring entities that deal exclusively in government securities under regulatory control for the first time. The bill, entitled the "Government Securities 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.[8] 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 and repo transactions, and would improve the transfer and control of securities under RP agreements. However, the GSRB would consider the possible impact that any of its rules might have on the liquidity of the RP 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.[9]

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 to enforce 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 and the exchanges). Thus, under the bill, all government securities brokers and nonbank dealers would be required to be members of organizations such as NASD or the exchanges.

In addition to the House-passed bill, Senator Alfonse D'Amato (R-NY) introduced a bill in 1985 that is similar to the House version. The only substantive difference is the bill would not establish a self-regulatory organization, but would give the Federal Reserve 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.

Thus, investors 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.

to cover shorts is referred to as the specific issues market because the dealer must find an investor holding a specific issue (security).

8. For a detailed summary of the bill, see Government Securities Act of 1985, *Federal Banking Law Reports No. 1095.*

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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