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FEDERAL RESERVE BANK OF NEW YORK

August 23, 1971

IMPROPER BOND TRADING PRACTICES

To the Chief Executive Officer of each State Member Bank in the Second Federal Reserve District:

At the request of the Board of Governors of the Federal Reserve System, we wish to call again to your attention the inappropriateness of certain bond trading practices ("overtrading") described in our letter to you dated August 6, 1968, and to alert you to other improper bond trading practices that have recently been reported. The incidence of such activities, involving both State and national banks, is increasing.

We have been informed that the municipal bond industry has experienced a proliferation of securities dealers who employ high-pressure sales techniques and engage in misrepresentation. Many of the new firms engaged in such activities select names similar to older, more established firms or nationally known commercial banks.

For your information, listed below are some of the types of improper bond trading practices that have come to our attention.

Alfred Hayes,
President.

IMPROPER BOND TRADING PRACTICES BY BROKERS AND DEALERS

1. Encouraging "overtrading" — Under this procedure, a bank owning bonds carried on its books at cost but having a current market value below cost sells such bonds at a price above the market, usually at a price equivalent to book value of the bonds. The bank then purchases from the same broker other bonds (often of longer maturity and with a higher yield) at a price sufficiently above market value to reimburse the broker for (1) loss sustained on the bonds sold to him by the bank and (2) a broker's fee. The bonds are then recorded at the new "cost" (above market value). Such transaction has the effect of (1) deferring the recognition of loss on bonds sold by the bank and (2) placing new bonds on the bank's books at a price above their true market value when purchased.

EXAMPLE

Bank A holds $100,000 of 3% bonds due May 1, 1976.

Book Value	$100,000
Market Value	$ 95,000
Dealer purchases bonds at	$100,000

Dealer sells Bank A $100,000 of 4% bonds due May 1, 1983.

Market Value	$ 92,210
Dealer sells @ $4.00 basis	$100,000

Resume

Bank A sells a 3% yield and purchases a 4% yield, covers up a market loss and gets new bonds at par.

Sales Advantage — Improves cash flow from interest by 100 basis points.

Dealer — Loss on purchase	$5,000
Dealer — Profit on sale	$7,790
Dealer's Net Profit	$2,790

Deferring losses incurred on the sale of bonds by recording bonds purchased at inflated prices is an unsound banking practice. When selling bonds the bank should record any gain or loss realized based on the actual market price prevailing at that time. Moreover, bonds purchased should be recorded on a bank's books at actual market value.

(Over)

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2. Misquoting bond rating, coupon price, maturity and yield.

3. Selling bonds as general obligation bonds when, in reality, the bonds may be airport revenue, parking revenue, water or sewer revenue, limited tax, or special assessment bonds; or selling obligations of author ties that are not backed by general taxing power.

4. Misrepresenting firms by posing as a salesman from a reputable bank or broker because of similarity of firm name.

5. "Confirming" sale of bonds to the bank and attempting to deliver when the bank had not actually agreed to purchase.

6. Breaking confirmed trades when the market moves against them or they are able to sell at a higher price elsewhere.

7. Selling bonds without possession, then breaking the contract when they are unable to acquire the bonds in the market.

8. "Tailgating" — Several firms working in conjunction on a sale by having the first firm offer at an extremely high price, then having successive firms show the bonds at reduced prices — which misleads the customer into believing he is obtaining a marked-down value when in actuality the bonds are well above the market.

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