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U.S. House of Representatives

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June 18, 1985

MEMORANDUM

TO: Members, Subcommittee on Telecommunications, Consumer Protection and Finance

FROM: Timothy E. Wirth, Chairman

RE: Second Hearing on H.R. 2032, "The Public Securities Act of 1985," legislation to regulate government securities dealers, on Thursday, June 20, 1985 at 9:30 a.m. in Room 2123 Rayburn House Office Building

Summary

On Thursday, June 20, 1985, the Subcommittee will hold its second hearing on H.R. 2032, "The Public Securities Act of 1985."

At this hearing, the Subcommittee will hear witnesses from the Securities and Exchange Commission and the Department of the Treasury. Members may recall that, at the hearing on the SEC authorization in March of this year, SEC Chairman Shad was asked to provide the Subcommittee with the Commission's recommendations for legislation to remedy problems in the government securities market. Chairman Shad asked for 90 days within which to formulate recommendations. As part of that process, the SEC consulted with the Department of the Treasury and the Board of Governors of the Federal Reserve System, and the results of that process will be reported at the hearing. Chairman Volcker of the Federal Reserve will testify at a final hearing next week on June 26, 1985.

Witnesses

Honorable John S.R. Shad, Chairman, Securities and Exchange Commission. Chairman Shad will testify on the recommendations of the SEC, adopted at the Commission's meeting on June 18, 1985. By a 3-1 vote, the Commission adopted the position that "if legislation is to be enacted," the Department of the Treasury should be given authority to write rules for government securities dealers, currently unregulated dealers should register with the SEC, and the SEC and bank regulators should enforce the

rules and inspect the books and records of dealers. The SEC further recommends that the Federal Reserve should continue to exercise surveillance over primary dealers.

Honorable Aulana L. Peters, Commissioner of the Securities and Exchange Commission. Commissioner Peters voted against the report adopted by the SEC, arguing that the SEC should take an affirmative position that regulation of government securities dealers is necessary. She further argued that the Federal Reserve or the SEC should have the primary rule-making authority, since the Treasury has not served in a market regulatory capacity and does not have expertise in government securities trading.

Honorable John J. Neihenke, Acting Assistant Secretary for Domestic Finance. Assistant Secretary Neihenke will testify, on behalf of the Treasury, that no regulation of government securities dealers is warranted; the market is taking care of itself. He will further testify that, if legislation is enacted, however, primary rulemaking authority should be given to Treasury.

Discussion

The major question raised by the SEC/Treasury proposal is why, if the Treasury believes no further regulation of the government securities market is necessary, should Congress place rulemaking authority with Treasury? How can we expect Treasury to aggressively protect the market?

Chairman Shad also should be questioned on whether he believes additional protections in the government securities market are needed at all. In an effort to produce a consensus position with Treasury, is the Commission recommending a regulatory structure that it, independently, believes is not adequate to protect the market?

We again need to address what specific regulatory structure will adequately protect investors, maintain confidence in our markets and yet not interfere with the liquidity of this very efficient and effective market.

The briefing memorandum supplied for the June 11, 1985, hearing, which contains detailed information about the government securities market and major issues, is provided for your information.

In addition, attached as the appendix to this memorandum is a discussion of "The Role of the Government Securities Market," for your further information.

Also attached is an "Executive Summary" of the Report by the Securities and Exchange Commission on the Regulation of the Government Securities Market.

APPENDIX

The Role of the Government Securities Market

The Government securities market plays a unique and critical role in the U.S. financial system. One of its functions is to facilitate financing of Federal deficits. But it also has two important monetary functions: it is the market through which the Federal Reserve (the Fed) acts to implement monetary policy and it is a primary market for short-term investment that contributes to the liquidity of the financial system as a whole. Financial institutions, businesses, individuals, foreigners and Federal, State and local government agencies -- all view short-term government securities as "near money". For risk averse investors -- including such institutional investors as insurance companies and pension funds -- long-term governments provide portfolio balance and stability.

Federal Reserve Transactions in Government Securities. The fact that virtually all sectors of the financial system and the economy as a whole participate in the government securities market contributes to its breadth and depth. And because this market is so broad and deep it is the ideal market in which to implement monetary policy actions. Since the late 1930s, Federal Reserve open market purchases and sales of U.S. government securities have been used as the primary tool of monetary policy.

The Federal Reserve buys and sells government securities in the open market to change the volume of bank reserves. When it buys securities, it increases bank reserves and makes possible an expansion of bank lending. At the same time, it takes government securities out of the hands of private investors in return for cash that can be invested in other financial assets. The effects of these two actions lead to an expansion of credit and lower interest rates. Fed sales of government securities produce the opposite results: bank reserves and bank credit fall; more government securities and less private securities are held by the public; total credit contracts and interest rates rise.

The table below shows the importance of Federal Reserve transactions in the government securities market. The Fed holds about 10 percent of the total government debt and financed only about 3.5 percent of the Federal deficit in calendar year 1984.

Federal Reserve Open Market Transactions
(in Millions of Dollars)

	1982	1983	1984	Jan. 1985	Feb. 1985
.S. GOVERNMENT SECURITIES					
ıtright Transactions (excluding matched transactions) - all maturities					
Gross purchases	19,870	22,540	23,476	0	2,976
Gross sales	8,369	3,420	7,553	2,768	214
Redemptions	3,000	2,487	7,700	1,600	400
latched Transactions					
Gross purchases	543,804	578,591	808,986	66,668	57,076
Gross sales	543,173	576,908	810,432	66,367	57,283
Repurchase Agreements					
Gross Purchases	130,774	105,971	139,441	20,225	19,584
Gross Sales	130,286	108,291	139,019	21,852	17,077
Net change in U.S. government securities	8,358	12,631	8,908	-6,295	5,077
FEDERAL AGENCY OBLIGATIONS					
Outright Transactions (redemptions only)	189	292	256	0	17
Repurchase Agreements					
Gross purchases	18,957	8,833	1,205	1,463	2,428
Gross sales	18,638	9,213	817	1,851	2,048
Net change in Federal agency obligations	130	-672	132	388	363
Total Net Change in System Open Market Account	9,773	10,897	6,116	-6,683	5,440
TOTAL U.S. GOVERNMENT SECURITIES HELD BY FEDERAL RESERVE BANKS	139,300	151,900	160,900	N/A	N/A

Source: Federal Reserve Board, Federal Reserve Bulletin, June 1985, Table 1.17 at p. A9, Table 1.41 at A30.

But the gross volume of Federal Reserve transactions under matched transactions and repurchase agreements amounted to over $1 trillion each for gross purchases and sales.[1]

These data do not show the role that the Fed plays as agent for foreign central banks. At the end of March 1985, the Fed held $114.9 billion of marketable U.S. government securities for foreign and international accounts and executed all purchases and sales for these accounts in addition to transactions for its own account.

For many years, monetarist economists have criticized the Fed for the scale of its transactions in relation to net changes in the system account. In their view, the Fed's involvement in the market contributes little -- if at all -- to the effectiveness of monetary policy. Some argue that Fed "churning" in the market exacerbates interest rate volatility, and that it increases the fee-income of private U.S. government securities dealers at the taxpayers' expense.

The Fed has argued that matched transactions and repurchase agreements are necessary for the conduct of monetary policy. Technical factors such as changes in Treasury balances with Federal Reserve banks result in changes in bank reserves that are not consistent with policy objectives and therefore require offsetting transactions to stabilize reserve levels. Changes in the volume of Federal Reserve loans and discount operations -- another major tool of monetary policy and one that is critical to the Fed's role as lender-of-last resort -- also require offsetting purchases or sales of government securities. For example, Federal Reserve loans to Continental Illinois escalated rapidly in the spring of 1984 and reached a peak level of over $7 billion a day in the fall. This required offsetting sales of U.S. government securities that contributed to a lower level of net purchases for the system account in 1984 compared with 1983 (see the table above).

Whatever the merits of these arguments, it is clear that the Fed plays an important role in providing liquidity to the government securities market. Moreover, fees paid to the primary dealers for Federal Reserve transactions constitute an important source of compensation for those institutions.

<u>The Issue of Credit Risk</u>. Given the scale of Federal

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[1] This figure excludes repurchase agreements involving Federal agency obligations. As the table shows, there was a shift in Federal Reserve policy with respect to the market for Federal agency obligations over the period covered. After 1982, the Fed's role in providing liquidity to this market declined until the early months of 1985 when the volume of repurchase agreements increased significantly.

Reserve transactions in the government securities market, it is clear that the Fed has an interest in the credit-worthiness of the dealers with whom it executes transactions. Although not subject to the Congressional authorization process, the Federal Reserve operates at the taxpayers' expense[2] and losses resulting from the failure of a government securities dealer would be unacceptable. Even though the Fed's relationship to the group of primary dealers is primarily a "business" relationship without regulatory authority, it has assumed a regulatory role consistent with the need to protect the public interest.

However, credit risks involving government securities dealers may be no less important to state and local governments that make direct investments of taxpayers' funds, or institutional investors that have fiduciary responsbilities to protect the public's savings. With the growth in Federal deficits, the significance of net changes in Federal Reserve holdings of government securities has declined while that of other investors has increased. Thus, maintaining confidence in the market for government securities has become a more critical public policy issue. The market's role in financing the deficit has assumed greater importance and the threat that actual or potential credit risks pose for that function must be carefully weighed against other public policy concerns.

For example, a recent article notes that, after sustaining losses in the E.S.M. failure, Beaumont, Texas has changed investment strategies. It now shuns U.S. government securities -- presumably the safest investment available in any market -- in favor of certificates of deposit in local, federally insured banks and thrifts. Such a response reflects a loss of confidence that could reduce the number of investors in government securities and increase the cost of deficit financing. Thus, any hypothetical costs that may result from additional regulation of government securities dealers to restore confidence should be weighed against the interest rate costs associated with the perception that investments in government securities entail more risk than investments in insured deposits.

The Fed's role in providing liquidity to the market cannot, alone, provide that confidence. But in the absence of additional regulation, a "flight to quality" on the part of investors in terms of their choice of dealers could require additional Fed involvement in providing liquidity to alleviate strains on primary dealers. In view of the additional transaction costs to the Fed that this might entail, the option of not providing additional regulation should not be viewed as costless.

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2 Federal Reserve earnings are derived primarily from interest on holdings of U.S. government securities. After deducting all expenses, the Fed returns the remainder of its earning to the Treasury.

Regulation of the Government Securities Market:

Report by the Securities and Exchange Commission to the Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce of the U.S. House of Representatives

June 20, 1985

EXECUTIVE SUMMARY

I. Response to date by the market, investors, state and federal regulators and dealers to the ESM and BBS failures.

A. Market Response

1. Acting Assistant Secretary of the Treasury Niehenke testified at the open SEC meeting that the failures have not had a perceptible adverse impact on the cost of financing of the national debt.

2. Some commentators have indicated that some investors have withdrawn from the government and repo market, especially the GNMA repo market.

B. Many investors are:

1. perfecting their security interests in repos;

2. not providing excess margin in reverse repo transactions;

3. limiting their dealings to better known and capitalized dealers, particularly regulated or primary dealers.

C. Regulatory bodies have taken the following actions:

1. The Federal Financial Institutions Examination Council has proposed, and the FRB and FDIC have adopted, guidelines for securities lending activities requiring adequate collateralization.

2. The FHLBB has rearticulated its investment guidelines for savings and loan associations and is considering requiring securities underlying repos to at least equal the value of the repo, possession or third party control of these securities, dealings only with regulated broker-dealers, and frequent marking-to-market of securities.

3. Municipal investment regulators, such as the NY State Comptroller, the State of New Jersey, and a number of municipalities, have issued or are considering issuing strict standards requiring possession or third party control of securities underlying repos, limiting the dealers that can be used, or prohibiting repos.

4. The FRB has issued voluntary capital adequacy guidelines, stepped up its visits to dealers, and issued educational materials, such as "Its 8:00 a.m. -- Do You Know Where Your Collateral Is?" Individual Federal Reserve Banks are holding educational seminars for investors.

5. The SEC has recently brought enforcement actions against certain government securities dealers and individuals associated with those dealers; is investigating the conduct of other persons who were affiliated with those government securities dealers; and is conducting examinations of certain governnment securities dealers who have voluntarily agreed to the examinations.

6. It has been reported that other federal and state law enforcement authorities are examining the conduct of certain government securities dealers and persons associated with those dealers.

7. The SEC Division of Investment Management has reiterated to all investment companies the need to perfect and maintain a security interest in repos (i.e., the need to take possession of securities and to mark them to market).

8. The SEC Chief Accountant's office and Division of Corporation Finance are preparing a proposed release which would require greater disclosure of repo activities and risks by registrants.

9. The AICPA has formed a task force to address repo auditing issues. The Government Accounting Standards Board and the AICPA are also working on repo disclosure projects. These initiatives have occurred under SEC oversight.

II. The agencies differ somewhat in their views of the necessity for legislation. If Congress concludes that additional legislation is to be enacted, the FRB, Treasury and SEC would find the following approach acceptable.

A. All currently unregulated dealers in Treasury or government-sponsored agency securities to be registered. Information on these dealers to be accessible to all relevant regulators. The SEC and the Treasury differ as to which should be the registrar.

B. The SEC and the bank regulators to be granted the authority to provide sanctions against or to bar those who violate either the securities or the banking laws.

C. The Treasury, in consultation with the FRB, to be granted authority to adopt rules as necessary on:

(1) capital,

(2) independent audit and recordkeeping,

(3) collateralization (e.g., segregation or delivery requirements), margin, and when-issued trading practices.

D. (1) All government and agency securities dealers to be subject to C(3);

(2) Presently unregulated dealers to be subject to C(1) and C(2) as well;

(3) All others to continue to be subject to SEC or banking agency capital and recordkeeping requirements.

E. Inspection and rule enforcement of

(1) non-bank dealers by existing self-regulatory organizations, under SEC oversight, including inspections.

(2) bank dealers by banking agencies.

III. FRB to continue to exercise surveillance over primary dealers.

IV. While the Commission has not conducted a formal cost-benefit analysis, if legislation is to be enacted the Commission recommends the following approach.

A. All currently unregulated dealers in Treasury or government-sponsored agency securities to be registered with the SEC. Information on these dealers to be accessible to all relevant regulators.

B. The SEC and the bank regulators to be granted the authority to provide sanctions against, or to bar, those who violate either the securities or the banking laws.

C. The Treasury, in consultation with the FRB, to be granted authority to adopt rules with respect to currently unregulated dealers in Treasury or government-sponsored agency securities as necessary on:

(1) capital, and

(2) independent audit and recordkeeping.

D. All others to continue to be subject to SEC or banking agency capital and recordkeeping requirements.

E. Inspection and rule enforcement of

(1) non-bank dealers by existing self-regulatory organizations, under SEC oversight, including inspections, and

(2) bank dealers by banking agencies.

F. FRB to continue to exercise surveillance over primary dealers.