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# ECONOMIC COMMENTARY

## Seeking Safety

by E.J. Stevens

Investors seeking safety frequently purchase U.S. government securities. Nonetheless, some investors lost over $750 million operating in the government securities market within the past five years.

These losses were not incurred because the government repudiated its debt, of course, or even because of falling prices of outstanding government securities (in fact, prices were rising much of this time). Rather, losses arose from failures of securities firms with whom the investors were dealing. And out of the ensuing debate and calls for reform has come the Government Securities Act of 1986.[1]

What is notable about the Government Securities Act of 1986 is that it imposes federal regulation on institutions because they do business in the government securities market, rather than on only some institutions that happen to do business in that market. Until now, it was possible to go into business free of any federal securities market or financial institution regulation as long as the business was restricted to being a broker or dealer in exempt securities, principally U.S. government securities.[2]

The Securities Act of 1934 fathered Securities and Exchange Commission (SEC) regulation of participants in nonexempt securities markets, and the banking acts of the 1930's fathered modern deposit institution regulation. Together, these acts blanketed customers with a protective (some would say overprotective) layer of regulatory insulation. But the government securities market remained a unique area of unregulated financial business. Now, that exception is gone, and that is probably a good thing. It remains to be seen whether regulations can be effective in curbing abuses without being unduly cumbersome and damaging to market liquidity.

Many large, very active, well-regarded and prudently operated government securities brokers and dealers have been unregulated. Some are among the more than three dozen 'primary' dealers who report their trading and financing activity and securities positions daily to the Federal Reserve Bank of New York as a precondition for engaging in transactions with the Federal Reserve System Open Market Account. Factors precipitating the new legislation and regulations do not center on these firms, but on questionable practices—sometimes outright fraud—on the part of a small number of other unregulated government securities dealers.[3]

Without entering into a complete or detailed recital of the provisions of the proposed regulations required by the Government Securities Act of 1986, this *Economic Commentary* sketches key features protecting against troublesome past practices.

### The Government Securities Market

It comes as a shock to some people to find that investing in U.S. government-related securities might be risky. *Holding* a Treasury security to maturity may be the epitome of a riskless dollar-denominated fixed income investment. *Buying* and assuring that one actually comes to hold such a security, however, requires prudential buyer behavior, particularly when transactions are arranged by telephone and, as likely as not, sold out again before any documentation is exchanged. Moreover, in the case of derivative instruments such as repurchase agreements, as well as futures and options, safety may not depend so much on the creditworthiness of the federal government as on the integrity and creditworthiness of the counterparty with whom a transaction takes place.[4] [See box 1]

An investor subscribing to a new issue or redeeming a maturing Treasury security can always deal directly with the Treasury via its fiscal agent, the Federal Reserve Banks. Other than that, however, the government securities "market" is an over-the-counter market created by a large number of brokers and dealers who operate independently, rather than within the rules of an organized exchange such as the New York Stock Exchange.

Perhaps the best way to characterize the government securities market is by analogy. Government securities dealers are like used-car dealers, holding inventories and standing ready to buy for and sell from that inventory. Similarly, government securities brokers might be likened to real-estate brokers, seeking to bring buyer and seller together.

The universe of all government securities brokers and dealers has included three types: 1) brokers or dealers registered with the SEC to do business in nonexempt securities, and also

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1. The Government Securities Act of 1986, enacted last October, is in the process of being implemented. Treasury Department-proposed regulations under the Act (Federal Register Vol. 52, No. 36-37) were issued on February 25, with comments due by March 27, and final regulations to be effective on July 25 of this year. These new regulations concern, "... the financial responsibility, protection of investor securities and funds, recordkeeping, reporting and audit of brokers and dealers in government securities" ... as well as ... "the custody of government securities held by financial institutions that are not government securities brokers and dealers."

**Box 1**
**Repurchase Agreements**

Repurchase agreements are temporary transactions consisting of the sale of a security and a promise to "repurchase" it. The timing on the purchase promise varies. A repurchase agreement is a method of investing money overnight, or for a specified number of days. The "purchased" securities are used as "collateral" to guarantee the safety of the invested funds. The party offering to sell securities and then buy them back later is making a repurchase agreement, also referred to as repo or RP. The other party, which is offering to provide money to purchase those securities and receive the funds back later (plus interest), is making a reverse repurchase agreement, sometimes shortened to reverse repo or RRP.

Extracted from: "Repurchase Agreements," Public Information Department, Federal Reserve Bank of Cleveland [1985].

doing a government securities business; 2) financial institutions, notably commercial banks, that are themselves (as opposed to affiliates) government security brokers or dealers; 3) previously unregistered, unregulated brokers and dealers with a business restricted to government securities. It is this third group that will be affected most substantially by the new Act, as well as all parties to repurchase agreements involving government securities.

Who or what is a government securities broker or dealer? For example, both individuals and large institutions such as pension funds, actively manage their own portfolios of government securities. Do their purchases and sales make them dealers? With no organized exchange in which membership would define an intention to make, rather than merely make use of, a market, what should be the criterion?

One of the major accomplishments of the 1986 Act (and regulations proposed to implement the Act) is to define a boundary beyond which involvement in government securities *does not* make one a government securities broker or dealer. These excluded cases involve institutions whose activity only involves: A) issuing and redeeming nonmarketable Treasury savings bonds; B) accepting tenders for new issues of government securities; C) engaging in fewer than 500 brokerage transactions per year—or simply acting as conduits, openly passing transactions through to a registered government securities broker or dealer; D) entering into repurchase agreements and fewer than 500 reverse repurchase agreements per year; E) government securities activities "incidental" to the futures business of an entity registered with the Commodities Futures Trade Commission[5]; and F) the government securities activities of corporate credit unions.

These exemptions identify financial services that conceptually are difficult to distinguish from government securities market activities. From a practical point of view, financial institutions offering these services are already closely regulated so that exempting them saves substantial regulatory cost without appearing to sacrifice any appreciable regulatory benefit.

## Abuses and Remedies

Basically, it is impossible to imagine regulations that would prevent all investor losses incidental to transactions in financial markets. Existing federal investor and deposit insurance plans are examples that probably come closest to such blanket protection against loss. But the proposed government securities market regulations make clear that investors in repurchase agreements should *not* make the mistake of assuming that the Securities Investor Protection Corporation (SIPC), Federal Deposit Insurance Corporation (FDIC), or Federal Savings and Loan Insurance Corporation (FSLIC) would cover losses resulting from the failure of a broker or dealer counterparty. A broker or dealer or financial institution that retains custody of securities sold under a repurchase agreement must advise its counterparty that SIPC protection may not apply and that, if it did, only to the extent of $500,000, or that FDIC or FSLIC coverage does not apply.

Rather than providing insurance, the thrust of the new regulations is to define acceptable practices of brokers and dealers, presumably with two intended results. First, to the extent that brokers and dealers who adopt the prescribed practices are less prone to failure, losses may be avoided by improved performance. Second, by defining a standard for acceptable practice, regulation may reduce the gray area of questionable practices within which might lurk miscreants seeking to exploit gullible, or unsophisticated, or unwary investors.

Two kinds of practices—having to do with custody arrangements and with the financial condition of brokers and dealers—have been identified as contributing to losses in the government securities market in recent years, and are the major focus of reform.[6]

1. *Custody:* Failure to take delivery of or to control securities involved in repurchase agreements was a major contributor to customer losses. Many customers who supplied cash (bought securities) through reverse repurchase agreements with counterparties who were unregistered government securities dealers found that they could not sell the securities when the dealer failed. The reason was that, when engaging in a then-typical "hold in custody" repurchase agreement, the dealer seller (borrower) was not required to deliver the security to the counterparty.

Not only was the seller allowed to retain custody, but he was not required to maintain control of the security in a segregated customer account. With no

2. The class of securities is that defined as "exempted securities" under Section 3 (a)(12) of the Securities Exchange Act of 1934, for example, securities issued or guaranteed by the Treasury, federal agencies, government related corporations, and off-exchange options, puts, calls, straddles and similar privileges on other types of government securities.

3. The legislation does mandate a study of 'blind brokering' arrangements among the primary dealers and a handful of interdealer 'screen brokers.' But the question at issue is the impact of these arrangements on the competitiveness of the government securities market, not the protection of customers.

specific security necessarily identifiable with the purchaser (lender), failure of the dealer left purchasers standing in line with other general creditors in bankruptcy proceedings.[7] In fact, in the most flagrant cases, it would appear that dealers were selling "air repos," that is, selling the same securities to more than one purchaser.

Recent public information campaigns have drawn attention to the nature of repurchase agreements and especially to the need to control collateral.[8] However, control of securities under a repurchase agreement contract is a complicated electronic and legal matter. While some repurchase agreements are made for "certificated" government securities, a vast and increasing amount are for securities that exist only in book-entry form. All Treasury bills have been issued in this form since 1977, and Treasury securities of all kinds have been issued only in book-entry form since July 1986. The proposed regulations seek to avoid confusion by explicitly covering book-entry securities.[9]

The foolproof (but most expensive) means of assuring control of repo collateral is for the buyer (lender) actually to take delivery of the security, and to return it when the repurchase is completed. If "taking delivery" of a book-entry Treasury security means changing the ownership record in the Federal Reserve book-entry system, then it is when actual delivery is *not* taken that issues of custody arise [See box 2].

**Box 2**
**Book Entry**

The Treasury computerized "book" of ownership entries is maintained by Federal Reserve Banks. Depository institutions hold two kinds of accounts, one for their own securities and another for those in custody for customers. Repurchase agreements transfer entries between or within accounts. Private clearing banks maintain records of transactions among active market participants during the day, allowing many trades within a clearing bank's custody account at a Federal Reserve Bank, which in this instance does not have the name of the ultimate owner of the securities. The legal right of ownership in such instances is based on receipts and/or other documents held by both the depository institution and the customer. A nondepository institution or individual always has the right to take ownership in its own name in a separate direct account at a Federal Reserve Bank.

The proposed regulation specifies that, when a government securities dealer enters into hold-in-custody repurchase agreements with a single customer aggregating *less* than $5 million, it must retain control of the security at all times, with written confirmation of the initiation of the transaction and of each subsequent substitution of a different security (which may be made only with prior consent of the counterparty). Acceptable control locations for a book-entry security are to include an account at a clearing bank or Federal Reserve Bank that does not comingle with proprietary securities of the dealer and over which the clearing bank has no lien or claim.

Requiring this custody arrangement for *all* hold-in-custody repurchase agreements might assure protection to all counterparties, but the regulation stops short of requiring this blanket protection. The reason is that hold-in-custody repurchase agreements *without* a requirement to maintain possession or control have become a significant structural element of the government securities market, including both cash and repurchase agreements. Dealers finance most of their inventories by repurchase agreements, including overnight, term, and continuing contract. The inventory of specific securities available for repo cannot be known, however, until the end of the trading day, at which late hour it would be physically difficult or impossible to arrange all the necessary repurchase agreements.

Alternatively, given the enormous daily trading volume, maintaining a repurchase agreement on each item of inventory throughout the day would be cumbersome and costly because it would mean executing a substitution when any security was sold, and a new agreement when a security was bought. Neither of these alternatives has been necessary in the past, however, because dealers have been able to comingle proprietary and customers' securities during the day, with all of the securities being eligible for a clearing lien, or for use by the seller for deliveries on other securities transactions during the day.

This practice is expected to continue because, for repurchase agreements with a single customer aggregating *more* than $5 million, the purchaser (lender) will have the option of agreeing to comingling and clearing liens.[10] The presumption is that large, active institutional investors will remain capable of making the sophisticated credit judgements required to support current custody arrangements without substantial risk, in return for lower cost.

The proposed regulation also comes at the custody matter from another angle. It requires segregation of customer repo collateral from the proprietary securities holdings of all depository institutions that are not government securities brokers and dealers, notably those specifically exempted by the definition of brokers and dealers.

In all, these proposed regulations mandate prudent practices that, had they been in place, might have saved many small municipalities and thrift institutions from significant losses over the past five years. On the other hand, the presumption is that very large participants in the market are sophisticated enough to recognize and monitor risks, and well enough informed to keep abreast of the changing creditworthiness of counterparty dealers to whom is entrusted hold-in-place custody without segregated possession or control.

2. *Financial Responsibility:* The second area of reform would provide

4. Purchase or sale of futures and options may carry no counterparty risk when traded on an organized exchange that guarantees completion of transactions. Settlement at the expiration of the contract, however, still carries the risk that the counterparty might not perform.

5. The meaning of "incidental" is to be defined by an impending SEC regulation.

6. A third problem — nonrecognition of accrued interest in pricing repurchase agreements on coupon securities — was corrected by a change in standard market practice even before enactment of the Government Securities Act.

7. The Bankruptcy Amendments and Federal Judgeship Act of 1984 modified the standing of purchasers to allow expedited sale of securities.

customers with more reliable information about the business behavior to be expected from government securities brokers and dealers. The regulations involve three aspects of financial responsibility. First, the past history of both firms and their personnel will be open to scrutiny. All government securities brokers and dealers must notify the appropriate regulatory authority of their business. In the case of registered brokers and dealers, this means the Securities and Exchange Commission (SEC); in the case of financial institutions, it is the relevant federal deposit institution regulator, or the SEC if no federal regulator is involved. Moreover, persons associated with the firms must file disclosure forms with their firms, indicating membership in self-regulatory organizations (for example, the National Association of Securities Dealers). Firms must verify this information before filing the form with the appropriate regulatory agency.

Second, firms must demonstrate that they maintain capital adequate to the market positions they hold. This is to be monitored through periodic reports of a firm's capital relative to the degree of risk it takes. Capital guidelines, similar to those already familiar to registered brokers and dealers and financial institutions doing business in other securities, now would be applied to all other government securities brokers and dealers as well.

Third, the regulations require all government securities brokers and dealers to maintain certain records, to file reports, and to undergo annual audits by outside auditors.

Penalties for failure to comply are comparable to existing SEC treatment of nonexempt securities brokers and dealers. Individuals will be subject to censure by self-regulatory organizations to which they belong. A record of that action would follow the individual if he or she were to attempt to gain a position at a new firm. Errant broker or dealer firms could find their registration revoked by the relevant regulatory body, presumably after conversations and warnings aimed at improved performance.

## Conclusion

Safe securities do not make safe transactions—as can be told by former customers of Financial Corporation (1975), Winters (1977), Hibband and O'Connor (1982), Drysdale (1982), Comark (1982), Lombard-Wall (1982), Lion Capital Group (1984), E.S.M. (1985), and Bevill, Bressler, and Schulman (1985) (year of failure in parenthesis), whose combined losses apparently totaled well over three quarters of a billion dollars.

Flaws in the practices of both investors and dealers apparently contributed to these failures. The major flaws are thought to have been in three aspects of market practice: pricing the repurchase agreement contract, custody arrangements, and customer unawareness of the integrity (or lack thereof) of unregistered government securities dealers. Repricing the repurchase agreement contract required no legislative intervention, but Congress did enact legislation directing the Treasury Department to issue regulations aimed at custody and protection of customers' securities and at financial responsibility of brokers and dealers.

The major thrust of these regulations is to standardize custody arrangements in repurchase agreements involving government securities and to bring previously unregulated brokers and dealers within a capital adequacy, financial recordkeeping, and customer protection standard similar to that which already applies to brokers and dealers in other securities.

Regulations don't necessarily solve problems. The Act itself recognizes the uncertain balance of regulatory costs and benefits by including a mechanism for evaluating its results. Both the Comptroller General and, in a joint study, the SEC, Treasury, and Federal Reserve are required to present studies in 1990, evaluating the effectiveness of these new regulations and making recommendations to Congress about continuing or modifying them. If for no other reason than this, seeking safety will remain a concern of both investors and regulators in the government securities market.

8. See *Repurchase Agreements,* Cleveland, Public Information Department, Federal Reserve Bank of Cleveland [1985]; and "It's 8:00 AM. Do you know where your collateral is?," Federal Reserve Bank of New York, 1985.

9. Another area of ambiguity is whether a repurchase agreement is a secured loan or a purchase and sale transaction, but the regulation specifically avoids any attempt to resolve this legal issue.

10. SEC rules for nonexempt brokers and dealers in similar circumstances specify a lower $1 million cutoff.

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