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Report to Congressional Committees

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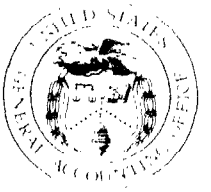
U.S. GOVERNMENT SECURITIES

More Transaction Information and Investor Protection Measures Are Needed



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General Government Division

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The Honorable Donald W. Riegle
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

The Honorable John D. Dingell
Chairman, Committee on Energy
and Commerce
House of Representatives

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking, Finance
and Urban Affairs
House of Representatives

This report discusses implementation of the Government Securities Act of 1986. The report was undertaken in response to the requirement included in that act.

The report includes a discussion of the availability of brokers' services in the secondary market for government securities, a discussion that follows up our December 1987 report on the subject that was also mandated by the act.

We are also sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System; Chairman, Securities and Exchange Commission; the Secretary of the Treasury; Chairman, Securities Investor Protection Corporation; other interested congressional committees and subcommittees; and to other interested parties.

This report was prepared under the direction of Craig A. Simmons, Director, Financial Institutions and Markets Issues, who may be reached on 275-8678 if you or your staffs have any questions. Other major contributors are listed in appendix VII.

Richard L. Fogel
Assistant Comptroller General

Executive Summary

Purpose

Public confidence in the integrity of the government securities market is essential for the federal government to sell its securities at the lowest cost. This confidence was shaken during the first half of the 1980s when several unregulated government securities dealers failed and investors lost money. As a result, to protect investors and to insure fair, honest, and liquid markets in government securities, Congress passed the Government Securities Act of 1986. The act and implementing rules set by the Treasury Department created a limited regulatory structure applicable to all banks and securities firms active in the government securities market.

This report responds to the legislative requirement that GAO evaluate the act's effectiveness and recommend whether or not Treasury's authority should be continued. The report also follows up on a 1987 GAO study that concluded government securities brokers should make timely information about transactions available to the public.

Background

The government securities market refers to the buying and selling (trading) of Treasury and federal agency and government-sponsored enterprise debt securities, government-supported mortgage-backed securities, and related contracts based on these securities. Trading activity in the full range of U.S. Treasury securities and non-mortgage-backed federal agency securities is dominated by 42 banks and securities firms designated as primary dealers by the Federal Reserve. These dealers agree to meet Federal Reserve standards for capital, creditworthiness, and market participation. Primary dealers reported daily Treasury security trading activity in 1989 of about $113 billion.

The act specified that the areas of registration, recordkeeping, capital adequacy, financial reporting, and audit were to be regulated. The act also regulates custody of securities used in financing transactions known as repurchase agreements that had been the source of investor losses. Although the act applies to all government securities brokers and dealers, the burden of complying was the greatest for the relatively few nonbank firms (specialist firms) that had not previously been regulated because they specialized in securities that were generally exempt from securities market regulation.

The act established Treasury as rulemaker with authority to write rules until October 1, 1991. The act placed rule enforcement authority with the Securities and Exchange Commission (SEC), working through industry self-regulatory organizations, such as the National Association

of Securities Dealers and the New York Stock Exchange, and with appropriate bank regulators.

A majority of primary dealer trading is conducted through seven specialized brokers that operate computerized screen-trading systems. Six of these brokers, known as interdealer brokers, allow only primary dealers (and a few dealers that aspire to be primary dealers) to trade on their systems. These interdealer brokers do not make information available to the public. The other broker serves more customers and disseminates much of its information to the public.

In December 1987, SEC, the Treasury, and the Federal Reserve agreed with GAO's conclusion that interdealer brokers should make transaction information publicly available because such information would make financial markets more efficient without any increase in risk to market safety. GAO also concluded that in keeping with the act's philosophy of limited regulation, brokers and their primary and aspiring primary dealer customers should be allowed time to work out expanded access arrangements on their own before a regulatory requirement is imposed. GAO said it would examine progress made in expanding access to information as part of this current study.

Results in Brief

The act appears to have improved investor safety in the government securities market. GAO believes, however, that gaps remain in the protection afforded to some individual and small institutional investors. These gaps could result in investor losses due to abusive practices by dealers. Some investors could also experience losses because specialist firms lack insurance coverage required of other securities firms registered with SEC.

Voluntary efforts by market participants have not resulted in public access to transaction information. GAO, therefore, believes legislation is needed to assure the timely public dissemination of transaction information by interdealer brokers.

GAO also believes that Treasury's role as rulemaker should be extended for a sunset period. New rules are needed in the areas of sales practices and information disclosure. Treasury has done a good job of developing rules to this point and, as Congress initially reasoned, appears to be best positioned to assure that new rules do not inadvertently damage the market or impair the government's ability to sell its securities at the lowest cost. These rules, when developed, will complete the initial rule

structure under the act and the decision can be revisited regarding who should be rulemaker beyond that point.

GAO's Analysis

Implementation of the Act and Areas Needing Attention

It is difficult to quantify the act's effectiveness because there is no way to identify problem situations that have been avoided. Thus, GAO focused on assessing the coverage of Treasury's rules, the implementation and enforcement of those rules, and the views of market participants.

As of July 1989, the registration process had identified 1,841 government securities brokers and dealers comprised of 63 specialist firms, 1,496 diversified securities firms, 281 bank dealers, and 1 thrift. GAO found a few areas in rule implementation and enforcement where improvements could be made, including better tracking of dealer registration status and narrowing differences in the frequencies with which bank and security dealers are examined. By and large, however, GAO found that the general view held by market participants was that the act has been implemented properly and has made the market safer. (See pp. 34-35.)

Sales Practices and Investor Protection

There are disparities between different securities markets regarding investor protection against abusive sales practices. In the markets for registered corporate and municipal securities, self-regulatory organizations enforce SEC-approved rules of fair dealing that supplement SEC's anti-fraud rules. These rules cover the reasonableness of price mark-ups and the suitability of the match between the risk characteristics of a security and the needs of a purchaser. This element of investor protection is missing in the government securities market.

The biggest gap is that National Association of Securities Dealers, the securities regulatory organization with the most explicit rules on price mark-ups and investor suitability, is not permitted under the act to apply such rules to the government securities transactions of the nearly 1,400 dealers and brokers it examines. (See p. 49.) Another concern is that while New York Stock Exchange and bank regulators say they look for abusive practices in the government securities activities of the firms they examine, the act does not require them to do this.

GAO believes that the absence of fair dealing rules (and related specific enforcement authority) makes transactions in government securities by some individuals and smaller institutional investors potentially vulnerable to abusive dealer practices. This is particularly true because in recent years securities have been developed in the government securities markets that have risk characteristics similar to those in registered markets. Examples of such securities are zero coupon bonds (whose prices are extremely sensitive to interest rate changes) and mortgage-backed securities (which are subject to cash flow variations). (See pp. 47-49.)

Actual abuse is hard to document, but there is some evidence that problems have occurred and that investors have lost millions of dollars. For example, according to information collected by the Government Finance Officers Association, one state lost over $200 million and a city lost over $60 million in questionable transactions with dealers. The Association also documented evidence of inappropriate transactions of zero coupon and mortgage-backed securities. Although there is no way to be certain, some or all of such losses might have been prevented by appropriate sales practice rules. The Government Finance Officers Association and other investors of public funds believe such rules are needed to ensure the safety of public investors. (See p. 56.)

As with sales practices, there are also disparities within the government securities market regarding insurance coverage on customer accounts. Of the 1,559 registered government securities firms, only the 63 specialist firms do not have some degree of insurance protection against losses in customer accounts due to fraud or failure of the dealer. Customer accounts at the remaining 1,496 firms have insurance coverage provided by the Securities Investor Protection Corporation. (See pp. 60-61.)

GAO believes that to attain better consistency of investor protection within the government securities market, the Securities Investor Protection Corporation coverage should be extended to customer accounts of specialist firms. (See pp. 62-63.) This would enhance investor protection while adding relatively little to the cost of operations of these firms and making little difference in the Securities Investor Protection Corporation's total exposure to losses.

Access to Broker Information Should Be Expanded

In the 2 years since GAO concluded that transaction information should be made public, interdealer brokers have made several efforts to arrange for greater public access to the information. However, these arrangements have faltered, in part because of brokers' concerns about possible adverse reactions on the part of the primary dealers. (See pp. 81-85.) To avoid further delay, GAO believes Congress should mandate public access.

Extension of Treasury's Rulemaking Authority

When the act was adopted, Congress chose Treasury as the rulemaker. Congress reasoned that because of Treasury's knowledge of the market and responsibility for managing the public debt, Treasury was in the best position to assure that implementation of the act did not inadvertently damage the market. Such damage could make it harder for the government to sell its securities at the lowest possible cost.

For similar reasons, GAO believes that Treasury should continue its role as rulemaker for a sunset period. New rules are needed regarding sales practices and disclosure of information on brokered trades. It is important that these rules not inadvertently damage the market or make it unduly difficult for the government to sell its securities. Treasury has done a good job in developing the rules the market is presently operating under and appears to be in the best position to assure that the new rules will be appropriate for the situation.

GAO expects that in setting the rules, Treasury would continue to coordinate closely with SEC so that the rules would also be appropriately similar to those applicable in other regulated securities markets. (See pp. 90-92.) As at present, the rules set by Treasury would continue to be enforced by the SEC, self-regulatory organizations, and the bank regulators.

The sales practice and information access rules, once in place, should complete the initial development of an overall rule structure for the market. Thus, at the end of the sunset period, the decision regarding who serves as the market rulemaker can be revisited. The decision at that time should be based on consideration of several factors, including market conditions, whether gaps exist in regulatory coverage, and any developments that have occurred affecting the way banking organizations or securities firms are regulated or supervised.

Recommendations

Congress should amend the Exchange Act to

- extend Treasury's rulemaking authority over the government securities market, subject to a sunset provision (see p. 92);
- give Treasury authority to adopt rules as needed over the sales practices of government securities brokers and dealers (see pp. 63-64); and
- require all government securities screen brokers to make transaction information available to market participants on a real time basis (see pp. 86-87).

Congress should also extend Securities Investor Protection Corporation insurance coverage to customer accounts in specialized government securities dealers (see p. 64).

GAO also recommends several measures to improve and simplify the administration of the Government Securities Act. (See p. 44.)

Agency Comments

The Department of the Treasury and the Securities Investor Protection Corporation provided written comments on a draft of this report. The Treasury agreed with GAO's recommendations regarding expanding access to broker screen information and extending Treasury's role as rulemaker under the act. The Securities Investor Protection Corporation did not take a position on GAO's recommendation to extend insurance coverage to customer accounts in specialist firms, but it expressed concern about the risks involved in extending coverage to a group of firms subject to rulemaking by Treasury rather than SEC. GAO believes the risks are not great and are outweighed by the benefits of providing consistent protection to customers. (See pp. 64-65.)

The Board of Governors of the Federal Reserve, SEC, and the National Association of Securities Dealers declined to provide written comments on the report. However, the Federal Reserve Board and SEC (under Treasury's leadership) are preparing their own required joint study on the rules' effectiveness that is due by October 1, 1990.

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Abbreviations

CATS	Certificate of Accrual on Treasury Securities
CBOE	Chicago Board of Options Exchange
CFTC	Commodities Futures Trading Commission
CMO	Collateralized Mortgage Obligations
FDIC	Federal Deposit Insurance Corporation
FHLMC	Federal Home Loan Mortgage Corporation
FNMA	Federal National Mortgage Association
FOCUS	Financial and Operational Combined Uniform Single (Report)
FOGS	Financial and Operational Government Securities (Report)
FRBNY	Federal Reserve Bank of New York
FRS	Federal Reserve System
FRB	Federal Reserve Bank
GAO	General Accounting Office
GFOA	Government Finance Officers Association
GNMA	Government National Mortgage Association
GSE	government-sponsored enterprise
GSBA	Government Securities Brokers Association
GSCC	Government Securities Clearing Corporation
HIC	hold-in-custody
IIA	Information Industry Association
NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automated Quotations
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
PSA	Public Securities Association
SEC	Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation
SRO	self-regulatory organization
STRIPS	Separate Trading of Registered Interest and Principal of Securities
TIGRS	Treasury Investment Growth Receipts

Introduction

Public confidence in the integrity of the U.S. government securities market is essential for the federal government to sell its securities at the lowest possible interest cost. To help preserve that confidence, Congress enacted the Government Securities Act of 1986 (P.L. 99-571, signed October 28, 1986). This law (the act) regulated, for the first time, brokers and dealers who did business exclusively in government securities or in government securities and other securities exempt from SEC registration. In 1984 and 1985, some unregulated dealers had failed and created losses for various institutional investors, thereby damaging confidence in the safety of the government securities market.

The act required us to report on whether the act's purposes have been achieved and to recommend any changes needed to protect investors or assure that the market was fair, open, and honest. We also were to recommend whether or not Treasury's rulemaking authority should be extended. This chapter describes the nature of the government securities market, the purpose of the act, and how we pursued our study.

The Nature of the Government Securities Market

A number of features distinguish the government securities market from other securities markets and contribute to its reputation as one of the most efficient,[1] largest, and most liquid[2] securities markets in the world. As background, this section describes these key features of the market: the securities themselves, the volume and importance of secondary market trading, the role played by primary dealers, and the trading systems operated by screen brokers.

U.S. Government Securities

In the broadest sense, the U.S. government securities market consists of all initial sale (primary market) and subsequent resale (secondary market) transactions of securities issued or guaranteed by either the federal government, individual government agencies, or a government-sponsored enterprise, as well as contractual obligations, such as repurchase agreements, futures, forwards, and options contracts, which give people the right or obligation to buy or sell these securities in the future. Appendix I describes, in chart form, the various securities and contracts and provides activity information. The three basic categories of these securities are: Treasury, agency, and mortgage-backed.

[1]Markets are efficient if buyers and sellers can complete their transactions quickly and with low transactions costs, and if information is rapidly reflected in the price of the security.

[2]Markets are considered liquid when those who want to sell government securities can usually do so at, or close to, the last sale price in the market.

Treasury Securities

Treasury issues marketable debt securities in the form of bills, notes, and bonds;[3] these are used to refinance debt, to help raise new funds needed to finance deficits, and to manage the government's cash flow. Treasury also provides a mechanism for the issuance of zero-coupon instruments, which represent the principal and interest coupon payments from selected Treasury notes and bonds of 10 or more years to maturity. The resulting securities, known as STRIPS (Separate Trading of Registered Interest and Principal of Securities), may be separately owned and are traded at a deep discount from face value because they pay zero interest until maturity.[4]

Treasury auctions its securities to the public using the Federal Reserve Banks as its fiscal agent. All marketable Treasury securities, including STRIPS, are issued in book-entry form with ownership recorded in an account established by a Federal Reserve Bank or at Treasury, and investors receive only a receipt as evidence of purchase. Treasury securities comprise about 59 percent of the nearly $3.3 trillion marketable U.S. Government securities outstanding as of December 31, 1989.

Mortgage-Backed Securities

Mortgage-backed government securities represent an interest in a group (pool) of mortgages. In connection with the activities of the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), or the Federal Home Loan Mortgage Corporation (FHLMC), lending institutions pool mortgages to create securities collateralized by the individual mortgages. Each month, holders of the securities receive a pro rata share of the monthly payment of interest and principal received on the underlying mortgages. GNMA does not issue these securities but guarantees the timely payment of scheduled interest and principal. FHLMC issues securities that carry a guarantee for the timely

[3]Treasury bills are short-term obligations that mature in a year or less. T-Bills do not pay interest during their term; the interest earned is the difference between the price paid by the investor and the par value paid by the government at maturity. Treasury notes and bonds are both debt securities that pay interest every 6 months and the par value at maturity. Notes have initial maturities of more than 1 year up to 10 years, and bonds have longer maturities, usually 30 years.

Treasury also issues nonmarketable securities to government trust funds and other accounts, such as the Social Security trust fund and the Federal Deposit Insurance Corporation (FDIC).

[4]Before Treasury made STRIPS available, certain government securities dealers began issuing zero coupon instruments, called generically Treasury receipts, which represent a claim against the principal or specific interest payments on a group of Treasury notes and bonds owned by the dealers. These securities, issued in definitive (i.e., not book-entry form), are marketed under trade names, such as CATS (Certificates of Accrual on Treasury Securities) or TIGRS (Treasury Investment Growth Receipts). These instruments have not been designated as government securities, but in its capital adequacy rules Treasury regards them as having comparable risks to STRIPS. With the development of the STRIPS program, Treasury receipts are no longer being issued, but outstanding securities are traded in the secondary market.

payment of scheduled interest and the ultimate repayment of principal. FNMA issues similar securities but guarantees timely repayment of principal as well. There is greater uncertainty regarding the duration of a mortgage-backed security than with a Treasury bond because any unscheduled prepayments of principal on the underlying mortgages are passed through to the holders of the security, thereby creating prepayment risk.

Mortgage-backed securities are sold directly by issuers to securities dealers. Mortgage-backed securities account for about 28 percent of the government securities outstanding as of December 31, 1989.[5]

Agency Securities

Although some agency securities are direct debt obligations of certain federal agencies, most are obligations of government-sponsored enterprises (GSE). GSEs sell debt obligations in the financial markets and channel the proceeds to agricultural, student loan, small business, and mortgage lending institutions either through direct loans or through the purchase of loans originated by these institutions. Although all agency securities are exempt from SEC registration, the nature of the government's backing varies. A few are backed by the full faith and credit of the United States, others are supported by the issuing agency's right to borrow from the Treasury, but some lack any formal governmental backing.

The major categories of agency securities actively traded in the government market are those issued by FNMA, FHLMC, Federal Home Loan Banks, the Student Loan Marketing Association, and the Farm Credit System. These agencies typically issue the securities through groups of dealers, known as selling groups, who locate purchasers. Agency securities account for about 13 percent of the government securities outstanding as of December 31, 1989.

[5]The previous discussion described the common mortgage-backed pass-through security. Because of the uncertainty of the principal payments, other mortgage-backed securities have been developed, such as collateralized mortgage obligations (CMOs), which are designed to give the investor greater certainty about the timing of the repayment of principal. Under a CMO, the investor buys the right to receive the interest or principal payments during various periods of time. Also, there are interest only and principal only mortgage-backed securities which allow investors to deal separately with the expected return from the interest and principal portions of a pool of mortgages. These types of securities can be considered government securities if they are issued by FHLMC or FNMA, but many are issued by private institutions as SEC-registered securities.

Repurchase Agreements Contracts

A principal focus of the act was regulation of repurchase agreements contracts (repos). Repos are two-part transactions that involve the initial sale of securities at a specified price with a simultaneous commitment to repurchase the same or equivalent securities at a specified price. The term of the repo transaction is determined by the parties to the repo. They can agree to terminate the transaction at a specified future date or on demand. According to a representative of the Public Securities Association (PSA), most repos are entered into on an overnight or short-term basis, but long-term repos are not uncommon. The repurchase price is usually higher, providing the equivalent of an interest return to the initial purchaser of securities.

Repurchase agreements are important in that they serve as a principal means by which dealers obtain money to finance their securities inventories; the Federal Reserve implements monetary policy; and public bodies, financial institutions, and other corporate investors invest cash balances. Dealers use repos aggressively, because they can obtain funds inexpensively and offer government securities to investors as security for the transaction. Dealers also initiate what are termed reverse repo transactions, in which the dealer is the initial purchaser of securities, to obtain securities that are needed either to meet delivery requirements or to engage in other repo transactions.

For many dealers, repo and reverse repo transactions have become a major line of business. Primary dealer activity in this market averaged over $776 billion per day in 1989, which is more than double the 1985 level and about 6 times greater than the average daily volume of regular trading in Treasury securities reported by these dealers.

While repurchase agreements are important, they also involve potential credit risk if the parties involved fail to meet their respective commitments to repurchase or sell the securities on the future date. Credit risk is even larger if customers allow a dealer to retain custody of securities that have been purchased. Such repos, called hold-in-custody (HIC) repos, can be a problem if dealers use those customer-owned securities for other transactions, while telling the investors that the securities were set aside in safekeeping. Customers of ESM Government Securities, Inc., and Bevill Bresler and Schulman Asset Management Corp. lost millions of dollars when these dealers failed in 1985, and there were not enough securities to satisfy customers' claims.

Derivative Products

Treasury securities are also the basis for derivative products that are an integral part of the government securities market. These products include both forward and when-issued trading agreements and standardized futures, options, and options on futures contracts bought and sold on organized exchanges. Most of these products, which are described in appendix I, are actively traded. For example, average daily volume of trading in futures contracts was over $38 billion during the year ending September 30, 1989. The exchange traded instruments were not included within the scope of regulation under the act because such instruments are already regulated by the Commodity Futures Trading Commission (CFTC) or, in the case of exchange traded options on securities, by SEC.

The Secondary Market

Except for futures and some options contracts that are bought and sold on registered exchanges, trading in government securities and related contracts occurs in a worldwide, 24-hour, resale (secondary) market in which investors, dealers, and brokers agree on trades over the telephone. Dealers and investors negotiate trades directly or conduct them through brokers—firms that do not buy or sell securities but specialize in arranging trades for others. Settlement, the exchange of securities for cash to accomplish trades, typically occurs on the next U.S. business day through depository institutions, located primarily in New York City, that offer clearing bank services.[6]

Secondary market trading performs two important functions. First, it distributes the debt to the private investors who end up holding most of the government's marketable debt. These investors include commercial banks, state and local governments, insurance companies, pension funds, other domestic and foreign financial institutions, and individuals. Second, the secondary market makes it easier for investors to resell the securities they own whenever they want to. An efficient and liquid secondary market for government securities is important because the market affects the structure of interest rates throughout the economy.[7]

[6]Mortgage-backed securities are the exception. Unless otherwise specified by the parties to a trade, mortgage-backed securities settle by class once each month on designated settlement dates.

[7]Certain changes in government policy, events, or new information of any type lead to expectations of changes in interest rates. Actions by dealers and other secondary market participants transmit these expectations into changes in interest rates on Treasury securities. Then, through arbitrage between the market in Treasury securities and the debt and equity markets, other interest rates are affected.

Importance of the Secondary Market to Treasury and the Federal Reserve

The safety, efficiency, and liquidity of secondary market trading systems have a direct impact on the rate of interest that must be paid on newly issued government debt. Easier resale opportunities lower investment risk, which in turn lowers the rate of interest that must be paid to sell the public debt. This fact is important considering the large amounts of money—$1.2 trillion in 1989—that Treasury must raise each year to finance current budget deficits and to refinance existing debt.

The liquidity of the secondary market also contributes to the Federal Reserve System's ability to conduct monetary policy. A central feature of monetary policy is the frequent purchase or sale of securities in the secondary market by the Federal Reserve Bank of New York (FRBNY).[8] In 1989, open market operation transactions averaged about $6 billion per business day. The more liquid the secondary market is, the easier and cheaper it is for the FRBNY to conduct these transactions.

Primary Dealers

Dealers are firms that buy and sell securities for their own accounts to both meet the needs of their customers and to profit from changes in the price of securities. An especially important category of dealers is the primary dealers, a group of securities dealers and commercial banks with whom FRBNY conducts its open market transactions. Dealers apply to become primary dealers, agreeing to meet certain standards and to provide the information FRBNY needs to monitor compliance with these standards. FRBNY expects primary dealers to be creditworthy, to participate actively in Treasury auctions, and to contribute to market liquidity by entering into a high volume of transactions on a continuing basis with other dealers and investors. The Federal Reserve also expects primary dealers to stand ready to buy Treasury securities from FRBNY or to sell securities to FRBNY even during adverse market conditions.

FRBNY can designate as many primary dealers as it believes to be appropriate. The number of primary dealers has grown over the years, although there has been a slight drop during the past year. There were

[8]FRBNY buys securities in the market when the Federal Reserve System wants to inject money into the banking system, and it sells securities when it wants to reduce the banking system's money supply. These transactions, conducted by the open market desk of the Federal Reserve Bank of New York for the System Open Market Account, are nearly all in the form of repurchase agreements and matched transactions. When the Federal Reserve makes a repurchase agreement with a government securities dealer, the Federal Reserve buys a security for immediate delivery with an agreement to sell the security back at the same price by a specific date (usually within 15 days) and receives interest from the dealer at a specified rate. This arrangement allows the Federal Reserve to temporarily inject cash into the economy to meet a temporary need and to withdraw these reserves as soon as that need has passed. Matched transactions are the reverse of repurchase agreements and are used to temporarily withdraw cash from the economy.

20 primary dealers in 1970, around 36 from 1981 through 1986, and 40 in 1987. The number increased to 46 in September 1988 and dropped to 42 in July 1989. There were 42 on June 28, 1990. Appendix II is the list of primary dealers as of June 28, 1990.

Firms attempting to demonstrate their creditworthiness and other qualifications to FRBNY in order to become primary dealers are called aspiring primary dealers. According to FRBNY officials, the qualification process typically takes at least 1 year from the time the dealer notifies FRBNY that it is aspiring and begins providing information to FRBNY. During this time, aspiring primary dealers are subject to limited and differing degrees of FRBNY surveillance.[9] FRBNY does not publicly identify or otherwise formally recognize aspiring dealers. The marketplace learns from the dealers themselves that they are aspiring. In February 1987, the market recognized 13 aspiring primary dealers; about 5 were recognized as of December 31, 1989.

Screen Brokers

Brokers are firms that are in business to arrange transactions for others. The most important brokers in the government market are the screen brokers, which operate the systems through which most trading by primary and aspiring primary dealers takes place. These brokers enhance liquidity by enabling these dealers and, in one case, certain investors to trade large quantities of securities quickly and anonymously. This anonymous trading, often referred to as "blind" trading, means that brokers arrange trades without revealing the identities of the buyers and sellers to one another.[10]

Dealers provide quotation and trade execution instructions by telephone to the brokers. This quotation information and the trading activity that results are subsequently displayed on a network of video display screens that brokers have installed in the dealers' trading rooms. Each

[9]FRBNY does not inform market participants of the identity of aspiring primary dealers, whether they are reporting their trading activity on a daily or monthly basis, or if FRBNY has visited them for on-site review. Those dealers in the initial application stage report their trading activity monthly, while those who are closer to an approval decision file daily activity reports. Unlike primary dealer reports, which are verified for accuracy at least once a year, aspiring primary dealer reports are not verified for accuracy until an on-site review is conducted by FRBNY just prior to formal designation of the dealer as a primary dealer.

[10]Treasury and agency securities are brokered and settled on an anonymous basis. Brokered transactions for mortgage-backed securities are not completely anonymous; names are not revealed when trades are arranged, but names are divulged after about 3 days as part of the transaction's clearing and settlement process. For repurchase agreements, which are considered credit transactions, names are divulged and must be acceptable before the trade is finalized.

government securities broker's screen displays the best bid and offer quotation available from its customers for each issue shown. These quotations are binding commitments for the quantities and prices specified and, as such, constitute a market for each issue displayed. Appendix III describes in more detail how trades are executed through brokers and shows a representative broker video display screen.

This report mentions two categories of screen brokers: interdealer brokers, which only service primary and aspiring primary dealers; and retail brokers, which also serve such dealers but also allow large institutional investors and other dealers to trade on their systems. In addition to the difference in trading access, retail brokers have permitted noncustomers to view the screens for information purposes through arrangements with information vendors. Interdealer brokers thus far restrict such information access.

The Government Securities Act of 1986

The act's primary purpose was to assure public confidence in the government securities market by regulating previously unregulated dealers and brokers and improving the safety of repurchase agreement transactions. The act required dealers and brokers that were previously unregulated to register with the SEC and join either an exchange or a registered securities association, i.e., the National Association of Securities Dealers (NASD). The Secretary of the Treasury was directed to issue rules for financial responsibility, possession and control of customer securities and funds, recordkeeping, financial reporting and audit for government securities brokers and dealers, and to issue rules governing the custody of government securities held by all depository institutions. Also, the act included a provision to prevent false advertising for government securities, particularly mortgage-backed securities, and gave SEC regulatory authority over clearing agencies for government securities transactions.

In developing its rules, Treasury was directed by Congress to consider the adequacy of the existing requirements on firms before imposing additional regulation. Consequently, the act imposed few new requirements on government securities brokers and dealers that were already registered with SEC as diversified securities firms, or on dealer operations that were part of regulated banks. But SEC-regulated firms had to update their registration to indicate that they were government securities brokers or dealers. Also, banks were required to file notice of their status as government securities dealers with their regulators, who then were to furnish a copy to SEC.

The registration and most regulatory provisions of the act went into effect by July 25, 1987, as stipulated in the act. SEC and NASD are responsible for enforcement of rules for the newly registered government securities specialist brokers and dealers, while the appropriate regulatory agency enforces the requirements on the other firms.[11]

Limitations on Treasury's Authority

Treasury's rulemaking authority for government securities broker/dealers was made subject to a sunset provision. Treasury's power to issue orders and to propose and adopt rules applicable to government securities brokers and dealers (Section 101 of the act) will terminate unless renewed on October 1, 1991. Should Congress not renew Treasury's authority or assign it elsewhere, rules in effect on the sunset date will continue in effect and, according to the legislative history, Treasury will still be able to make technical adjustments. Treasury's authority to prescribe securities custodial requirements for depository institutions (Title II of the act) is not subject to the sunset provision.

The act's legislative history makes it clear that it was designed to address identified weaknesses in the market without creating duplicative requirements, impairing the operation of a market that appeared to be working efficiently, increasing the costs of financing the federal debt, or compromising the execution of monetary policy. Government securities continue to be exempt from SEC registration requirements. The act also limited regulators from applying requirements common in other markets, such as sales practice and trading systems rules.

Sales practice rules govern the broker/dealers' trading relationships with their customers to ensure that transactions are priced fairly and that dealers properly carry out their responsibility for fair dealings with their customers. The act did not give Treasury authority to write rules governing the sales practice of brokers and dealers and restricted NASD from applying any such rules to the government securities activities of its members. In addition, NASD cannot require specialist broker/dealers

[11]The appropriate regulator for non-bank securities firms, including separate securities subsidiaries of bank holding companies, is SEC. Examinations for these firms are performed by the designated self-regulatory organization (SRO), usually either NASD or the New York Stock Exchange. Regulators for depository institutions are: Office of the Comptroller of the Currency (OCC) for national banks, the Federal Reserve System (FRS) for bank holding companies and state-chartered banks that are members of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC) for state-chartered nonmember banks and some insolvent thrifts, and the Office of Thrift Supervision (OTS) for thrifts. OTS assumed this responsibility from the Federal Home Loan Bank Board in 1989. We will use OTS as the name for the thrift regulator in this report. Futures commission merchants, which do enough transactions in government securities to register with SEC as brokers or dealers, continue to be regulated by the Commodity Futures Trading Commission (CFTC) through appropriate SROs.

to have their employees pass a securities industry qualification exam, nor can the Securities Investor Protection Corporation (SIPC) provide coverage for the customers' accounts of such dealers.

The act also did not give Treasury authority to write rules governing access to government securities trading systems—including those operated by the screen brokers. Access policies include the eligibility criteria for trading on the system and the availability of information on trading activity to participants and the general public. Such areas were left unregulated as the individual business decisions of firms. Outside the government market, the SROs can promulgate such rules under CFTC and SEC approval when they are considered necessary to ensure that markets are fair, open, and honest. The act did, however, require GAO to study whether broker access decisions were unnecessarily restrictive.

GAO's 1987 Study of Access to Broker Systems

In December 1987, we completed our study of broker access arrangements and reached conclusions, concurred in by FRB, SEC, and Treasury, regarding limitations in both trading access and information availability.[12] We concluded that trading access limitations were not unreasonable at that time, but that different arrangements could reasonably evolve if regulation of brokers and dealers and improved transaction clearing arrangements reduced the risks of anonymous trading. We also concluded that brokers and dealers should develop arrangements to make transaction information available because such information would enhance investor protection and contribute to the public interest through greater efficiency and equity in the government securities and related markets.

We concluded that market participants should be given the opportunity to develop such arrangements before pursuing regulatory interventions. We also said we would review the status of information access and trading access arrangements in this report.

Objectives, Scope, and Methodology

Section 103(b) of the act directed us to evaluate whether the amendments made by the act have been effective in protecting investors and the integrity, liquidity, and efficiency of the market. Also, we were to assess whether implementation of the act has permitted unfair discrimination between market participants or has imposed any unnecessary

[12]U.S. GOVERNMENT SECURITIES: An Examination of Views Expressed About Access to Broker Services, (GAO/GGD-88-8, Dec. 18, 1987).

burden on competition. We were to make any recommendations we believe were necessary to further the objectives of the act, including, at a minimum, a recommendation regarding whether Treasury's rulemaking authority should be extended.

Accordingly, within the broad mandate of the act, we organized our work around four issues:

1) Did Treasury, SEC, and the bank regulators effectively carry out their responsibilities under the act, and are any changes needed?

2) Are changes in the act's regulatory coverage needed to deal with developments in the government securities market that affect investor protection?

3) Are limitations in the act's regulatory coverage still appropriate with respect to whether screen brokers should be required to expand either trading or information access to their trading systems?

4) Should Treasury's authority to promulgate rules be extended considering its performance thus far and any additional areas that we believe warrant regulatory attention?

We discussed these issues and our approach to addressing them with the committees that had written the act: the Senate Committee on Banking, Housing and Urban Affairs; the House Committee on Energy and Commerce; and the House Committee on Banking, Finance and Urban Affairs.

Our analysis of these issues involved extensive interviews with representatives from various entities affected by the act. The organizations contacted are listed in appendix IV. The federal agencies and SROs we contacted were directly involved in the market or in regulating participants. Trade associations for market participants and government securities dealers were selected on a judgment basis, in part because of their interest and involvement in our previous study. We also sought to obtain views of a cross section of market participants that could have been affected in various ways by the act. We also contacted all screen brokers and major financial information services that provided coverage of the market. In these discussions, we obtained viewpoints and supporting data regarding how well the act was implemented; how the act affected their operations and the market; areas where more or less regulation is

needed; and technological, legal, and regulatory developments affecting market operations and regulation.

In addition to analyzing the information obtained from these discussions, we

- analyzed comment letters Treasury received in developing the regulations and Treasury's responses to subsequent inquiries and exemption requests;
- compared registration lists maintained by SEC and various agencies to test for potential unregistered firms and to determine the quality of SEC records;
- compared the capital adequacy and other regulatory provisions applied to specialist dealers by Treasury with SEC's requirements for diversified firms;
- analyzed investor protection rules used in other markets;
- reviewed regulator examination procedures and selected examination reports and summary statistics for government securities brokers and dealers; and
- developed market activity statistics from the Federal Reserve Bulletin and other published sources.

We mention some firms by name in the report because their activities are a matter of public record. However, in developing our findings and conclusions, we also considered certain proprietary data developed through our discussions that we could not describe explicitly in the report.

We worked in accordance with generally accepted government auditing standards. We did our fieldwork in Washington, D.C., New York, N.Y., and Chicago, Ill., from December 1988 to April 1990.

Scope Limitations

During this study, we did not attempt to render a judgment on the overall safety and soundness of the market or of any market participants. Moreover, we did not try to evaluate the quality of the regulatory oversight and examinations provided by various regulators or the effectiveness of their various rules. Also, our meetings with primary dealers and screen brokers were done while these parties were subject to an open Justice Department order for these parties to maintain records relating to discussions pertinent to the issue of access to screen broker services. The Justice Department has had an antitrust investigation of broker access limitations in process for several years.

Agency Comments

We met with officials of Treasury, SEC, the Board of Governors of the Federal Reserve System, and OCC throughout our review and provided these agencies the opportunity to comment formally on the report. Section 103(a) of the act requires Treasury, SEC, and FRB to conduct their own study to evaluate the effectiveness of the rules and to report their findings by October 1, 1990.[13] We also sent the report for comment to NASD and the Securities Investor Protection Corporation (SIPC)."

The Department of the Treasury and SIPC provided written comments. Relevant portions of their comments are presented and, where appropriate, evaluated at the end of chapters 2, 3, 5, and 6. The comments are reprinted in their entirety as appendices V and VI, respectively.

We also received technical comments on the draft from the Department of Treasury, SEC, and the Board of Governors of the Federal Reserve System. These comments were incorporated as appropriate.

We did not provide the GSEs, GNMA, or Commodity Futures Trading Commission a draft for official comment because our discussions with officials from these agencies revealed no significant concerns with current market operations.

[13]Section 103(a) states:

"Task Force Recommendation - The Secretary of the Treasury, together with the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System, shall evaluate the effectiveness of the rules promulgated pursuant to section 15C of the Securities Exchange Act of 1934 in effecting the purposes of such Act, and shall submit to the Congress, not later than October 1, 1990, their recommendation with respect to the extension of the Secretary's authority under such section, and such other recommendations as they may consider appropriate."

Implementation of the Government Securities Act

Although it is not possible to come up with hard evidence about the impact the act has had on the market, for the most part we have found that market participants are generally satisfied with the way the act has been implemented. They believe the act has made the market safer without serious adverse effects. However, we have some concerns about the effectiveness of some aspects of the act's implementation, and we believe Treasury should consider simplifying its rules on capital adequacy.

Implementation of the Act

This section highlights actions taken by Treasury and the other regulators to implement key provisions of the act. These provisions concern registration, regulation and examination of specialist firms, repurchase agreements, advertising, and clearing agencies.

Registration

Three types of government securities brokers and dealers were initially brought under regulation by having to register or file notice of their government securities business by July 25, 1987. The first type, representing a major reason the act was enacted, was previously unregulated brokers and dealers engaged exclusively in the business of buying and selling government and certain other exempt securities. These firms, called specialist firms, had to register with SEC and obtain membership in an SRO as a condition for continuing to operate in the market.[1] The second type was brokers and dealers already registered with SEC. These firms simply had to update their registration with SEC on a revised form that better described the firms' government securities activities.[2] The third type was banks and thrifts, which, using criteria stipulated in the act and the regulations, must decide whether they qualify as brokers

[1]SEC has the authority to register or deny registration to brokers and dealers required to register with the Commission. It prescribes the form and information required for registration or withdrawal from registration. SEC uses Form BD, the Uniform Application for Broker-Dealer Registration. Included as part of the application on Form BD is a statement of financial condition and other data on financial resources, such as the applicant's assets, liabilities, net worth, and capital adequacy. Additionally, a Form U-4 must be filed, which discloses information on persons associated with government securities brokers and dealers. A firm must amend its registration if its business changes or if it withdraws from the market.

To obtain NASD membership, firms had to pay NASD assessments and have their associated persons fingerprinted.

[2]Previously, SEC-registered firms indicated if their government business represented 10 percent or more of their operations. The new form required this same information and also required firms to designate if they did broker or dealer activity or both, and whether they did their government business in a specialized firm or as part of a diversified operation. The form also could be used to give notice that the firm was ceasing its government securities business.

and dealers.[3] If they met the criteria, they were required to file notice with their regulatory agency on a form prescribed by the Federal Reserve, with a copy sent to SEC.[4]

Regulators took varying degrees of initiative to encourage firms to register. NASD worked with SEC, Treasury, the Public Securities Association, and some state regulators to develop a list of potential specialist dealer registrants that were contacted by mail to inform them of the requirements. For diversified dealers, NASD and NYSE sent out notices to members informing them of the need to amend their registration if they were government securities brokers or dealers. Similarly, FRB and FDIC sent out notices to their banks along with copies of appropriate filing forms. In contrast, both OCC and OTS relied upon the banks' and thrifts' awareness and good faith efforts to file timely notices.

Status of Registration Process

According to the regulators, as of July 25, 1987, a total of about 1,740 firms had registered or filed notice. By July 1989, 2 years later, there were 1,841 registrants—63 non-bank specialists, 1,496 diversified firms, and 281 bank dealers. The initial notice of one thrift broker/dealer was still on file as of the July 1989 date although, according to Treasury officials, it appears not to have been active.[5] The 1,559 non-bank firms

[3]Many banks provide a number of dealer-like services for their customers in trust departments and by redeeming and safekeeping customer securities. Moreover, banks are typically active market participants, buying and selling government securities for their own portfolios. Treasury did not require banks and thrifts to register as brokers and dealers if their government securities activities were limited to

- handling savings bond transactions;
- submitting tenders for the account of customers at Treasury auctions;
- doing limited brokering of government securities, which means either effecting fewer than 500 brokerage transactions annually or effecting all brokerage transactions on a fully disclosed network basis through a registered government securities broker-dealer;
- purchases or sales in a fiduciary capacity and/or purchases and sales of repurchase or reverse repurchase agreements.

[4]Like SEC's registration form, the G-FIN form requests identification information on the bank and its associated persons. However, the form does not require a description of the percentage involvement in government securities financial information on the bank.

[5]In interpreting the statistics in table 2.1 it is important to recognize that the number of dealers in any one category reflects the way firms choose to organize their government securities activities within their total operation. For example, banks both within and outside of the holding company structure can organize their securities activities among affiliate firms in a number of ways. The bank itself can be dealer, it can have separate affiliates or subsidiaries registered as diversified dealers or government securities specialists, or it can do both. Non-bank securities firms can split or combine their operations in much the same way.

that registered under the act represented about one-fourth of all non-bank securities firms registered with SEC. The 281 bank dealers were about 2 percent of all banks.

NASD is the predominant examining authority for SEC-regulated non-bank brokers and dealers, although NYSE examines a majority of the non-bank primary dealers. For banks, OCC regulates about 70 percent of the 281 dealers, including the 3 banks that are primary dealers.[6] Table 2.1 presents data on the number of government securities brokers and dealers and their regulators.

[6]An additional 10 firms conduct their primary dealership through Section 20 subsidiaries of bank holding companies.

Table 2.1: Registered Government Securities Brokers and Dealers: Data on Types of Firm/Institutions, Regulators, Number of Primary Dealers, and Regulators' Total Workload (July 1989)

Type of firm/institution and regulator	Government securities broker/dealer[a]	Primary dealers[b]	Regulators total workload[c]
Securities firms regulated by SEC			
NASD	1,378	18	5,712
Specialist	63	9	
Diversified	1,315[d]	9	
NYSE diversified	168	20	392
Other[e]	13	0	[f]
Subtotal	**1,559**	**38**	
Banking and thrift institutions			
OCC	191	4	4,280
FDIC	43	0	7,622
FRB	47	0	1,037
Subtotal banks	**281**	**4**	
Office of Thrift Supervision	1	0	2,934
Grand Total	**1,841**	**42**	

[a]Includes primary dealers shown in next column.

[b]Excludes two primary dealers named by FRBNY on December 8, 1989. Both firms are NASD-diversified firms.

[c]Figures represent the number of firms or institutions subject to examination by each regulator. Workload figures are shown to provide a perspective on the significance of the number of government securities brokers and dealers relative to the total number of firms/institutions to be examined by each regulator.

[d]Figure does not include 88 memberships that were pending.

[e]Includes firms examined by the Chicago Board of Options Exchange (CBOE), the American Stock Exchange, the Midwest Stock Exchange, and the Philadelphia Stock Exchange, as reported by SEC.

[f]Figure not available.

Source: Data on the number of government securities dealers and brokers and classification of primary dealers were developed by reconciling various listings of firms provided to us by regulators and Treasury from various internal reports. All figures should be considered close approximations, because the same monthly dates were not available from all sources.

When the act was being written, an estimated 200 to 300 unregulated firms were in the market, although in December 1986 NASD, in cooperation with other regulators, had identified only 117 potential registrants. As it turned out, even fewer firms than expected registered as specialists. On August 31, 1987, 1 month after the effective date of the registration requirement, 67 firms had registered, of which 35 were among

the 117 identified.[7] Of the initial 67 registrants, 46 were among the 63 specialists still operating in July 1989 (although some had changed names).

The 63 specialist firms operating in July 1989 consisted of 16 brokers (9 screen brokers, 4 screen broker subsidiaries or affiliates, and 3 non-screen brokers), and 47 dealers, of which 9 were primary dealers. About a third of the 47 specialist dealers were affiliated with diversified securities firms or bank holding companies.

Regulation and Examination of Specialist Firms

Treasury's regulations for specialist firms took effect on July 25, 1987; and NASD, in conjunction with Treasury and SEC, held three seminars to inform firms of the requirements. The rules for recordkeeping, reporting, and audit were essentially the same as those employed by SEC through the SROs for registered securities firms. With respect to capital adequacy, Treasury's requirements for interdealer brokers were based on the requirements applied by SEC to similar screen brokers in the municipal securities market, but with a higher minimum capital level.[8] For dealers, Treasury made several modifications to the SEC approach sufficient to require specialist dealers to report their capital level on a special set of forms.[9]

[7]When a previously unregulated dealer was faced with the requirement to register as a specialist firm, the dealer had several options. On the basis of a review of registration data and discussions with NASD, we determined that the 117 expected registrants behaved as follows: 35 registered as specialists; 18 registered as diversified firms, or eliminated their separate government securities operations and merged them into an already registered diversified dealer or newly registered bank dealer; 8 remained in the securities business, but discontinued their government securities transactions; and 56 left the securities business or reorganized under a new name.

[8]Treasury allowed such brokers to obtain permission to maintain a minimum capital level of $1 million (municipal brokers need $150,000), in lieu of applying the more complicated calculation required of dealers. To qualify, brokers had to meet certain conditions, including having only registered dealers as customers. The interdealer screen brokers all initially opted for the $1 million minimum capital level. However, only two use it now, in part because certain customers that are foreign affiliates of U.S. primary dealers could not be treated as registered dealers.

[9]Specialist dealers that calculate capital using Treasury's approach file quarterly and annual reports with NASD on the Financial and Operational Government Securities (FOGS) report form instead of the Financial and Operational Combined Uniform Single (FOCUS) report form used by all other broker dealers. The forms essentially provide much of the same basic income and balance sheet information but are arranged differently to correspond to the different methods for computing minimum liquid capital. Treasury's modifications for determining dealer capital adequacy were based on the capital adequacy guidelines that FRBNY was already applying to the specialist primary dealers and that FRBNY had published prior to the act as voluntary capital adequacy guidelines for other specialist firms. Treasury believed that its capital adequacy approach was better suited to measuring specialist dealer risk and would be easier for specialist primary dealers to implement.

NASD determined specialist firm compliance with requirements through its examination process. Its goal has been to examine these newly registered firms annually. Data we received from NASD showed that from July 1987 to November 30, 1989, NASD had conducted 219 on-site examinations of 78 different specialist firms, with 73 of the 219 exams being premembership exams. We also noted NASD's goal is to annually examine firms that maintain accounts with customer securities and funds and to examine other firms every 2 years. NASD appears to have met its goal for specialist firms.

We did not evaluate the quality of NASD's exams. However, SEC had independently examined 10 of these specialist firms to ensure that NASD was doing a good job, and it was generally satisfied with NASD's performance.

We obtained information on the results of the examinations done by NASD and SEC during the period July 1987 through April 1989. This information showed that the examinations detected problems in a number of areas (see Table 2.2). However, NASD and SEC officials agreed that the findings were not unusual for firms newly regulated and that, overall, specialist firms were making a legitimate effort to comply with the rules. For example, the financial responsibility (primarily capital adequacy) findings typically involved incorrect computations of minimum liquid capital that resulted in capital being under- or overstated, but not so understated as to result in capital being less than the minimum requirement.

Table 2.2: Problems Disclosed During Regulatory Examinations of Specialist Firms July 1987 - April 1989

	NASD	SEC
Number of examinations[a]	65	10
Category and number of deficiencies		
Recordkeeping[b]	46	9
Reporting & Auditing[c]	32	2
Financial Responsibility[d]	33	9
Customer Protection[e]	22	2
Registration/Employee Qualification/Supervision[f]	34	2

[a]NASD's 65 exams were of 55 institutions; SEC's 10 exams covered 10 institutions.

[b]Includes deficiencies in recordkeeping ledgers, such as stock records and customer ledgers, cash receipts and disbursements blotter not maintained, etc.

[c]Covers inaccurate FOCUS and FOGS reports and failure to meet audit requirements (i.e., changed annual audit but did not notify regulator), etc.

[d]Consists primarily of capital computation errors but also includes capital deficiencies, etc.

[e]Includes failure to maintain separate customer accounts, improper confirmations on repurchase transactions, etc.

[f]Problems pertain to inaccurate filing of forms for associated persons, Form BD not current, employee not fingerprinted, supervisory procedures inadequate, etc.

Repurchase Agreements

As noted in chapter 1, a principal focus of the act was regulation of repurchase agreements (repos). Treasury's efforts to promulgate rules under the act coincided with a number of efforts to better control securities recordkeeping practices associated with hold-in-custody (HIC) repos. These include SEC efforts to improve its repo rules for registered securities firms, bank regulator efforts to increase the safety of bank repo practices, the PSA's efforts to standardize dealer repo practices, and initiatives by investor groups such as the Government Finance Officers Association (GFOA) to increase awareness of HIC repo risks. Treasury's rules that took effect on July 25, 1987, were essentially the same as those developed by SEC, except for two minor differences.[10] In fact, when Treasury amended its rules in August 1988, it replaced the text of the rule it had previously adopted with a citation that incorporated the SEC rules by reference. (The SEC rules became effective January 31, 1988.)

Although Treasury was successful in getting rules promulgated, the task was not without controversy. Repurchase agreements were the subject of the most written comments and informal inquiries Treasury received during the rulemaking process. Specifically, of the inquiries Treasury

[10]Treasury required that the written agreements had to specify that HIC repos were not protected by SIPC coverage and that foreign customers could waive a right to daily confirmations.

received between June 2, 1987, and April 28, 1989, about 40 percent related to these areas.

The principal points of controversy concerned costs. The rules imposed costs on dealer operations by requiring dealers to (1) have signed repo agreements with all HIC repo counterparties, and (2) issue confirmations to the customers of the securities held in custody whenever a new transaction occurred or the identity of the securities changed. Treasury insisted that these costs were necessary to provide customers with the information they need in situations where there are potential risks because a dealer is acting both as counterparty and custodial agent for the customers' securities. Many dealers said these costs resulted in excessive paperwork and provided investors with more protection than they needed. Furthermore, these requirements tended to affect bank and non-bank dealers differently depending on their product lines, customer base, and ability to modify their recordkeeping systems. Treasury, not dissuaded by these concerns, amended its rules on August 1, 1988, to eliminate an exemption to repo agreements and daily confirmations that it had originally provided for certain banks.[11] Treasury based its action on the view that broker-dealers that are not financial institutions were already complying with confirmations and control requirements and because "some cost increase is a necessary and expected outcome of legislative requirements to establish regulations for government securities transactions and, in particular, for repurchase transactions."[12]

Advertising

The act gave NASD authority to regulate the government securities advertising activities of its members, primarily because of problems

[11]Initially, Treasury had exempted banks from the daily confirmation requirement if they met certain conditions but rescinded this exemption over the protests of several banks in an August 1, 1988 amendment (effective December 1, 1988). Banks were particularly upset by the daily confirmation requirement because they had developed products such as overnight "sweep" repurchase transactions, which would become much more costly with daily confirmations. In a sweep repurchase transaction, excess funds are swept from a customer's deposit account for overnight investment in instruments that include repurchase transactions. Since sweep repurchase transactions are recurring transactions, generally giving rise to a new repurchase transaction daily, a new confirmation has to be issued daily. On the other hand, certain securities firms also offer a similar service to their customers by sweeping the uninvested balances in customers' investment accounts and investing them in various instruments, including repurchase agreements. These securities firms' repo transactions were subject to daily confirmations under the rules passed by Treasury on July 25, 1987.

[12]Text of Treasury August 1, 1988, amendments to its July 24, 1987, Government Securities Act rules, Federal Register vol. 53, No. 147, page 28962.

with mortgage-backed securities advertising.[13] NASD rules governing advertising requirements for government securities became effective on January 1, 1989. The new rules require NASD members to send to NASD, for review, all advertising in government securities within 10 days of first use.[14] During 1989, 98 firms submitted 242 ads for review. NASD told us that 47 percent were acceptable as submitted, 52 percent required revisions, and 1 percent were rejected. In addition, NASD received 20 complaints, usually from a broker/dealer's competitor. Most complaints involved GNMAs and zero coupon government securities. According to NASD officials, after NASD review, the advertising material was revised.[15]

SEC Regulation of Registered Clearing Agencies

Clearing agencies process the paperwork confirming securities trades to arrive at a net amount due between buyers and sellers. Typically, a clearing agency steps in to bear the risk of a transaction failure by becoming the buyer to every seller and the seller to every buyer. The act expanded SEC's authority over the activities of clearing agencies in registered securities to include clearing agents operating in the government market. This authority includes approving the access criteria and operating plan of any such systems as it does for clearing agencies operating in other markets. SEC has approved four systems involving government securities: the Mortgage-Backed Securities Clearing Corporation (MBSCC), Participants Trust Company (PTC), Government Securities

[13]Beginning in 1979, NASD's Advertising Department received complaints regarding GNMA advertisements that raised concerns, primarily because the yields quoted were based on a calculation using an accelerated rate of prepayment rather than the traditional 12 year average life, resulting in an inflated yield figure. This distinction was not being disclosed in the ads. Compounding the situation was the lack of disclosure that such a prepayment rate was not guaranteed over the life of the pool, and that the advertised yield would be subject to fluctuations. Although the Department recognized that the ads appeared deficient, it could not take an active role in the regulation of advertising because NASD rules could not be applied to exempt securities.

Concern for government securities advertising arose again in 1985 when interest rates started to fall dramatically and the advertising problems appeared more abusive. In making a letter appeal to Congress on the need to regulate government securities advertising, the president of GNMA stated that "This provision is necessary because many investors continue to be misled by advertising appeals and prospectus reports which fail to adequately address yield calculation, price fluctuations, investment risk factors, extent of the government guarantee, and other characteristics unique to the GNMA security which will assist the average investor in making an informed decision."

[14]In general, advertisements subject to filing requirements include material published or designed for public use through newspapers, magazines, radio, television, etc., but would not include material referring to government securities solely as part of a listing of products and/or services offered.

[15]NASD officials told us they review advertising as part of the examination process and also have a separate system to periodically spot-check members' advertising. Statistics on findings from these two areas were not available.

Clearing Corporation (GSCC), and Delta Options Clearing Corporation (Delta).[16]

Benefits and Costs of the Act

The legislative history of the act as set forth in committee reports and floor debates shows that Congress sought to improve the safety of the market by ensuring that all broker/dealer participants were subject to a basic regulatory scheme and assure that the repurchase agreement market not be a source of loss to investors. Congress hoped that one consequence of the act would be to stop investor incentives to deal only with primary dealers at the expense of responsible, financially sound nonprimary dealers. Congress also wanted to be sure that Treasury's rules would not impose excessive costs on participants and, thereby, affect Treasury's cost of selling the debt. Congress was also concerned that Treasury's rules not favor dealers in Treasury securities at the expense of dealers in other government securities.

Dealers and brokers told us that they believe that the market is safer for investors now that the act has been implemented, although regulation such as that provided under the act will not prevent fraud from occurring. Greater safety results from the fact that all securities brokers and dealers are now clearly subject to capital requirements, prudential rules, and regulatory inspection. Therefore, NASD and SEC now clearly have the authority to enter a firm and inspect the firm's books and records to determine whether or not fraud has occurred.[17] In the case of repurchase agreements, our discussions with regulators and market participants found no support for additional repo-related rules in this area. However, given the inherent risks involved in HIC repos, these officials also point out that the safety of repo transactions depends upon the honesty of the person doing the transaction, investor awareness, and examiner diligence in enforcing the act's requirements.

We were not able to identify any major positive or negative effects on market liquidity or efficiency resulting from implementation of the act, although our efforts were limited because of the absence of marketwide activity data. We observed some temporary reduction in primary dealer

[16]MBSCC and PTC combine to provide clearing and settlement services for mortgage-backed securities. GSCC, approved by SEC in 1988, is centralizing the processing of transactions in Treasury and agency securities by primary and aspiring primary dealers, screen brokers, and clearing banks. Delta is part of an SEC approved proprietary trading system for over-the-counter options on Treasury securities. The trading system part of the Delta system is an affiliate of an interdealer screen broker.

[17]Prior to the act, only SEC could enter the specialist firms' premises. To do so, SEC had to obtain a court order based on evidence of suspected fraud.

trading and repo activity in late 1987, when the act's major provisions went into effect. However, the timing of the act's implementation coincided with the problems in the stock market in October 1987. None of the market participants or regulators we spoke to attributed any changes in repo market activity to the implementation of the act.

Moreover, neither Treasury nor FRB officials said that the act had any adverse effect on Treasury's cost of selling the debt or FRBNY's ability to conduct monetary policy. We also found no adverse effect on the market for government-sponsored enterprise securities caused by implementation of the act or Treasury's rules.

Increasing the Acceptability of Nonprimary Dealers

Investors reacted to the problems with the unregulated dealers E.S.M. Government Securities, Inc., and Bevill Bresler and Schulman Asset Management Corp. by limiting trading to primary dealers only. Specifically, after the E.S.M. failure, OTS guidance to thrifts and GFOA policy guidance to its members encouraged institutions to do business with primary dealers.

The absence of information on the volume of nonprimary dealers' transactions prevented us from determining quantitatively whether the role and activity of nonprimary dealers have changed in the marketplace since the act was adopted.[18] The qualitative evidence we found was mixed. One nonprimary bank dealer told us municipalities were more willing to do business with his firm since passage of the act. However, New York State's investment policy recommendations for local governments, which calls for limiting repurchase agreement activity to registered primary dealers or to banks and trust companies authorized to do business in New York State, is still in effect. A GFOA official told us its guidance emphasizes that thrifts and public investors should deal with registered firms (i.e., not just primary dealers), taking the steps necessary to investigate the reputation and capability of any dealers with whom they choose to do business.

[18]Statistical information from SEC did not enable us to determine the number of diversified dealers before and after the act, and no data are collected on transaction volume. In addition, data reported by FRB on primary dealer activity can change because the number of primary dealers changes.

Costs on Market Participants and Regulators

The act did impose some costs; regulation always does. We did not attempt to gather systematic verifiable information on costs from those affected by the act. While no one suggested to us that the act raised costs by an amount that adversely affected the market as whole, it is clear that implementing the act was expensive for some firms. The results of our discussions with market participants follow:

- The major cost paid by all specialist brokers and dealers was the NASD annual assessment. In obtaining SEC approval for its assessment charges, NASD said its 1988 cost for implementing the act was about $2.4 million, and it expected to recover about $1.5 million from its assessment of specialists in 1989 (based on a net rate of 0.125 percent of specialist firms' annual gross income (revenue) derived from their government securities business). Screen brokers challenged the assessment as excessive because they claimed it resulted in too high a charge relative to their need for and cost of examination. SEC agreed with NASD that the cost was appropriate. The NASD assessment will likely continue to be an issue. However, SEC can address any concerns through its process of approving NASD rules.
- Non-bank diversified dealers said the act imposed few additional costs on them. Dealers most adversely affected were specialist firms whose recordkeeping systems were not automated or suited to keeping the customer account records required. One specialist primary dealer estimated its start-up costs at about $289,000 to adopt in-house systems, while a nonprimary specialist dealer provided an estimate of $50,000. While such costs are no doubt significant to the firms involved, we believe they should not be considered as pure regulatory compliance costs because such expenditures also helped to bring firms up to industry standards.
- Bank dealers experienced recordkeeping system costs similar to non-bank broker/dealers and also seemed to be the most affected by changes in the repo business. As discussed previously, several banks had viewed the loss of their sweep repo business as significant and had voiced their concern formally to Treasury prior to its August 1988 rule amendment. Also, an ABA official told us that annual costs to implement the new repo requirements averaged $75,000 per bank for five banks surveyed. While such costs are important, like Treasury we were not persuaded that they were too high a price to pay to ensure consistency in repo practices.
- The act imposed additional costs on Treasury, SEC, and the bank regulators, but these agencies did not view them as substantial and some agencies could not estimate them. Treasury estimated its fiscal 1987 costs at $208,400 and subsequent annual costs at about $300,000. Most of the

initial costs of the agencies were for promulgating rules and educating participants, while recurring costs involve examination, monitoring, and administration of the regulations.

Areas in Need of Attention

We have four concerns that we believe warrant attention from Treasury, SEC, and the regulators to ensure that the act's provisions are implemented effectively without imposing an unnecessary regulatory burden. These concerns relate to the accuracy of SEC's data base and differences in both examination frequency and advertising regulation for bank dealers relative to non-bank securities firms. Also, an opportunity to simplify regulation results from the fact that only a few firms have registered as specialist firms and are using Treasury's capital adequacy rules.

Problems With SEC's Data Base

Congress mandated the registration and notification requirements so that market participants could be identified and come under regulatory oversight. SEC keeps track of data on government securities brokers and dealers as part of its data base of the registration filings of all brokers and dealers, which these firms must keep up-to-date. The information is used for developing program statistics on market participants and regulator workload, and it is also used as a checklist to ensure that all dealers operating in the market are being regulated. For example, NASD examiners in New York obtained listings of registered government securities dealers from SEC so they could check for unregistered firms. In addition, Treasury referred to SEC several callers who were interested in learning whether or not particular firms were registered as government securities brokers or dealers.

We found SEC's data base was not completely reliable for determining the number and identity of active broker dealer participants in the government securities market. According to Treasury and NASD, SEC's quarterly listing of specialist dealers typically contained 10 to 20 firms that no longer were active as specialist firms. Typically, it also omitted 2 to 5 firms that were active as specialists. SEC's listing of diversified brokers and dealers was also incomplete when compared to NASD records. We obtained a list from SEC of 96 firms that prior to July 25, 1987, had reported on the old BD registration that they were deriving 10 percent or more of their revenue from government securities activities. We found, and SEC verified, that none of these firms had filed amended BD forms giving notice of their continued business activities as government securities dealers. As of February 15, 1990, 48 of the 96 firms were

shown on a NASD listing as being diversified government securities dealers, indicating that they were active in the market.

In addition to firms that had not filed, we found that the information in the data base was incomplete or inconsistent in 151 of 1,257 cases where firms filed the proper forms. Most of these were fairly obvious omissions. For example, firms indicated that they did 10 percent or more of their business in government securities but did not indicate if they were a specialist or diversified firm. We believe such errors could have been detected and corrected before the data were input into the system.

We realize the difficulty in maintaining an up-to-date data base of broker-dealer filings when the responsibility for accurate and timely submission is on the dealers and considering the frequency with which dealers enter or leave the market or adjust their lines of business. However, we also believe that there are practical steps the SEC can take to improve its data base.

At a minimum, SEC needs to improve its verification and checking of submissions that are obviously incorrect or incomplete so that erroneous information is not made part of the data base. Secondly, SEC should develop a process to reconcile its list of registrants with agency records. Such a process would not only assist SEC, it would help the self-regulators to determine if broker dealers have corrected their registration if required by examination findings.

SEC officials acknowledged that there are some problems with the accuracy of the data, and they said that they would give the issue some attention in the near future.

Infrequent Examinations by Some Bank Regulators Raise Compliance Concerns

Periodic examination by regulators is the primary means of ensuring compliance with all of the act's provisions—both those that apply to dealers and those that apply to depository institutions' custody of customer securities. The act did not prescribe how frequently regulators should examine registered brokers and dealers or nondealer depository institutions having custody of customer securities; instead it left the timing issue to the discretion of regulators. According to regulator records, OCC, FDIC, and OTS have examined their institutions less frequently than FRB, NASD and NYSE and were also slower to issue guidance on the act to examiners. Statistics also indicate that when examinations were done, compliance violations were usually detected. Therefore, we

have concerns about the extent to which OCC, FDIC, and OTS-regulated institutions are meeting the act's requirements.

Examination Frequency Varied

On page 30, we said that NASD did timely exams of newly registered specialist firms. For diversified dealers, NASD officials said they were meeting their goal of examining firms with customer accounts annually and other firms every 2 years. NYSE officials said they were examining all institutions annually. Similarly, FRB reported that in 1988 it had met its goal of having each state member bank examined annually (1989 statistics were not yet available).[19] FRB did 875 of the 1,063 exams itself; the rest were done by state bank examiners. Also, NASD, NYSE, and FRB had amended their guidance to examiners to reflect the act's requirements by May 1, 1988.

OCC's policy is to schedule exams using criteria based on asset size, random sampling, and identified need. Banks with assets over $1 billion are to be examined every other year—this would include 145 government securities bank dealers. OCC plans to examine one-sixth of all smaller banks—including 54 bank dealers—each year based on a random selection process. This criterion itself means less frequent exams than for FRB-regulated banks. However, in addition, OCC does not appear to be meeting its examination goals.

The majority of OCC regulated bank dealers, both large and small, were not examined for compliance with the act during 1988 or 1989. OCC reported to Treasury that in 1989, through November, it had examined 15 of the 199 bank dealers for compliance with the act's rules and reviewed compliance with repurchase agreement and custodial requirements for 24 other banks. OCC did not report statistics for 1988, but on the basis of other information provided to Treasury, it appears few exams were done. OCC says that some additional exams were done in both 1988 and 1989 and not reported to the national office. OCC said it did not issue its compliance procedures relating to custody of securities in repurchase agreements until January 1, 1989, because of delays in finalizing the related sections of the regulations. OCC did not view the hold-in-custody implementing regulations as finalized until August 1, 1988.

[19]Figures discussed in this section of the report represent those reported by the regulators in their response to a Treasury questionnaire on GSA implementation that was sent out in November 1989. The figures do not reflect those discussed on pages 41 and 46, which pertain to a different time period.

Like OCC, FDIC has examined few of its government securities bank dealers and did not update its examination guidance until February 1989. Although FDIC's policy is that banks are to be examined at least once every 2 years, through November 30, 1989, FDIC had completed exams of 2 of 47 dealers and 5 were in process. FDIC did not provide us statistics regarding coverage by state bank examiners. FDIC also did not provide statistics as to how many nondealer banks were examined for compliance with the securities custody requirements under the act. However, FDIC officials acknowledged that compliance with the dealer requirements and the securities custody requirements were not the focus of FDIC examinations until after FDIC issued its guidance to examiners in 1989.

OTS did not issue any guidance to the thrifts pertaining to the act until May 1989, and it did not prepare and disseminate an examination module for determining compliance with the act until October 1989. As a result, OTS has conducted only a small number of exams to determine compliance with the act's requirements. However, as noted below, the potential for noncompliance with the act resulting from lack of examinations is probably less for thrifts than for banks because thrifts are less likely to be dealers or custodians of customer securities.

Although a number of thrifts participate actively in the mortgage-backed securities market, a telephone survey of district thrift examiners by OTS officials in December 1989 did not identify any likely registrants. Also, thrifts are not major custodians of customer securities in repurchase agreements, except for certain "retail repurchase agreements" in which the thrift pools investor funds and invests them through a repo. Under these circumstances, the thrift may have to provide confirmations of securities ownership to the investors as required by the act.

OTS officials assert that it is likely that the examiners would have detected any serious deficiencies in the government securities activities of thrifts as part of the examiners' routine review of internal control and audit. Notwithstanding this assertion, we believe the limited and delayed OTS action creates some uncertainty as to whether thrifts have complied with the act's requirements.

Examinations Disclose Compliance Problems

We reviewed statistics and summary categorizations of exam findings provided by NYSE, FDIC, and OCC and two completed exam reports from FRB. This information shows that the majority of exams had noncompliance findings, particularly in the area of repurchase agreement related requirements. For example, OCC provided statistics on 31 examinations

completed in 1989 through September 25, of which 22 found 1 or more violations: 18 examinations identified customer protection violations, most of which showed improper compliance with repo requirements; 7 cited failures to fully comply with securities custodial holding procedures; 5 found problems with registration or filing requirements, 1 of which pertained to a bank that should have registered as a dealer but had not done so.

Implications of Examination Results

Effective examination is needed in order to determine whether the act's requirements are being implemented properly. However, the apparent lack of timely examination of bank dealers raises some complicated issues. We see no reason why, in principle, bank dealers should be examined less frequently than non-bank dealers, notwithstanding the differences in capital requirements applicable to the two types of dealers. On the other hand, it is widely recognized that bank examination resources are strained. Bank regulators could plausibly argue, in some instances, that on safety and soundness grounds, certain situations were of higher priority than checking on compliance with the requirements of the act.

The fact that bank and non-bank dealers do not appear to be subject to the same frequency of examination is a specific example of a larger problem—how to achieve a reasonable degree of comparability of treatment for dealers competing in the same market but examined by different regulators. We have not tried to address this larger issue in this study. While it will take time to solve all aspects of the broader issue, we think it would be reasonable for Treasury, SEC, and the bank regulatory agencies to address the more limited matter of frequency of examination in the near future. The study on implementation of the act that these agencies are to prepare by October 1, 1990, would be an appropriate place for this topic to be discussed and recommendations developed, because the study was to address the effectiveness of rules promulgated under the act.

Broadening Authority Over Government Securities Advertising

While NASD member firms are explicitly subject to NASD rules to prohibit abuses in government securities advertising, no comparable requirement applies to bank dealers. Bank regulatory officials acknowledge that the absence of a provision addressing advertising rules for bank dealers in government securities creates an unevenness in regulatory requirements between bank and non-bank dealers. However, the regulators did not see a need to provide additional regulatory authority in this area, primarily because they believe few banks advertise, and if complaints were

received, they could be investigated under SEC's anti-fraud rule (10b-5), which covers all securities.

While investigating complaints is important, NASD's experience demonstrates that other measures can be valuable. As discussed previously, NASD receives ads for review within 10 days of first use. In doing so, NASD found that at least half of the ads needed some change to make them acceptable. The relatively high revision rate in the ads that were submitted appears to demonstrate the value of such a review program as a supplement to complaint investigation.

It is difficult to determine how serious a problem there might be with the government securities advertising practices of bank dealers because this issue has not been a focus of regulatory attention. Bank examiners are not required to specifically evaluate the ads during their examinations, and bank regulator complaint records did not separately identify advertising issues. Bank regulators told us that in their experience, few bank dealers advertise their government securities activities. NASD's experience is also that relatively few dealers seem to advertise their government securities activities.[20]

The advertising authority given to NASD permitted officials to implement a program with some success. The bank regulatory agencies have no similar specific authority, although an OCC official said that the agency had authority to look at advertising under general anti-fraud provisions that it enforces. While we were unable to assess the effect of excluding bank dealers' government securities advertisements from explicit regulatory scrutiny, we see no reason why they should be excluded if we want to provide a comparable level of protection to all investors.

Potential for Simplifying Capital Requirements for Specialist Dealers

As discussed earlier, Treasury's regulatory requirements for specialist firms, except for the dealer capital adequacy rule and related reporting requirements, are essentially the same as the requirements SEC applies to diversified dealers. In basic design, Treasury's capital rates are also similar to SEC's. Capital can, however, be somewhat more complicated to calculate under Treasury's rule, and Treasury believes its rule is better suited to measuring specialist dealer risk and is easier for specialist primary dealers to implement.

[20]As noted on page 50, 98 NASD-regulated government securities brokers and dealers submitted ads for review in 1989. This represented about 7 percent of the 1,378 NASD-regulated government securities firms.

NASD and many dealers view Treasury's methodology as complex. They say that eliminating these rules would mean that duplicate financial forms could be eliminated, and regulator examination and CPA audit guidelines could be standardized for all securities firms. NASD officials told us eliminating the specialist category would simplify their examination scheduling and lower costs. The few specialist firms in districts outside of New York do not justify establishing permanent examiner expertise in all regions. Consequently, when exams need to be done in these regions, some of which are for large firms, examiners with government securities experience must be brought in from other regions or headquarters. NASD officials said that if all firms had to comply with the SEC capital rules, such expertise would not be a problem.

If the specialist rule were to be eliminated, some firms might have to maintain higher capital levels. However, NASD officials also say, and a FRBNY dealer surveillance official confirmed, that larger specialist dealers typically reported capital levels that were substantially in excess of required levels under both methods because the marketplace often wants to see substantial excess capital as an indication of the dealers' capacity to handle large transactions. Because of the excess capital reported, the NASD officials note that changing the minimum capital rules for these specialist firms would, therefore, not tend to affect the amount of capital actually held by the firms.

We believe that efforts to simplify capital regulation by eliminating a separate capital rule for specialist firms have merit. However, we are not persuaded immediate action is needed. Forcing dealers to change capital rules would impose additional compliance costs on dealers who set up their systems to meet the Treasury's requirements when the act was passed. We also observed that Treasury and SEC officials are continuing to review areas of difference in their requirements, a process that we expect would continue to refine both methods. Unless Treasury can demonstrate that a common capital rule is inappropriate for specialist firms, such efforts and the continued decline in the number of specialist dealers should make it possible to phase out a separate rule for specialized dealers.

Conclusions

Market participants indicate that implementation of the government securities act has succeeded in establishing a regulatory structure that applies to all dealers and improves the safety of the repurchase agreement market. Overall, Treasury has done a good job of getting reasonable rules in place on time without overburdening the market, and NASD

seems to be meeting its examination goals to ensure that newly regulated firms come under compliance.

Our concern about the act's implementation is that inaccuracies in SEC's data base of registrants and the limited number of compliance examinations by OCC, FDIC, and OTS raise doubts as to whether the act's registration and repurchase agreement provisions are being complied with to the degree possible. Moreover, the result of NASD's review of ads filed by its members suggests the need for a similar review of bank dealer ads.

Improving the SEC data base calls for relatively straightforward corrective action. Dealing with issues of examination frequency and advertising regulation of bank dealers are more complex because they need to be approached within a context of bank dealers' overall responsibilities and workload, as well as in the context of ensuring comparable oversight of the act's provisions.

Now that all government securities brokers and dealers have been brought under regulation, we believe it is appropriate to review the need for the unique capital requirements Treasury imposed on specialist firms to ensure that the differences in requirements are necessary and appropriate.

Recommendations

To deal with these concerns we recommend the following:

- SEC should develop a procedure for ensuring the accuracy of dealer registration data by, at a minimum, reviewing broker/dealer submissions for obvious omissions and inconsistencies and periodically (at least annually) having the self-regulatory agencies and bank regulators review SEC's lists of registrants to identify discrepancies for follow-up by either SEC or the regulator.
- The Secretary of the Treasury, SEC, and FRB, as part of their required study of the act's effectiveness, should develop recommendations to ensure that bank dealers' government securities activities, including advertising, are provided oversight comparable to the activities of NASD-regulated firms.
- Unless Treasury can demonstrate that a common approach results in capital requirements that are inappropriate for specialist firms, the Secretary of the Treasury and SEC should work together in developing a plan to phase out Treasury's unique capital requirements for specialist dealers.

Agency Comments

The Department of the Treasury commented on our recommendation that the Secretary of the Treasury and SEC should work together in developing a plan to phase out Treasury's unique capital requirements for specialist dealers. Treasury said that an informal staff level working group has been established, comprised of representatives from SEC, the Federal Reserve Bank of New York, and Treasury. This working group is considering the issues that need to be resolved in order to develop a uniform capital rule that would apply to the government securities activities of both specialist firms and other securities brokers and dealers. Pending the outcome of this study, Treasury said that it and SEC will continue to take advantage of opportunities to minimize the differences in the agencies' respective capital rules.

Additional Investor Protection Measures Are Needed

The act said that our study should include an examination of the effectiveness of the act in protecting investors. As noted in chapter 1, the act specifically limited Treasury's rulemaking authority and prohibited NASD from enforcing its rules of fair practice on the government securities activities of NASD members. In addition, newly registered specialist broker/dealers are not eligible for membership in the Securities Investor Protection Corporation and, therefore, cannot provide insurance coverage for customer accounts.

We believe Congress should reconsider the limitations on sales practice rules and SIPC coverage that now exist in the U.S. government securities market. Many of the reasons these investor protection measures were adopted in SEC-regulated securities markets also apply in the market for U.S. government securities.

The Need for Sales Practice Rules in the U.S. Government Securities Market

To ensure fair dealings and protect investors, the Securities Exchange Act of 1934 required that all exchanges and registered securities associations promulgate rules for their members to supplement the requirements of the act and of SEC regulations. These rules, which we refer to as sales practice rules, apply to transactions in SEC-registered securities. The rules define and regulate the kind of fraudulent or manipulative acts and practices that the securities laws were enacted to prevent, and they sometimes serve as a substitute for SEC regulations.

Sales practice rules for registered securities cover broker/dealer pricing practices (mark-up practices) and placement of customer funds in securities with risk characteristics suitable for the customers' investment objectives (suitability requirements). They also prohibit other practices, such as excessive trading of customer accounts to generate commissions (churning). Sales practices rules have been developed by self-regulatory organizations, such as NYSE and NASD, and approved by the SEC.

Sales practice rules also apply to transactions in municipal securities. Using its broad rulemaking authority over the sales practices of municipal securities dealers and brokers, the Municipal Securities Rulemaking Board (MSRB) has promulgated sales practice rules modelled after those of NASD.[1]

[1]MSRB's rules are approved by SEC. MSRB has no enforcement authority. Like Treasury, under the act, MSRB relies on SEC—through the SROs—and the bank regulators to ensure compliance.

The Government Securities Act does not apply sales practice rules to transactions in government securities, and the act prevents NASD from applying sales practice rules to government securities transactions. Many investors are, nonetheless, covered in some way by existing regulatory arrangements because the act does not prevent registered securities exchanges, such as NYSE, from applying such rules. In a similar manner, bank regulators have adopted the practice of applying MSRB's sales practice rules to transactions in U.S. government securities as well. We believe investors would be better served if Congress adopted legislation to protect customers of all U.S. government securities dealers by requiring sales practice rules comparable to those that exist in the markets for SEC-registered and municipal securities.

Sales Practice Rules Supplement Anti-Fraud Protection Available in All Markets

All securities dealers are subject to federal anti-fraud statutes. The law is contained in Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act.[2] Taken together, these provisions administered by the SEC prohibit material misstatements or omissions and fraudulent or manipulative acts and practices in the offer, purchase, and sale of securities.

SEC enforces the anti-fraud provision and takes the position that when individuals or firms put out their shingles as broker/dealers, they agree to operate honestly and in accordance with generally accepted industry standards and practices. This so-called "shingle theory" means that at a minimum, any deviation from the norm must be disclosed to the customer.

As pointed out in chapter 2, the act made it easier for SEC to act against fraud in the government securities market because information that could be used to bring fraud charges can be obtained much more easily from regulated firms. When a firm is regulated, officials from SEC and

[2]The SEC anti-fraud rule applicable to all securities dealers is rule 10b-5, which essentially restates the provisions of the two laws. Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or,

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

the SROs can have full access to a firm's books and records at any time. The act, therefore, makes the government market comparable to other securities markets with respect to the regulators' ability to enforce the anti-fraud statutes. However, the act does not provide for the type of sales practice rules that help to protect customers against abusive practices in other securities markets.

Sales practice rules have several practical benefits. First of all, they set a standard for conduct for all brokers and dealers operating in the market. These rules also gain force because they can be used by customers as support for legal action, principally in arbitration proceedings, alleging wrongdoing by brokers and dealers. Finally, the existence of sales practice rules enables regulators to cite a broker or dealer for violations without having to prove that the dealer had intended to defraud a customer.

As with any regulation, there are costs associated with sales practice rules. The rules limit broker/dealer activities and involve administrative costs that firms can be expected to pass on to customers. Unfortunately, it is difficult to quantify either the benefits or the costs of sales practice rules. The quantitative information that would be most useful in assessing the need for sales practice rules—evidence of investor losses that have occurred because of sales practice abuses—is hard to document. There is little incentive for individuals or those managing funds for others in a fiduciary capacity to admit to, and to publicize, instances where they have lost money. In preparing this report, we did not attempt to make an independent assessment of the prevalence of sales practice abuses in the government securities market, nor did we attempt to evaluate the effectiveness of sales practice rules in preventing abuses in the registered and municipal securities sales markets.

On the basis of information currently available, the case for extending sales practice rules to the U.S. government securities market rests principally on the following line of reasoning. Sales practice rules that supplement the basic anti-fraud provisions of the securities laws have become a fixture in securities markets in the United States. If these rules make sense for other securities markets, then they also make sense for the government market as well, because there are similar opportunities for abuse in both types of markets.

Characteristics of the Government Securities Market That Warrant Sales Practice Rules to Protect Investors

The government securities secondary market has traditionally been characterized as a wholesale market dominated by primary dealers and large institutional investors who are presumed to know what they are doing. While no comprehensive statistics on secondary market trading are available,[3] our discussions with market participants indicated that although the market is still primarily a wholesale market, there is evidence of increased secondary market participation by retail investors—smaller institutions, corporations, and individuals. For example, GFOA has provided guidance to its members regarding the development of suitable investment practices because these state and local government fiscal officers are more directly involved in the market due to increased pressure to narrow fiscal deficits through active management of their cash balances. In addition, a number of new investment instruments have been developed to facilitate investor participation, such as Treasury STRIPS and collateralized mortgage obligations. According to an NASD official, many of these instruments are purchased by retail-level investors. As noted below, the risk characteristics of many of these instruments are similar to the risk characteristics of registered securities.

Retail-level participants are valuable because they provide additional depth and liquidity for the market and profit opportunity for the dealers. We believe these retail-level participants are, however, also more vulnerable to losses relative to large commercial banks, insurance companies, and other large institutional market participants. Retail participants tend to be more dependent on information and execution from the dealers and may be less aware of risks and market values.[4]

NASD Should Have Authority to Enforce Sales Practice Rules in the Government Securities Market

NASD's inability to enforce sales practice rules in the government securities market creates a major investor protection gap in this market. The act's limitations on NASD mean that customers of NASD-examined dealers (approximately 63 government securities specialist broker/dealers and over 1,300 diversified broker/dealers) do not receive sales practice protection for their government securities transactions. As a result, customers of NASD-examined diversified dealers receive less protection on government securities transactions than on other securities transactions

[3]Reports of daily transaction activity that primary dealers provide FRBNY are the only data collected on market activity. These reports differentiate trades completed through brokers from direct trades between dealers and their customers (see table 4.1), but they do not differentiate the volume of trading with different categories of customers.

[4]As will be discussed in chapter 4, some large institutional investors can execute transactions with dealers through a screen broker in the same anonymous way that major dealers execute trades with each other.

with those same dealers. This situation has the potential to be especially confusing to investors because customers, seeing the NASD seal on the door of the securities firm, may not be fully knowledgeable about what transactions are and are not subject to all of NASD's sales practice rules. Customers of NASD-examined firms also receive less protection than customers examined by NYSE or bank regulators.

Contrast Between NASD-Examined Firms and Those Examined by NYSE or Bank Regulators

As a result of the act's limitations, NASD can only review improper practices in the context of the anti-fraud provisions of the securities laws.[5] NASD summarized its views on the problems resulting from the limitations in NASD's authority in a letter to Treasury in 1989.

"Because there are no sales practice regulations for government securities, NASD disciplinary actions involving abusive practices must rise to the level of fraud before anything can be done. While there are specific rules for equity securities or municipal securities addressing matters such as suitability, mark-ups, fairness of commissions, churning and other sales practices, there are no such rules for government sales practices, other than the SEC 10b-5 fraud rule. To successfully prosecute a 10b-5 case, the conduct must be so egregious as to rise to the level of fraud, and all the attendant evidentiary standards must be met including proof of scienter [intent]. Thus, many questionable sales practices falling somewhere between compliance and fraud go unaddressed in the absence of clear statutory or regulatory authority to do so."[6]

In contrast to the situation with NASD, if investors do their government securities transactions with any of the approximately 168 NYSE-examined government securities broker/dealers, their transactions would be covered by NYSE's sales practice rules. SEC and Treasury officials told us NYSE is not prevented from applying standards regarding

[5]In its report on a provision of S. 1416 that carried over to the enacted legislation, the Senate Banking Committee report stated:

"Since government securities would continue to be treated as exempted securities for purposes of the Exchange Act, a registered securities association would have no authority with respect to government securities brokers, government securities dealers, and government securities transactions except as specifically authorized in the bill or as already exists in current law....

Aside from the areas of regulation described in section 15A(f)(2), a registered securities association would not be authorized to regulate transactions in exempted securities by member brokers or dealers. For example, a registered securities association would be precluded from adopting, under section 15A(b)(6), any rules of fair practice applicable to government securities brokers and government securities dealers or from establishing any standards of financial responsibility, operational capability or competence with respect to government securities brokers, government securities dealers or their associated persons."

[6]Letter from NASD dated March 3, 1989, to Robert Glauber, Under Secretary for Finance, the Department of the Treasury.

sales practices to government securities activities because the act prohibited only registered securities associations, not exchanges, from applying such rules. Similarly, if the transactions were with one of the approximately 280 bank dealers, they could be subject to bank regulator oversight, although the authority and mandate to evaluate government securities sales practices is indirect.

NYSE Applies Sales Practice Rules to the Diversified Government Securities Dealers It Examines

NYSE officials told us that NYSE examines the government securities-related sales practices of its members in the overall context of activities in and management of customers' accounts.[7] In other words, NYSE examiners look to see that a member handled customer transactions, including those in government securities, in accordance with NYSE rules. NYSE officials said that sales practices in the government securities market are covered in the NYSE examination program, with the scope of each examination depending upon whether problems are expected based on the existence of complaints or internal control weaknesses.

NYSE rules covering sales practices essentially require every member organization to adhere to good business practices, properly supervise accounts, and report any suspected rule violations or complaints from customers to the Exchange. NYSE also has a suitability rule that requires member firms to use due diligence to learn the essential facts relative to every customer, every order, and every account. Regarding mark-up practices, NYSE uses its rules requiring good business practice and proper supervision as a basis for examination and any necessary action.

NYSE officials believe their rules provide an adequate basis for regulating the government securities related sales practices of member firms. They believe their ability to enforce the rules, in combination with the member firms' desire to maintain a good reputation, works to deter firms from knowingly engaging in improper conduct. They provided statistics on examination findings and complaints showing that few problems have been found or complaints received.[8] However, during the July 25, 1987, to June 30, 1989, period, NYSE had applied its rules as the

[7]NYSE rule 401 states that every member, allied member, and member organization shall, at all times, adhere to the principles of good business practice in the conduct of its business affairs.

[8]NYSE officials said that from July 25, 1987 to June 30, 1989, they conducted 330 examinations of government securities dealer members, and in 35 exams, there were 46 government securities related findings. They said none of the findings were sales practice related. NYSE officials also said that only 8 of the 340 sales practice complaints it received about its dealer members during the first 6 months of 1989 were government securities related. None of the government securities related complaints resulted in regulatory sanctions against any firm.

criteria for sanctions against 10 individuals who were dismissed by their firms because of improper government securities dealings.

Bank Dealers

The primary focus of bank examinations is to ensure that the institution is operating in a safe and sound manner. Bank regulators told us that they do not have explicit authority to review the government securities sales practices of bank dealers, but they do so in the general context of ensuring that the bank is properly handling transactions involving customers' securities and funds. Bank regulators said that they follow the guidelines promulgated by MSRB for municipal securities sales practices because the typical bank dealer handles government and municipal securities as part of the same operation. An official of the American Bankers Association (ABA) told us that the sales practices of banks in government securities are conducted and operated in accordance with the rules of SEC, NASD, (as applied to registered securities), and MSRB, and that the bank policies and procedures manuals are subject to bank examiner review.

There is some evidence that investors are benefiting from bank regulator enforcement of sales practice rules on government securities bank dealers. Regulators have investigated sales practice complaints received from customers of bank dealers, which have resulted in corrective actions.[9] Although no statistics on the number of sales practice findings generated by bank examinations were available, bank regulators told us that examinations have not revealed many government securities sales practice problems. In addition, regulatory officials have periodically advised bank examiners and the institutions being examined regarding the nature of the standards that are being applied and the types of problems found.[10]

[9]OCC told us they had received 50 complaints concerning sales practices in the government securities market between July 1987 and July 1989. The complaints were grouped into 5 categories: Unauthorized transactions (15), customer not receiving purchased securities (12), pricing (10), misrepresentation (8), and customer disadvantaged (5). Nearly half of the settled claims resulted in some compensation to the investor.

[10]For example, in 1984 OCC used exam findings to clarify guidance to its examiners about what are unfair or unsafe practices. Some of the specific problems noted were:

- overtrading (churning) customer investment portfolio,
- investing customer funds in speculative long-term securities or stripped securities unsuitable for the customer, and
- improper pricing of securities.

Investor Protection Concerns

The preceding discussion indicates there is evidence that government securities investors derive some benefit from NYSE and bank regulator application of sales practice rules. If NASD were to be given similar ability to enforce sales practice rules, the benefits to investors would likely fall in the areas of dealer mark-ups and investor suitability in the government securities markets.

Dealer Mark-Ups

Rules involving dealer pricing practices (mark-ups) consider both the size of the mark-up and whether or not the customer was told what the mark-up was (disclosure). While the reasonableness of a particular mark-up is a judgment call based on a number of factors, some criteria for fraud have evolved as SEC has taken legal action against dealers, and those actions have been supported or negated by the courts. Specifically, SEC has considered any undisclosed mark-up in excess of 10 percent of the price of any security to be fraudulent, because such a mark-up is far in excess of industry norms. Mark-ups in excess of 5 percent are considered questionable.

For registered securities, NASD has administered a 5 percent mark-up guideline on its members. This guideline creates a somewhat stricter standard than that contained in the SEC anti-fraud rules. It also allows NASD to bring an action without having to prove fraudulent intent.

SEC's position is that mark-ups smaller than 5 percent can also be considered fraudulent if they are undisclosed and in excess of industry norms. SEC articulated this view in an April 1987 notice[11] in which it stated that mark-ups in the government securities market are typically lower than in equity markets, and that the industry norm was to charge a mark-up on Treasury securities of 1/32 percent to 3-1/2 percent. However, SEC has not taken court action on mark-ups just exceeding these norms, choosing instead to pursue cases where the mark-ups exceeded the 10-percent or 5-percent thresholds.

NASD believes it should have authority to enforce mark-up rules in the government securities market (1) because of the difficulty of proving intent and (2) because contemporary standards for maximum mark-ups are even farther below the thresholds for fraud than are the maximum markups for registered securities. In a 1988 poll of dealers, NASD was

[11]Securities and Exchange Commission Release No. 34-24368, Zero Coupon Securities, Federal Register Vol. 52, No. 82, April 29, 1987, pp. 15575-15577.

told that mark-ups typically ranged from 3 to 13 basis points (1/32 percent to 4/32 percent) for Treasury notes and bonds.[12] Thus, a mark-up of, say, 3 percent for such Treasury securities could easily be excessive but go unchallenged in the absence of a rule, because the practical fraud thresholds are generally in the 5- to 10-percent range.

In the absence of specific NASD rules governing mark-ups, the Arkansas Securities Commissioner in April 1989 issued a mark-up schedule applicable to government securities transactions. This schedule establishes mark-up limits for various types of transactions ranging from 1/4 percent to 2-1/2 percent (25 to 250 basis points). Dealers are required to provide justification for mark-ups that exceed these guidelines.

The Arkansas rule was adopted because of the activity of certain government securities dealers in the state. These dealers have come under extensive regulatory and criminal investigations resulting in fines, suspensions, and prosecutions for certain firms and participants. Some of these firms engaged in excessive unsuitable trading of customer accounts (usually small banks and thrifts and state and local governments), which has resulted in sizable losses for the institutions but substantial commission income for the bond salesmen. NASD and the Arkansas State Securities Commission eventually moved against those institutions by applying the anti-fraud statutes. However, NASD officials believe that its inability to enforce sales practice rules inhibited NASD from moving against these firms more quickly.

Arkansas' response of creating its own rule is understandable. However, the state's action underscores yet another reason to incorporate sales practice rules within the scope of federal securities laws. If each state begins to take action on its own, the national character of the government securities market would be diminished somewhat. Because of the government's interest in selling its debt at as low a cost as possible, we believe standards for protection should be promulgated at the federal level. Such standards can still allow some flexibility to deal with regional differences in markets.

Investor Suitability Rules

Investor suitability rules have been developed in the context of SEC's requirements that broker/dealers must deal fairly with their customers. For example, NASD's rule, which applies only to registered securities

[12]The results of NASD's poll were consistent with guidelines set out in bank examination manuals. The manuals note that mark-ups on government securities ranging between 1/32 and 4/32 of a point are typical, and that higher mark-ups should be evaluated to determine whether circumstances justified them. For example, infrequently traded securities can have higher mark-ups.

transactions and cannot be applied to government securities transactions, states that:

"In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[13]

This means, for example, that a dealer cannot excessively trade a customer's account, recommend a purchase beyond the customer's ability, or recommend speculative securities inappropriate for the investor's objectives.

MSRB has a similar rule, which states that dealers are required to make reasonable inquiry as to the financial condition and investment objectives of the customer so that the dealer has reasonable grounds to believe the investment is suitable for the customer and no reason to believe it is not. The MSRB rule still allows the dealer to execute the transactions at the direction of the customer once it has communicated its concerns to the customer.

The importance of applying investor suitability rules to the U.S. government securities market is illustrated by the regulatory treatment of zero coupon instruments and mortgage-backed securities. These instruments are available both in the government securities market and the registered securities market. The primary suitability problems associated with these securities arise from the nature of the instruments themselves, not from the presence or absence of a government guarantee for the securities.

Zero coupon instruments present suitability problems for some investors. Because these instruments are priced at a deep discount, their price is very sensitive to interest rate changes and may fluctuate considerably prior to maturity. Such changes could result in significant losses to an investor who could not hold them to maturity. NASD officials are concerned that investors are not adequately informed of this risk.

Mortgage-backed securities also present suitability concerns for the unknowledgeable investor or one that may have intermittent liquidity

[13]NASD Rules of Fair Practice: Recommendations to Customers, Article III, Section 2, Paragraph 2152.

needs. The cash flows associated with these securities are hard to determine because they depend on how fast borrowers pay off the principal on the underlying mortgages (usually by sale of the mortgaged property or refinancing). Such behavior is very sensitive to movements in interest rates and can leave a customer with funds to reinvest unexpectedly at the worst time—when interest rates have fallen. Also, different parts of the country and types of mortgages have different prepayment characteristics. Thus, all 9-1/2 percent GNMA mortgage-backed securities are not alike in maintaining their value over time as interest rates change.

The most systematic effort we know of to document investor losses that have occurred since passage of the act has been conducted by the Government Finance Officer's Association (GFOA). GFOA has collected information on a number of instances in which state and local governmental entities have lost money—in some cases, millions of dollars—due to investments that appear to be unsuitable. According to this information, one state lost over $200 million, and a city lost over $60 million in inappropriate speculative bond trading. In addition, one jurisdiction incurred losses by trading zero coupon bonds, and another by inappropriate hedging of transactions in mortgage-backed securities.

The losses in the various situations documented by GFOA appear to result from poor practices by both investors and dealers in much the same way as did losses in the repurchase agreement market, which prompted passage of the act. GFOA has issued guidelines to its members that they review the use of long-term securities, including GNMAs and zero coupon securities, to ensure that the risk characteristics are suitable to the investor's objectives. GFOA has been supportive of NASD's concerns regarding the need for appropriate sales practice rules.

We have not attempted to review the details of the cases identified by GFOA to determine what parties were at fault and whether the losses would have been prevented by explicit sales practice rules. The cases do, however, show that the potential for loss in the government securities market is similar to that in the markets for registered and municipal securities. We therefore think it reasonable that less sophisticated individual and institutional investors in the government securities market should have the same protections against abuse that exist in the registered and municipal securities markets.

Sales Practice Rules Should Be Promulgated at the Federal Level

Lifting the limitations on NASD's authority to enforce sales practice rules is a necessary step in providing adequate protection to investors in the government securities market. For the firms it examines, NASD would then be in a position, just like the NYSE, to enforce its SEC-approved sales practice rules in the government securities market.

We believe, however, that government securities dealer sales practices should also be subject to explicit rulemaking by a federal agency. This would highlight the importance of investor protection in this market. Explicit rulemaking would also make it more likely that similar protections would be available to customers of both bank and non-bank dealers.

Why Rulemaking by a Federal Agency Is Appropriate

Vesting rulemaking authority in a single federal agency represents the best way to develop consistency in a market in which both bank and non-bank dealers operate. The presence of both banks and securities firms in the government securities market creates potential regulatory problems, because each type of firm comes under the jurisdiction of a different type of federal regulatory arrangement. Securities firms are regulated and supervised by SEC and must also join a self-regulatory organization such as NASD or the NYSE. Banks, on the other hand, are regulated and supervised by one of the federal banking agencies—OCC, the Federal Reserve, or FDIC.

At the present time, NYSE and the banking agencies both rely on examiners' judgment to protect investors against sales practice abuses. NYSE does not have an explicit rule governing mark-ups, nor has it provided written guidance to its examiners as to what constitutes unreasonable mark-ups in government securities. NYSE officials told us examiners are to use their own judgment as to whether a dealer's mark-ups to a customer are excessive. They said criteria for this judgment is primarily derived from SEC guidance and enforcement actions.

Bank regulators include a discussion of reasonable government securities mark-ups in the examination manual. The examination procedures say that examiners are to test for unsafe and unsound practices, including comparing trade prices on selected transactions with independently established market prices as of the date of trade. Federal Reserve officials said that examiners have considerable room for judgment in evaluating the reasonableness of mark-ups and generally challenge only those that are clearly egregious because the individual examiners have

no readily available industry standards for mark-ups in government securities.

Given the division of responsibility among federal agencies, the best way to get as consistent an approach as possible to protection against sales practice abuses is to have the same general rules apply to all types of firms. The principle of providing rulemaking authority that applies to bank and non-bank dealers is reflected in the Government Securities Act, particularly in regard to repurchase agreements.

When faced with the issue of how to establish consistent investor protection measures among all bank and non-bank dealers operating in the municipal securities market, Congress created MSRB. MSRB's rules, which apply to all types of dealers, are also subject to approval by SEC. While we believe that a single focus for rulemaking is appropriate, this does not mean that an entirely new agency analogous to MSRB must be established. The Government Securities Act already provides a framework for establishing rulemaking responsibility in the government securities market. The topic of the appropriate role of Treasury and SEC in setting rules is discussed in chapter 6.

Structuring Rules for the Market

It was not our objective in this study to develop the specific sales practice rules for government securities dealers. In keeping with the underlying philosophy of the Government Securities Act, we believe every effort should be made to assure that sales practice rules in the government securities market are as consistent as possible with the rules already developed for other securities markets by SEC, MSRB, and self-regulatory organizations. In keeping with current practice for registered securities, the rulemaking authority can be used to approve rules developed by SROs (such as NASD), and it can also be used to approve rules proposed by the agencies that regulate and supervise banks.

Fair practice rules need to be flexible enough so that attempts to control abuses do not inhibit the operation of a market that, for the most part, works well. Examiners need to be able to consider a number of factors that affect the trading relationship between the dealer and the customer and the terms of the particular trade. These factors include the size of the trade, the type of investor, the role of the dealer in executing the trade, the dealer's role as a marketmaker, the extent to which the securities are actively or inactively traded, and the information on current market prices available to the customer.

A flexible arrangement also allows the regulatory system to keep current with changing market conditions so that regulators and the firms being regulated can be held accountable for the protection afforded to investors. For example, certain "sophisticated" investors could be excluded from coverage because they operate in wholesale segments of the market and can be presumed to be knowledgeable about risks, values, and prices. Such arrangements need to be flexible because the criteria for sophistication can change, particularly if (as will be discussed in chs. 4 and 5) trading and information systems evolve that give some investors access to, or knowledge of, the prevailing interdealer market prices for government securities.

Qualifying Examinations for Dealers and Brokers

Brokers and dealers in SEC-registered securities are required to pass a qualification examination intended to safeguard the investing public by helping to ensure that registered representatives are competent to perform their jobs. This exam, known as the Series 7 exam, is a companion requirement to the investor suitability rules because it tries to measure whether or not a candidate has attained an entry level of competency necessary to properly advise customers and process the customer's transactions. For example, registered representatives of NASD member firms who are engaged in sales and trading activities are tested for knowledge about the trading and risk characteristics of products they recommend and sell to investors. Managers and supervisors are examined for knowledge of the securities laws and regulations for which they have compliance responsibility.

Broker and dealer personnel who deal solely in government securities are not required to pass such an examination. However, it is difficult to assess the amount of harm caused by the absence of an examination requirement, because the effectiveness of the testing process has not been evaluated and it was beyond the scope of our work to do so. We found that regulators' opinions about the need for an exam generally are favorable but the degree of support varies. Officials from SEC and FRB recognize that while exams are useful, passing an exam does not ensure an individual's competency or integrity. On the other hand, two NASD officials said that exams should be required of chief financial officers of government specialist firms. They pointed out that a financial officer of a diversified firm can get fired for failing to pass the required exam, but the officer would have no problem joining a specialist firm because a test is not required.

The uncertainty created by the lack of qualification exams is also a concern because, as noted earlier, government zero coupon and mortgage-backed securities have risk characteristics similar to nongovernment zero coupon and mortgage-backed securities. Consequently, if testing requirements for managers, sales personnel, and traders in nongovernment securities were considered important for ensuring enforcement of rules relating to investor suitability, it would seem reasonable to have them for personnel of firms involved in comparable government securities.

Protecting Government Securities Investors Against Broker/Dealer Failure

SIPC is a nonprofit corporation that insures the securities and cash in the customer accounts of member broker/dealer firms against the failure of those firms. Except for government specialist dealers and certain other specialists,[14] all brokers and dealers registered with SEC (who, therefore, also must be members of a national stock exchange and/or NASD) are automatically members of SIPC. When a brokerage firm fails, SIPC will try to transfer accounts to another brokerage firm and then will liquidate the firm's assets to settle any remaining claims. SIPC protects customers' cash and securities up to a maximum of $500,000 per customer, with a limit of $100,000 on cash and cash equivalents. SIPC does not, however, protect investors against losses due to market fluctuations in security prices or due to repo transactions.

In passing the act, Congress did not make government securities specialist dealers eligible for membership in SIPC. Therefore, if 1 of the 63 specialist broker/dealers fails and is maintaining customer accounts, these customers have no federal protection for their funds.

We believe this gap in SIPC coverage is not appropriate. There is nothing in the operation of a government securities specialist dealer that uniquely insulates such firms from the types of risks that led Congress to authorize SIPC. We found that 20 specialist dealers could maintain customer funds and securities.[15] Fraud in handling customer accounts could

[14]Non-bank broker/dealers do not have to join SIPC if their business is exclusively: (1) distribution of mutual fund shares, (2) sale of variable annuities, (3) insurance business, or (4) furnishing of investment advice to investment companies or insurance company separate accounts.

[15]Of the 63 specialist brokers and dealers in July 1989, 16 were brokers and 47 were dealers. Information available on 43 of the 47 dealers showed that 23 of the 43 firms claimed an exemption from certain capital requirements because they did not maintain customer accounts. Of the other 20 dealers that did not claim the exemption, 12 had nondealer customers and could maintain accounts for those customers such that it would have to provide SIPC coverage if it were a registered firm. We did not attempt to determine how many of these firms were maintaining customer accounts, but we are aware of one specialist dealer that was doing so.

occur as easily in a government securities specialist firm as in any other securities firm. Similarly, specialist firms could go bankrupt from poor investment decisions just as easily as other firms.

We believe the absence of SIPC coverage for specialist dealers can be confusing to investors in sorting out the protection provided when dealing with certain firms. Specifically, we found that 13 of 47 specialist dealers have affiliates that are diversified securities firms that provide SIPC coverage. We also found that some of these specialist dealers share the same office space and personnel with their diversified affiliates. As we entered the premises of one such dealer, we observed that the door listed the names of the firms and had a SIPC membership seal at the bottom of the door. We think such a shared arrangement can easily keep investors from appreciating that transactions with different affiliates may carry different protection.

One way to reduce the potential for confusion would be to require specialist dealers to clearly disclose that they do not provide SIPC coverage.[16] However, we question whether customers of specialist dealers should be without SIPC protection if they would have such protection by dealing with a diversified firm. As was the case with sales practices, we believe the protection for investors in the government market should be at least as great for comparable risks as it is in other securities markets. We also see no reason why specialist firms should be able to avoid the responsibilities for supporting the integrity of the market that derives from SIPC insurance.

Another way to reduce the potential for confusion would be to abolish the category of specialist firms and require all securities firms operating in the government securities market to register with SEC, in the same manner as firms dealing in registered securities. Because of the limited experience that exists under the government securities act, we feel there is not enough information available to determine whether the specialist firm category established by that act could be abolished. However, differences between specialist and other securities firms should greatly diminish as similar capital requirements and sales practice rules are applied to all securities firms operating in the government securities market.

[16]Such a disclosure currently exists for repurchase agreements involving SIPC-insured firms. Treasury rules require that all repo agreements include a notice that SIPC coverage does not protect a customer's securities held in custody by a SIPC-insured dealer.

Extending coverage to the relatively small number of specialist firms would not represent a major expansion of SIPC's potential liability. Payment by specialist firms of a SIPC premium would, of course, represent an increased cost to those firms, although SIPC premiums are not large relative to the total revenue of securities firms.[17] Because the activities of such firms could easily involve two areas—repos and transactions in Treasury bills—that are not subject to the regular SIPC assessment formula, a special assessment formula for such firms would have to be developed.

The fact that SIPC coverage is available only for non-bank securities firms also raises a question about the comparability of insurance protection for customers of bank and non-bank dealers. Our understanding is that, although not obvious, there is a considerable degree of comparability in protection for bank dealers' customers because of the way deposit insurance works. According to FDIC officials, money (up to $100,000) received from a customer to buy securities would be considered an insured deposit if the bank were to fail. Similarly, if a bank failed, securities held for a customer would be returned to that customer. Because most insured banks are merged into another institution rather than liquidated, amounts in excess of $100,000 would typically be transferred to the new institution and would be available to the customer there. Bank customers would appear, however, to have less protection than under SIPC if a bank failed, a customer's securities were missing, and the bank was liquidated rather than merged into another institution.

We recognize that whether the deposit insurance system should cover dealer activities is an issue that can reasonably be addressed in its own right. If the definition of insured deposits were changed so that funds given to a bank for the purchase of securities were not covered, arrangements should be made for providing coverage for the securities activities of bank dealers similar to that now provided by SIPC.

[17]SIPC assessments are based on a firm's gross revenue subject to a number of adjustments. However, for several years prior to 1989, SIPC has had sufficient balances such that it assessed each member a $100 administrative charge instead of the regular assessment. A SIPC official told us a regular premium of 3/16th of 1 percent of adjusted revenues (minimum $150) was collected starting in 1989. The official said adjustments related to repurchase agreements typically reduced the premium assessment for many government securities dealers toward the minimum amount. Furthermore, the Securities Investor Protection Act of 1970, the act that authorizes SIPC, limits the assessment on commissions earned from transactions in Treasury bills based on SIPC's loss experience on such instruments over the preceding 5 years.

The comparability of bank dealer and non-bank dealer customer protection is a relevant issue to address as part of an overall assessment of the regulatory requirements imposed on these two classes of dealers. However, we believe equalizing the SIPC coverage for customers of specialist and diversified non-bank government securities dealers is possible without addressing this larger issue.

Conclusions

When the Securities and Exchange Acts were adopted, and for many years subsequently, it could plausibly be argued that participants in the U.S. government securities markets did not need all of the sales practice protection designed for investors in registered securities. The principal reasons for this were the wholesale nature of the market, the size and competitive nature of the market, and the underlying soundness of the securities being traded.

Subsequently, it has become harder to draw the line between sophisticated investors who do not need protection and other investors who do. The Government Securities Act was passed in 1986, after it became clear that the presence of unregistered government securities firms could hurt investors and damage the market. Congress decided that it was in the national interest to be sure that investors in U.S. government securities would always be dealing with firms that were subject to certain requirements common to all securities dealers.

We think the same logic inherent in the act should be extended to sales practices and SIPC insurance. The current limitations on NASD and the differences in sales practice enforcement by NYSE and bank regulators, together with the lack of SIPC coverage for specialist firms, have created a situation in which some investors in the government securities market can receive less protection from sales practice abuses and losses than can investors in SEC-registered securities. We see no compelling justification for allowing such limitations in protection to continue.

Recommendations to Congress

We recommend that Congress amend Section 15 of the Exchange Act (and such other statutes as may be necessary) to authorize a federal agency to adopt general rules of fair practice applicable to all government securities brokers and dealers. Self-regulatory organizations and bank regulators should also be authorized to develop and enforce specific requirements within the context of general rules. The rules, at a minimum, should cover dealer pricing practices (mark-ups) and investor suitability requirements. The question as to whether Treasury or SEC

should have rulemaking authority is addressed in chapter 6 in the context of extending Treasury's authority beyond the sunset date.

We also recommend that Congress amend the Exchange Act to require that all non-bank government securities specialist dealers provide SIPC coverage if their business with customers is similar to that for which SIPC coverage normally applies in SEC-registered securities markets. Furthermore, SIPC's assessment structure should be modified so that specialist firms covered by SIPC pay their fair share of the assessment burden.

Agency Comments and Our Evaluation

SIPC commented on two aspects of the draft report. SIPC did not take a position on our recommendation to extend SIPC coverage to customers of specialist firms. SIPC expressed concern, however, that requiring specialist firms that held customer accounts to become SIPC members would represent a departure from past practice. To date, all SIPC members are subject to the full rulemaking authority of SEC. Under our recommendation, the firms would be subject to Treasury rules. SIPC stated that because differences in financial responsibility rules might affect SIPC's exposure to risk, such a change needed to be thoroughly thought through, explored, and discussed.

We agree that the change we are proposing should be considered carefully. However, we believe the change does not represent as great a departure from current practice or as great a potential insurance risk as the SIPC comment seems to imply. Under the Government Securities Act, all securities firms doing business in the government securities market are already subject to Treasury's rules; and the Treasury rule that potentially makes the most difference to SIPC—the capital adequacy rule applicable only to specialist firms—is similar in design to the SEC rule.

Our recommendation in chapter 2 that differences between the Treasury and SEC rules be eliminated is based on simplifying the regulatory structure, not on a concern that the Treasury rule would sanction situations that were inherently riskier than those permitted under the SEC rules. As noted in chapter 2, Treasury says it is working with SEC and Federal Reserve System officials to develop a common capital rule. The risks to SIPC from having Treasury as rulemaker are also minimal because the supervision of specialist dealers, including enforcement of the rules, would be conducted by an SRO (NASD) that already supervises many SIPC members and that is subject to full SEC oversight. If, over time, differences between specialist and other firms are greatly diminished, it might

be appropriate to abolish the specialist category, at which time the concern raised by SIPC would no longer be an issue.

SIPC also said that changes in the assessment structure were needed if membership in SIPC were extended to specialist firms and those firms were to pay their fair share of the SIPC burden. The issue arises because specialist firms are likely to conduct business that is concentrated in activities subject to little or no SIPC assessments. We agreed with this comment and added a recommendation in this chapter concerning assessments to be sure that specialist firms would pay their share.

Trading Access to Screen Broker Systems Should Not Be Regulated at This Time

Ensuring the fairness and openness of key market systems has played an important part in the development of securities market regulation. To achieve these objectives, SEC has been provided authority to regulate the operating practices of exchanges and trading systems in registered securities markets. However, when it passed the Government Securities Act of 1986, Congress did not see the need to regulate the operating practices of the over-the-counter market for government securities because the market, for the most part, worked well.

This chapter discusses whether rulemaking authority should be extended to include regulating the blind trading systems operated by screen brokers, focusing specifically on access criteria. The issue arises because even though a great deal of trading takes place directly between dealers and investors, these broker systems continue to be the principal way major dealers trade with each other.

As noted in chapter 1, we examined the question of access to broker services in our 1987 report. In that report, we separated the question of trading access from the question of expanding access to information contained on the broker screens. We will follow the same separation in this report.

The Nature of the Issue

Most observers agree the government securities market is an efficient, liquid market. It accomplishes an average daily trading volume that is many times greater in dollar value than the combined volume that occurs on stock market exchanges and the over-the-counter National Association of Securities Dealers Automated Quotations (NASDAQ) system operated by NASD. As noted earlier, the market is dominated by 42 primary dealers who have pledged to FRBNY that they will keep the market liquid by bidding at Treasury auctions by standing ready to enter into transactions with FRBNY, and by continuously making markets in a broad spectrum of issues and maturity ranges.

A major feature of the government securities market is the existence of limited access in the interdealer and retail screen broker systems that figure so prominently in the trades conducted by primary dealers. Available statistics show that these screen brokers have become an even more important part of the market since 1987. The volume of secondary market trading by primary dealers was not much higher in 1989 than in 1987, but the percentage of primary dealer trades conducted through brokers increased. In 1989, an average of 58.9 percent of all primary

dealer trades were conducted through screen brokers. In 1987, the percentage was 55.9 percent. (See table 4.1.)

Table 4.1: Primary Dealers Average Daily Trading Volume in Treasury Securities: 1985-1989

Dollars in billions

	1985	1986	1987	1988	1989
Average daily trading volume	$75.3	$95.4	$110.1	$101.6	$112.7
Screen brokered trades[a]	$36.2	$49.6	$61.5	$59.8	$66.4
Percent of trades screen brokered	48.1	52.0	55.9	58.9	58.9

[a]Interdealer and retail brokers.

Source: Federal Reserve Bulletins (March 1988, May 1989, March 1990).

Since the screen broker systems constitute the main wholesale market for government securities, the question arises as to whether access to these systems—and perhaps other features of these systems as well—should be subject to rules, approved by a federal agency, designed to keep markets fair and open. Such rules, however, would represent a different type of regulation than contemplated in the act.

In securities market regulation, a clear distinction exists between regulation of the activities of individual broker/dealers and the regulation of structured trading systems within which firms may operate. Broker/dealer regulation includes the operation of the firm and its dealings with customers—the capital adequacy and recordkeeping requirements and sales practice rules discussed in chapters 2 and 3. Structured trading system regulation used to regulate exchanges concerns such things as who has access to the system, rules of procedure, responsibility for controlling risks, and financial responsibility in the event of a failure.

The legislative history of the act makes it clear that Congress did not intend to apply trading system rules to the government securities market. The act only regulates certain aspects of individual broker/dealers. Furthermore, as the following discussion shows, the government securities market has many characteristics that make it inappropriate to consider screen broker systems to be like exchanges. If consideration is to be given to regulating access to broker systems, Congress and the appropriate regulatory agencies would need to develop measures tailored to the special circumstances of the government securities market.

Differences Between Exchanges and Screen Broker Systems

The most highly regulated trading systems are found in the stock market. These trading systems include the NYSE and other stock exchanges together with NASDAQ. These structured trading systems bring buyers and sellers together in a single location or through a single electronic system so that members can obtain the best price quotations available from all other members. On these systems, certain dealers—called "marketmakers" or "specialists"—take responsibility for maintaining continuous markets in the stocks for which they have responsibility. Members of these systems are obligated to pass all transactions in listed securities through the exchange or NASDAQ so that the price of the transaction can be recorded. A continual flow of information on market transactions is available to investors through financial information services.

The exchanges and NASDAQ are owned by their members, but their rules of operation are subject to approval by the SEC. These rules cover such things as eligibility requirements and trading responsibility rules in the event that a problem arises. The organizations are self-regulatory organizations under the securities laws. This means that they are responsible for enforcing securities regulations on their members and they are held accountable by the SEC for the diligence of their efforts.

The structure of the government market varies considerably from the stock market. There is no centralized trading place or single electronic system. Rather, the market is essentially a decentralized dealer market in which dealers, brokers, and investors do business over the telephone. The trading systems, independently operated by several screen brokers, provide an efficient way to accomplish telephone trading while also providing anonymity to the participants. Also, unlike exchanges, there are no designated marketmakers for the systems. Primary dealers, who are obligated to be marketmakers by virtue of their FRBNY designation, can choose to use various screen brokers for trading, but there is no requirement that they do so.

The rules for broker trading systems take the form of generally accepted practices rather than enforceable rules. Moreover, each screen broker is free to make its own private business decisions without regulatory approval regarding: access criteria; market coverage; commission rates; trade execution processes, including how it assigns trade execution priority; and the terms for access to information on completed trades. Because dealer participation is voluntary, brokers would be able to be responsive to the interests and needs of their more active customers whose participation generates revenue for the broker. Also, unlike

exchanges, brokers are not required to enforce the securities laws on their customers.

These basic differences in the trading system components of the government securities market and exchange markets have continued for some time. However, changes in the clearing and settlement component of the government securities market have recently occurred which are making a major part of the government market comparable to the clearing and settlement arrangements in registered securities.

For exchange-traded securities, the risks that trades will not be completed as agreed are small because the vast majority of trades are settled and cleared through a single clearing corporation, the National Securities Clearing Corporation (NSCC) whose members have pledged capital to, in effect, guarantee all the trades it clears. In contrast, trades in Treasury and agency securities are usually cleared and settled on the next day through banks that specialize in this activity.

Although each clearing bank monitors the size of its risk exposure to each customer and can require customers to put up funds, these individual clearing arrangements do not provide any systemwide way of managing or sharing clearing and settlement risk. Because dealers and investors can have clearing arrangements with several banks, the dealers' or investors' total exposure is unknown. Therefore, if the dealer or investor defaults on its obligations, the risks associated with that failure fall onto the clearing bank and the particular entities that had open trades with the firm. However, the recent start-up of the Government Securities Clearing Corporation (GSCC) is a development which promises to bring some comparability to the way clearing and settlement risks are managed among major market participants. (See p. 71.)

Trading Access to Systems in the U.S. Government Securities Market Will Be a Continuing Matter for Congressional Oversight

Our December 1987 report addressed the question of whether regulations should control who should be allowed to trade on the blind trading systems in the U.S. government securities market. Given the importance to the government and the general public of the smooth operation of the government securities market, we concluded in our previous report that at that time the potential risks from forcing expansion outweighed potential benefits. We noted that blind trading systems only work if participants in those systems can be confident that the risks inherent in such systems are being properly monitored and controlled.

Primary dealer status, to which any dealer can aspire, provides a basis for giving participants that confidence. If a firm meets the FRBNY primary dealer standards, other firms have confidence that the firm is committed to actively making markets in the full maturity spectrum of Treasury securities, has the experience to know what it is doing, and has sufficient capital. In addition, FRBNY's periodic review of primary dealers' activities provides assurance beyond that supplied by annual audits and examinations that the firm is living up to its primary dealer commitment.

Our earlier report also pointed out, however, that changes could occur in the market that would make expanded trading access less risky and therefore more feasible.

> "Changes occurring in the secondary market may make it more feasible to develop alternative means for controlling risks in blind brokerage systems by identifying the nature and degree of risks more carefully, by fixing responsibilities more clearly on market participants for bearing them, and by designating appropriate monitoring systems. One development that could lead to expanded access is experience currently being gained by implementation of a regulatory structure under the Government Securities Act of 1986. In time, confidence in this regulatory and supervisory structure could lessen the market's reliance on certain aspects of FRBNY's primary dealer designation. If a proposal can be developed which adequately controls risks, we see no inherent reason why primary or aspiring primary dealer status needs to be a necessary condition for trading on interdealer broker systems."[1]

Changes Over the Past 2 Years Are Not Sufficient to Warrant Action on Trading Access at This Time

During the past 2 years, some of the changes that would make expanded access less risky have begun to occur. Under the Government Securities Act, all firms operating in the market, including brokers, are now registered with SEC or federal bank regulators and are subject to minimum capital requirements and to periodic examinations. Also, in 1988, GSCC

[1] U.S. Government Securities: An Examination of Views Expressed About Access to Brokers' Services (GAO/GGD-88-8, Dec. 18, 1987), p. 65.

began operating under rules approved by SEC as a centralized clearing agency servicing primary and aspiring primary dealers, screen brokers, and clearing banks. The basic concept is that brokers and dealers must submit their trade confirmation paperwork to GSCC, which compares the paperwork to confirm the trade and then nets out offsetting obligations between all participants. The result is that each participating dealer and broker transfers cash and securities through the clearing banks for only their net obligation to the system. GSCC, like clearing corporations in the registered securities market, becomes the counterparty to each trade.

Because GSCC is majority-owned by the participating dealers, brokers, and clearing banks, the risk of unsettled obligations is shared by all participants. GSCC requires all participating dealers that have begun to net their transactions to have a net worth of at least $50 million and excess net capital of at least $10 million. GSCC has also proposed that screen brokers maintain liquid capital of at least $4.2 million.[2]

During 1989, GSCC made substantial progress toward providing coverage of the major segments of the government securities market and in getting full participation from the major dealers and brokers. As of February 1990, GSCC is comparing transactions for all Treasury and agency securities and is netting transactions for Treasury notes, bonds, and bills. GSCC has nearly all of the primary and aspiring primary dealers and screen brokers submitting trades for comparison at the end of each trading day and over half of this group involved in netting. GSCC officials expect to expand market coverage and participation during this year and later hope to receive transaction information from participants as it occurs, rather than in batch form at the end of the day.

While the presence of capital adequacy requirements and the GSCC are important developments, neither measure will necessarily prevent a firm from failing or fully eliminate the disruptive effect of a firm's failure to fulfill its obligations. Such failures can be harmful because the same security is often bought and sold several times during a trading day before it reaches the dealer or investor that owns it at the end of the day. Thus, when a trade fails, it can cause several market participants either to, in turn, fail on their obligations or to engage in other trading to replace the undelivered securities or funds. Consequently, although the capital adequacy rules and GSCC will help to ensure that brokers and

[2]GSCC arrived at the $4.2 million for brokers by adding the Treasury minimum capital level of $1 million to $3.2 million, which is twice the brokers' $1.6 million contribution to the clearing fund. The $50 million in net worth for dealers is the same as the amount required of primary dealers by FRBNY.

dealers ultimately do not experience large losses when a firm fails, they cannot fully prevent the disruption to liquidity caused by undelivered commitments.

The absence of measures to limit such liquidity disruptions continues to be the major reason for our position that access should not be expanded by regulation. Limiting access to primary and some aspiring primary dealers has thus far been a workable way to limit potential liquidity disruptions. We believe such risks could be reduced if GSCC continues to develop successfully and if its system is proven to be workable.[3]

In the meantime, one other development relating to FRBNY's oversight of primary dealers should be noted. Starting in the summer of 1990, FRBNY plans to cut back on its day-to-day monitoring of primary dealers. At that time, primary dealers generally will report their positions to FRBNY on a weekly rather than daily basis.[4] FRBNY will still maintain significant oversight responsibilities and retain the ability to act immediately in response to any problems that may arise. Still, the cutback in monitoring underscores the importance of market participants themselves, including brokers, doing the monitoring necessary to control their exposure to risks without relying implicitly on FRBNY's oversight of primary dealers.

Basis for Oversight in the Future

Looking ahead, there are other issues in addition to risk management that we believe need to be considered by Congress and others in assessing the need for regulation of access to broker trading systems. For example, changes in technology can make it relatively easy for a system designed to disseminate information to be converted into a trading system. This possibility can already be seen in the foreign exchange market, where a major information vendor now operates a trading system. The customer base of such systems could extend considerably beyond that now served by interdealer brokers. As a result, regulation might be needed to address questions of fairness regarding who is allowed to participate in such systems and how trade execution priorities are determined.

[3]GSCC currently processes transactions in batch form overnight to arrive at the amount of money and securities to be transferred on the following day. However, GSCC has the capability to receive transaction information directly from each participant as the transactions occur. Such an on-line system would immediately identify unmatched trades and also allow for ongoing monitoring of the dealers' exposure to the system.

[4] FRBNY plans to collect daily reports on securities included in Treasury financing during the when-issued trading period.

Developments in regulation of registered securities market trading systems may be another factor that helps shed some light on operations in the government securities market. Recently, a class of firms has arisen that performs many of the functions that traditionally have been associated with exchanges. These firms, known as proprietary trading systems, are privately owned businesses that use new technology to create market trading systems that have much in common with screen brokers in the government securities markets.

In SEC's view, proprietary trading systems lie somewhere between the exchanges and dealer systems for servicing their own customers in terms of how they should be regulated. In April 1989, SEC proposed rules for these trading systems. The rules would require the systems to obtain SEC approval of their operating plan, which would cover such areas as qualification criteria, terms of order execution, order routing standards, and the handling of and liability for system errors.

The systems that gave rise to the proposed rules include several automated execution systems for trading common stocks and trading and information systems for common stocks, limited partnership interests, and municipal bonds. Some of the systems are blind systems in the sense that those conducting the trades do not know who the counterparty is. One system, Delta Options Corporation, is of particular significance because it issues, trades, and clears transactions in government security options using the trading system of an interdealer broker.

In SEC's view, more than just broker/dealer regulation was needed for these systems. Broker-dealer regulation provides some protection to system participants because the firm must maintain adequate capital and properly protect customer securities and funds. However, SEC believes broker/dealer registration may limit oversight of the actual organizational nature of the systems, including regulation of entry criteria, terms of execution, routing of orders, and the handling of systems errors or failures. SEC believes that as those systems grow in importance, the question of access to those systems on terms that are fair and nondiscriminatory may become increasingly significant.

Finally, in conducting oversight of trading systems in the future, there are other public interest considerations besides fairness and openness. The market must continue to function in a way that allows the Treasury and the Federal Reserve to carry out their respective debt management and monetary policy roles in a reliable, efficient manner. Current

arrangements involving the primary dealer system have proven successful in these areas. Any changes should be made cautiously so as not to damage these important aspects of the market.

Conclusions

Although the risks involved in expanding access appear to be reduced from what they were in 1987, in our judgment the systems are not yet in place to give assurance that expanded access can safely be forced by regulation. As the market continues to change, the questions associated with expanded access should be reassessed in light of market and regulatory developments as well as the continued importance of the market for debt management and monetary policy purposes.

Action Is Needed to Expand Access to Brokers' Information

Our December 1987 report concluded that access to transaction information from interdealer brokers' screens should be expanded. We also said that market participants should be given time to voluntarily expand access on their own. Unfortunately, market participants have generally not done so. We therefore believe the point has been reached where legislative action is needed.

Information Access Remains Limited

Although changes have occurred over the past 2 years in the ownership, management, and operations of some of the brokers, access to information on broker screens remains as restricted as before. Thus, as in 1987, the only dealers with access to comprehensive information about transactions and quotations in the entire wholesale market for government securities are the primary and aspiring primary dealer customers of the interdealer brokers.

In December 1987, we reported that of the nine screen brokers, seven interdealer brokers provided access to their screen information to no more than 53 firms: the 40 primary dealers and 13 aspiring primary dealers. As of January 31, 1990, six interdealer brokers limited access to no more than 49 dealers, consisting of 44 primary, and 5 aspiring primary dealers.

In 1987, we also reported that two of the nine screen brokers were retail brokers that allowed information from their screens to be displayed by information vendors in literally thousands of locations around the world. Only the larger of the two, Cantor Fitzgerald Securities Corporation, remained active as of January 31, 1990.[1]

Cantor transmits its screen quotation pages directly to primary and aspiring dealers and certain other large customers in the same way that interdealer brokers do. However, unlike the interdealer brokers, Cantor

[1] According to Government Securities Brokers Association officials, the other retail broker, Newcomb Government Securities, never was a significant market participant. Since our previous report, Newcomb was sold and restarted as an interdealer broker, Brokerage Corporation of America (BCA). BCA began its operation in 1989 but became inactive in January 1990.

The six interdealer brokers active in February 1990 were also active in 1987. These firms are Fundamental Brokers, Inc.; RMJ Securities Corp.; Garvin Information Systems; Liberty Brokerage Inc.; Chapdelaine and Company, Government Securities, Inc.; and Hilliard Farber and Company, Inc. One former interdealer broker, MKI Government Securities, ceased its Treasury and agency security business and now operates only in the mortgage-backed securities portion of the government securities market under a new company's name. A new interdealer broker, TGB Corp., started operations in early 1989 but became inactive in January 1990.

also provides a data feed to Telerate, a subsidiary of Dow Jones Incorporated, which in turn transmits some of the screen pictures to its network of financial information subscribers.

A number of market participants have told us that viewing the Cantor screen on Telerate provides important information on the market. However, as we noted in our previous report, viewing only the Cantor screen is not the same as seeing all of the interdealer broker screens. Although Cantor will broker all Treasury issues on demand, due to space limitations only the more active Treasury issues appear regularly on the screen.[2]

Moreover, Cantor currently does not have screen pages showing live quotation and trading activity for agency securities or zero-coupon Treasury securities. Therefore, market participants who only see Cantor cannot see the entire government and agency market, as do the primary and aspiring dealer customers of interdealer brokers.[3]

We also learned that in 1989 Cantor reformatted its data transmissions so that Telerate subscribers receive less information than do the dealers and investors that receive their information directly from Cantor. Cantor stopped showing Telerate customers the screen quotations for short-term Treasury notes maturing in the 1-1/2 to 3-year range and for a few selected longer term Treasury maturities. A Cantor official said this change was made because these issues were relatively inactive and it was in the best interest of its business. Cantor's action is significant because before the change, there were no differences in the content of information received by various types of Cantor customers.

[2]Interdealer brokers have several pages on which virtually every Treasury issue is listed. The additional quotation pages allow customers of interdealer brokers to view the entire market and readily see quotation and transaction activity occurring at intermediate dates within the 30-year range of Treasury maturities. Although a broker estimates that about 80 percent of the screen-brokered trading takes place in 8 to 10 active issues, market information on other issues can be important for some investors seeking to sell off their securities holdings to meet liquidity needs or for investors seeking the "cheapest" securities to fulfill delivery commitments related to futures contracts or repurchase agreements.

[3]We found in February 1990, as we had in 1987, that at least three interdealer brokers provide screen coverage of all segments of the Treasury and agency securities markets.

Other Information Available Through Financial Information Services

In our 1987 report we recognized that market participants lacking access to the interdealer broker screens had access to other types of market information through news media and financial information services other than Telerate. Although the identity, coverage, and format of these services have changed somewhat since our previous report, the type of data presented is essentially the same. These sources provide periodically updated benchmark quotations from dealers plus summary analytical pages based on these quotes. For example, some systems allow the user to track changes in one or more dealers' bid prices over the course of the trading day and for longer time periods, as well as to look at the high and low bid over various periods. The most important differences between the information available from financial information services and that available through interdealer broker screens are as follows:

- The dealers providing benchmark quotations are not committed to actually trading at the quoted prices.
- The difference between the bid and offer prices are all stated at standard differences of 2/32nd to 4/32nd of a point because the dealers' quotations are meant to be an indication of the market and not necessarily the actual spread in the market.
- The services do not provide real time information on completed transactions or allow users to observe transaction activity occurring.

Why Information Access Is Important

There is a strong basis in economic theory for believing that financial markets are most likely to operate in the public interest when as many market participants as possible have accurate, current information about market conditions. Information on Treasury securities is of particular importance as noted in a recent Chicago Board of Options Exchange publication:

"The most closely watched interest rates are the benchmark rates on short-term and long-term U.S. Treasury securities. They reflect changes in the economy, inflationary expectations and the value of the U.S. dollar. Other interest rates including bank prime lending rates, bond rates, and home mortgage rates, respond to trends in the Treasury market."[4]

At the present time, as noted above, complete information about the market is available only to a limited set of dealers. In our judgment, the differing proprietary interests of dealers and brokers must be given due

[4]Chicago Board of Options Exchange, Take Interest: Options on Interest Rates, (Chicago, Ill., 1989), p. 2.

consideration because the trades are business transactions between privately owned firms. However, as in all securities market regulation, the proprietary interests of these firms need to be weighed against the importance of market information to all market participants.

Benefits of Expanded Access to Information

Although the government securities market is an efficient one, there is no reason to assume it is as efficient as it can be. Benefits from expanded information access, though not possible to quantify, fall in three areas—market efficiency, investor protection, and equity.

Market Efficiency

Expanding information access would tend to increase market efficiency by creating a more knowledgeable group of market participants and encouraging innovation. In this regard, changes in technology that are occurring in the market, in our judgment, make information access even more important today than it was in 1987. Then, broker systems typically operated in what is known as a broadcast mode. That is, the data were transmitted from the brokers' communication stations and displayed on the customers' display screens according to the format prescribed by the brokers. All the customers of any one broker viewed the same format. To obtain completed trade information, the customer had to watch the screen, although to a limited extent some brokers transmitted a listing of recently completed transactions in particular securities.

Since then most brokers, including Cantor, have used new developments in computer-to-computer communication technology to transmit information. By using digital feed systems, the broker's computer "talks" either to the customer's computer or to an information vendor's computer. Those computers, in turn, can process the information received, combine it with any other digitally fed data from other markets, apply analytical software, and present the analyzed data in the best format for the customer.

The availability of this technology makes access to interdealer broker transaction information even more important because those with access can do more with the information they receive. Although Telerate customers can receive some digital information based on Cantor, primary and aspiring primary dealers are the major beneficiaries from the new technology because they alone can receive all interdealer broker transaction data. For example, some dealers have systems which show changes in transaction prices and quotations as they occur on several interdealer broker screens. A vendor who developed one such system

for a dealer is now marketing it directly to primary and aspiring primary dealers as a feature of its information system. Other information vendors are providing similar data to primary dealers but are taking the information from only one interdealer broker.

Investor Protection

From an investor protection standpoint, the availability of transaction information from the interdealer screens will make it easier for more investors to become sophisticated in protecting their interest by being better able to evaluate the reasonableness of the prices quoted by dealers. The availability of such information would, in our judgment, be an important consideration in making distinctions among wholesale and other investors in the formulation of sales practice rules as recommended in chapter 3.

SEC and NASD officials agreed that publicly available market information also makes it easier for examiners to protect investors. Currently, without good market transaction data, it is very time consuming for an examiner to determine if a dealer sold securities at a reasonable mark-up from the market price unless the dealer purchased the same security on the same day. This is particularly true of infrequently traded Treasury issues and zero coupon and agency issues which are not routinely displayed on the Cantor screens on Telerate. Without such information, examiners have to solicit transaction or quote sheets from a sample of dealers. This practice is obviously less efficient than having information on the brokered transactions of all major dealers in a data base available for review. Therefore, good transaction information will contribute to the regulators' ability to enforce any mark-up rules developed in response to our recommendations in chapter 3.

Equity

Expanded information access would make trading in financial markets more equitable. Specifically, non-primary dealers whose principal business is trading or investing in markets closely linked to the government securities market could then obtain the information they feel is necessary to compete with primary and aspiring primary dealers in these other markets. For example, in 1989, CBOE introduced short-term and long-term interest rate indexed options whose values, respectively, depend on the market price of the current 13-week Treasury bill and a composite price of the two most recent issues of the 7-year, 10-year, and 30-year Treasury notes. Current values for these instruments are computed by Telerate based on activity on the Cantor retail screen. Moreover, the cash market Cantor screen is what is displayed next to the interest rate option screen for traders to see on the floor of the exchange.

So long as the Cantor screen accurately reflects the current cash market, the values of the interest rate option will be accurate. However, any one broker screen, including Cantor, can trail behind the market if the majority of trading in the relevant Treasury securities is occurring through other brokers. Or the screen may show a false direction, if, for example, heavy buying on the one broker screen is offset by selling on others. We believe it reasonable to conclude that regardless of the accuracy of the Cantor prices, an interest rate options trader seeing only Cantor is at some disadvantage compared to a dealer that knows all cash market broker activity.

Assessment of Potential Harm From Expanded Information Access

Given the key role that the government securities market plays in financing the government and in the economy as a whole, it is important that actions are not taken that could damage the market. We considered three ways that expanded information access could possibly damage the market: introduction of additional risk, reduction in market liquidity, and impairment of the ability to manage the debt or to conduct monetary policy.

Turning to the first of these, we noted in the preceding chapter that risk considerations are of crucial importance in considering trading access matters. However, we have found no evidence that wider dissemination of information would damage the blind trading systems of interdealer brokers that are so important for maintaining the liquidity of the government securities market. Information access does not introduce additional risk into these systems and hence brokers' and dealers' exposure to credit risk would remain unaffected.

Dealers have argued that expanding information access could damage the liquidity of the secondary market. Over the past 2 years, the operations of some primary dealers are reported to have been unprofitable. Some dealers have suggested that expanded information access might remove a market advantage that primary dealers have and lead some dealers to give up their primary dealer status.

We question whether the liquidity of the market would be significantly affected in an adverse way by expanded information access. Indeed, we think the situation could actually be the reverse of what the dealers contend. That is, a better informed investing public can make the markets more liquid—although perhaps more competitive for the dealer. Ultimately, it is the funds of investors beyond the primary dealers that end up buying most of the government securities that are offered for sale in

the market. Moreover, if liquidity were to be materially damaged, it would mean that the ability of primary dealers to make trades is somehow dependent on their ability to maintain an information advantage over their customers. Achieving a high volume of trading that depends upon keeping a significant part of the investing public poorly informed seems to us to be a questionable policy.

We also found no evidence that expanded information access would damage debt management or monetary policy activities of the government. Treasury and the Federal Reserve, the two agencies with direct responsibilities for these functions, concurred with our 1987 conclusion that information access would serve the public interest. Officials of the SEC also agreed that expanded information access was desirable. Officials of all three agencies still hold this view.

Why a Legislative Solution Is Needed

In our 1987 report, we concluded that market participants should be given the opportunity to expand access before regulatory intervention was pursued. In the past, the Public Securities Association has often worked with the Federal Reserve and the Treasury to develop rules and procedures to deal with various problems. Moreover, we found that there was still uncertainty at that time about the costs, nature, and timing of information that would best serve market participants' needs. Finally, we observed that the consensus among federal agencies that expanded information was desirable would likely help to encourage private market participants to broaden access without the need for regulation.

In its comments on our 1987 report, SEC expressed skepticism that interdealer brokers would achieve expanded access voluntarily. SEC said that dealer resistance to dissemination, coupled with potential issues regarding the proprietary nature of trade and quote information, could undermine the success of voluntary measures. At this point, it appears that the SEC's skepticism has been borne out and that a legislative mandate will be needed to ensure development of satisfactory information access arrangements.

Unsuccessful Efforts to Expand Information Access

We are aware of four efforts with the potential to expand information access that were undertaken between the time our previous report was issued and April 1990 when we completed our review of the broker access issue in preparing our draft report. One was linked to an interdealer broker's decision to become a retail broker, two were part of

new or modified brokering systems, and the other was a joint effort by three brokers developed explicitly to provide access to the transaction information from their screens. None of these efforts succeeded in expanding information access. A brief description of each effort follows:

- RMJ Broker's plan to go retail. In March 1989, RMJ announced that it was going to act as principal in brokered trades (as Cantor Fitzgerald does) as part of a plan that would eventually allow RMJ to expand its customer base (become a retail broker) and sell the information on its screens to an information vendor. In making the announcement, RMJ management said such a move was necessary for continued survival because of competition from other brokers. While an adverse reaction did not occur immediately, according to RMJ officials, over the next month, some of the larger primary dealers stopped doing business with RMJ, which caused other dealers to turn to other brokers where the screens were more active. When RMJ saw the resulting financial losses, it backed off its plans and reverted to its former status as an interdealer broker. An official of PSA said that one reason for the primary dealers' lack of acceptance of the RMJ arrangement was that the dealers had doubts about RMJ's financial capacity to act as principal in the trades brokered by the firm.
- Chapdelaine: CHATS system. In early 1989, Chapdelaine, an interdealer broker that emphasized agency securities, established a separate affiliate to develop an interactive electronic trading system for Treasury security trading. Chapdelaine officials have installed this system (called CHATS) at several primary dealers and after testing, expect to have the primary dealers trading on the system in 1990. Chapdelaine officials have discussed the possibility of providing information access to their system to nonparticipants but are not pursuing this effort at this time until their trading system effort gains acceptance. The officials do not want any potential dealer resistance to expanded information access to jeopardize their trading system effort.
- TGB Corporation. TGB Corporation was an interdealer broker that began operating in May 1989 by offering a somewhat more automated trade processing system than current interdealer brokers. The system promised faster execution at lower cost and included plans to sell real time information access to information-only subscribers at a proposed fee of $600 per month. From the beginning, TGB experienced some difficulty gaining the support of the dealer community because of concerns about how well the system would work. TGB made several modifications to the original system proposal in an effort to attract more primary dealer business. One of the modifications was to drop its plan to have information-only subscribers. In January 1990, TGB became inactive.

- Newco. This information expansion effort was proposed in August 1987 by three brokers: RMJ, Garban, and Fundamental Brokers. The joint venture, known as "Newco," would have purchased last trade price information from the three brokers and any other brokers or dealers who wanted to participate, and sold the information to a distributor of financial information, who in turn, would have made it available for sale on a non-exclusive basis to other information providers. On April 3, 1989, the Justice Department announced that it did not intend to challenge the joint venture under the antitrust laws. The Newco plan did not move forward however, and the principals at this time do not appear to have plans to restart it. A number of factors appear to have caused the project to lose momentum. After its own experience, RMJ management decided that it would not be prudent to pursue the joint venture unless Newco had the support of the largest dealers. Also, management at Fundamental Brokers changed and the principal spokesman for the proposal retired due to illness.

The information access elements of these efforts have not been implemented even though the principle of greater access was endorsed by the primary dealer community as a whole. On April 28, 1989, PSA's Primary Dealer Committee unanimously adopted a task force report which endorsed the concept of expanded information access.[5] The final report did not discuss the RMJ effort but argued that CHATS, TGB, and Newco should have a chance to develop before a regulatory solution is imposed. However, a year has passed, TGB is out of business, and the information access aspects of the other efforts appear to be at a standstill.

The Potential for Dealer Resistance May Continue to Inhibit Information Access Initiatives

During our meetings with all of the brokers and the major information vendors we learned of a number of other arrangements involving various combinations of brokers, information vendors, dealers, and financial analysis software corporations that were in varying stages of development. However, brokers were in agreement that a broker's effort to expand information access will only survive if the broker has the support of a significant portion of the top 5 to 10 dealers. Brokers told us that these larger dealers generate a substantial portion of the broker's commission revenue and by their participation make any broker's screen sufficiently active to attract other dealers to trade on them. Brokers said

[5]Public Securities Association, "Report and Recommendations of the Task Force on Government Securities Price Information," April 1989.

that if dealers did not like one or more brokers' plans to expand information access, the dealers could take their trading business to a broker that was keeping access limited.

We are not able to determine all the specific reasons for the lack of support for brokers' efforts to expand information access arrangements. Some primary dealers told us that the market neither needs nor wants additional information and that brokers and vendors do not want to commit themselves to providing information that the market will not pay for.[6]

A particularly important factor, however, appears to be dealers' concerns about revenue. We noted previously that the profitability of a number of primary dealers declined over the last 2 years—a period during which trading volume has not increased very much. This has increased the importance of revenue considerations associated with expanded access, and as yet, satisfactory arrangements have yet to be worked out.

When we were completing our draft report, we were aware that six of the larger primary dealers have invested several million dollars in developing a joint effort to provide the marketplace information on their transactions in an effort to capture revenue from the sale of information apart from the brokers. In 1990, PSA also established a task force representing interdealer brokers and dealers to recommend a proposed structure for an industrywide joint venture to disseminate price information. The task force issued a report regarding the minimum information to be disseminated, allocators of revenue, and corporate structure. A proposal to implement a joint venture was approved by the Primary Dealers Committee at the end of April 1990. Since then, PSA formed an implementing sponsor group representing eight dealers and interdealer brokers. All firms currently transacting business through brokers would be eligible to participate.

While it is to be expected that dealers would try to obtain as much revenue as possible from information arrangements, in our judgment, the current revenue position of certain dealers should not inhibit implementation of expanded information access that would benefit the market as a whole. Representatives of several brokers and information vendors

[6]This sentiment was expressed by officials of one information vendor currently active in the market. However, all other information vendors and brokers we talked to welcomed the opportunity to compete and find out what the market would bear.

told us they are ready to provide expanded information access once it is clear that all brokers must expand information access. In their view, if brokers are required to make information available as a condition for doing business, primary dealers will not be able to take their business to a broker that limits access to its information.

Brokers also told us they were confident that blind brokering is important enough that dealers will continue to use their services even if the transaction information is publicly available. Moreover, they believe they can work out acceptable arrangements without detailed regulatory requirements. We would prefer this approach to a detailed regulatory solution because we believe competitive pressures on these privately owned brokers, dealers, and information vendors and the continuing improvements in information technology should allow a number of innovative approaches to develop.

Key Elements of an Information Access Requirement

For the reasons just cited, we believe Congress should act to require information from government securities brokers to be made available on a real time basis to those willing to pay appropriate fees. At a minimum, Congress should require brokers to make last sale (price and volume) information available to vendors on a real time basis as a condition for doing business. Although Congress could specify the exact language concerning information disclosure in legislation, we believe it would be preferable for Congress to impose the requirement for information access but give necessary authority to a federal agency to write any rules needed to enforce the mandate. In that way, the agency could be responsive to market developments and ensure that information on transactions occurring on the market's major trading systems is publicly available.

We believe that in a world where technology and brokering arrangements can change quickly, the requirement needs to be drawn in such a way as to not impose a rigid structure on the market that would stifle innovation or give unwarranted benefits to certain dealers, brokers, or vendors. In this regard, the Justice Department's acceptance of Newco set forth certain principles that we believe should be considered in evaluating information access arrangements:

- Broker arrangements with vendors should not be exclusive. In other words, if one or more brokers contract to send data to an information vendor, other vendors should be able to purchase the same information from either the vendor or the broker. Nonexclusive arrangements serve

to prevent dealers and brokers from creating special transaction execution systems that are unavailable to other investors. It also allows for innovation to take place in the market and keeps the regulation from locking in place a particular set of institutional arrangements.

- Any broker participating in a joint venture should be able to make other arrangements to still sell its own screen information even in competition with the joint venture.

We also believe the access requirement should impose a near-term date for action. Dealers and brokers have already had a substantial amount of time to develop access arrangements on their own and we are aware of a number of efforts that could be implemented fairly quickly.

The intent of any access requirement should be to include all major trading systems operating in the market. The information access requirement we are recommending is most obviously directed at the screen brokers because they currently operate the principal trading systems in the market. However, arrangements among dealers, information vendors, or other brokers could conceivably create new automated trading systems that would diminish the importance of screen brokers. An access requirement should be broad enough to be sure that such new trading systems could not operate outside a narrowly structured information requirement imposed on interdealer brokers. In adopting an information access requirement, Congress and the appropriate regulatory agency may need to address legal issues associated with ownership of information utilized in trading systems.

Conclusions

On the basis of brokers' experience over the last 2 years, we believe Congress needs to give the industry a clear, enforceable mandate to expand information access and thereby eliminate screen brokers' concerns about possible primary dealer reaction to the brokers' information expansion efforts. The question of which federal agency should receive regulatory authority is discussed in chapter 6.

Recommendations to Congress

To provide the public with the benefits of information access to screen brokers and similar trading systems for government securities, we recommend that Congress amend the Exchange Act to require that government securities transaction information from screen brokers and any trading systems that serve a similar function be made available on a real time basis to those willing to pay appropriate fees. Regulatory authority

should be provided at the federal level to prescribe regulations as needed to ensure that transaction information is available.

Agency Comments

The Department of the Treasury concurred with our assessment that expanded access to broker screen information would serve the public interest. The Department also supported our recommendation that Congress should mandate public access and provide federal rulemaking authority to provide regulations, as needed, to ensure that information access is expanded.

Treasury's Rulemaking Authority Should Be Extended

The mandate for our study included a requirement that we recommend whether or not Treasury's rulemaking authority over government securities brokers and dealers should be extended beyond its sunset date of October 1, 1991.[1] For the same reasons Treasury was given rulemaking responsibility under the act, we believe Treasury's authority should be continued for a limited period of time.

Why an Extension Is Appropriate

When the act was adopted, Congress chose Treasury as the rulemaker over several other possible alternatives—SEC, the Federal Reserve, or a new entity patterned after MSRB. Treasury was selected primarily because of its role and expertise in a market that is so vital to the government's ability to finance the federal deficit. By choosing Treasury as the rulemaker, Congress sought to ensure that the new regulations would not inadvertently damage the market and thereby increase the government's cost for selling the debt. Congress also anticipated that Treasury would be able to promulgate regulations that applied in an even-handed manner to both bank and non-bank securities dealers.

We pointed out in chapter 2 that Treasury has done a good job in meeting the act's rulemaking requirements. However, our principal reason for supporting a continuation of Treasury's authority is not Treasury's past performance. Rather, it is that concerns about the impact of rulemaking on market safety and equity continue to be important considerations.

To some extent, these concerns involve rulemaking under current authority. Thus, we noted in chapter 2 that dealers and depository institutions have both raised concerns that confirmation requirements for securities involved in repurchase agreements may be unnecessarily burdensome, even though they may be imposed equally on dealers and nondealer depository institutions. We believe it is better for Treasury to be in a position to consider any changes that might be needed than to have separate regulators make rules that could potentially result in different requirements for different types of firms.

[1]Treasury's power to issue orders and to propose and adopt rules applicable to government securities brokers and dealers (section 101 of the act) will terminate unless renewed on October 1, 1991. Should Congress not renew Treasury's authority or assign it elsewhere, rules in effect on the sunset date will continue in effect and, according to the legislative history, Treasury will still be able to make technical adjustments.

Treasury's authority to prescribe securities custodial requirements on depository institutions (title II of the act) is not subject to the sunset provision.

The most important considerations, however, involve areas where additional rulemaking will be needed. In chapters 3 and 5, respectively, we recommend that Congress provide regulating sales practices in the government securities market and the information access arrangements of government securities screen brokers. We believe it is appropriate to give lead rulemaking responsibility in these areas to Treasury, subject to a sunset provision, for the reasons of market safety and equity that led Congress to select Treasury in the first place.

Sales Practice Rules

Concerns in the sales practice area described in chapter 3 relate primarily to potential abuses of individuals and smaller institutional investors, such as small banks and thrifts and local governments. We are not aware of any concerns with respect to the wholesale transactions between dealers and larger institutional investors, such as large commercial banks, insurance companies, and major pension funds. Dealers told us many of these large investors are more like competitors than they are customers because of their sophistication and the size of positions traded.

Sales practice rules in registered securities markets typically exempt dealer-to-dealer transactions in recognition of competitive concerns. In the government securities market, similar competitive concerns relating to the participation of large institutional investors that are not dealers also need to be taken into consideration. It would, for example, be inappropriate if sales practice rules placed dealers at a competitive disadvantage relative to large institutional investors. It would also be inappropriate if the rules made dealers, particularly primary dealers, less willing to accept the risks associated with being market-makers in government securities. Because of its involvement and familiarity with the market and its participants, we believe Treasury should have the responsibility for ensuring that rules designed to ensure fair treatment of retail customers do not inadvertently harm dealer participation in the wholesale market.

As was the case with repurchase agreements, rules promulgated in the sales practice area must also apply to both bank and non-bank dealers. Since Treasury routinely deals with both the banking industry and securities firms, we believe Treasury is in a good position to balance the competing interests of these firms in setting sales practice rules. As was true of the rules for repurchase agreements and for other areas covered

by the act, sales practice rulemaking should be consistent for both securities dealers and depository institutions involved in the market. Differences in the precise nature of the rules for each of these types of institutions could affect the size and distribution of compliance costs, placing one set of institutions at a competitive disadvantage with the other.

Information Access

Regarding information access issues, we believe Treasury should also be given the authority to evaluate the arrangements developed by government securities brokers, dealers, and information vendors and to promulgate rules, if necessary, to ensure that such arrangements are fair and beneficial to the operation of the secondary market. We expect that arrangements regarding cost, revenue, and the exclusivity of information distribution could affect the relative roles and profitability of brokers, dealers, and information vendors, and could, over time, affect the importance and concentration of brokered transactions within the secondary market. In our judgment, Treasury's involvement in the market puts it in the best position to evaluate the reasonableness of these arrangements and their effect on competition and market safety.

Importance of SEC Involvement

As noted previously, we believe that in developing new rules Treasury should make every effort to make them conform to SEC requirements whenever possible. For example, two types of government securities in need of sales practice attention—zero coupon and mortgage-backed securities—are similar to securities traded in the registered securities market, and protection in the government market should, therefore, be comparable. We believe Treasury should make every effort to ensure that sales practice rules for such securities differ from SEC-approved rules only when the risks associated with such securities are actually different.[2] Treasury demonstrated its willingness and ability to coordinate with SEC when it developed the repurchase agreement rules under the act.

[2]SEC took note of the similarities between certain government and nongovernment securities in an Amicus Curiae brief filed on December 8, 1989, with a United States district court in New Jersey. The brief was filed in support of a civil action against a securities firm for fraudulent mark-ups in certain government and nongovernment mortgage-backed collateralized mortgage obligations (CMO) and mortgage-backed principal-only securities, which are similar to zero coupon securities. SEC asserted that it was reasonable to apply the same standards because the market treated the government securities at issue as comparable to non-government securities to which the NASD mark-up standards applied.

Applying a Sunset Provision

Congress' decision to sunset Treasury's rulemaking authority has provided a useful opportunity to review the appropriateness of the rules that Treasury developed and the continued need for a separate rulemaker. We believe Congress should apply this logic again and place a sunset on the continuation of Treasury's authority.

One reason for including a sunset provision when extending Treasury's rulemaking authority is that when the transition period associated with implementing the act's rules has been successfully completed, the need for continuing Treasury as a separate rulemaker could diminish.

For example, to simplify the regulatory structure it might, at some point, make sense to combine some or all of the rulemaking for the government securities market with that for other registered securities markets. Along these lines, we noted that most of the securities firms that operate in the market are diversified dealers already regulated by SEC. We also pointed out that Treasury's regulatory requirements for specialist firms, except for the dealer capital adequacy rule and related reporting requirements, are essentially the same as the requirements SEC applies to other registered dealers. We recommended that Treasury develop a plan to phase out the separate rules for specialist brokers and dealers unless SEC's capital rule is determined to be inadequate or inappropriate. Similarly, once sales practice rules and information access arrangements are in place, there could be less of a need to treat rulemaking in these areas separately from that applicable to registered securities.

Another reason for a sunset provision is that the concept of functional regulation could evolve over the next several years in a way that has implications for the continued need for Treasury as a rulemaker. Under functional regulation, a regulatory agency would regulate a particular type of activity no matter what type of firm engaged in it. Currently, however, it is not clear how to apply this concept to a situation like that in the government securities market in which both banks and securities firms can be dealers. We pointed out in chapter 2, for example, that many bank dealers are examined less frequently than are non-bank dealers. Achieving greater consistency in the frequency and quality of enforcement of securities laws among bank and non-bank dealers remains an unresolved issue in ongoing policy discussions about how best to regulate the financial services industry. But should greater consistency be achieved, Treasury's role as a rulemaker to reconcile separate practices in the Treasury securities market could become unnecessary.

Finally, as the government securities market has grown in size and complexity and become more international in scope, we have become concerned about the ability of any regulator to monitor developments and anticipate problems in this market. An added benefit of the sunset provision is that it increases the likelihood that, within several years, attention will again be focused on identifying gaps in regulatory coverage that may have developed in the market.

Conclusions

Because Treasury is responsible for selling the government's debt, we believe it is important as a policy matter that Treasury be heavily involved in rulemaking that affects the safety and efficiency of the government securities market. Treasury also needs to participate actively in the rulemaking process to be sure that rules apply equitably to both bank and non-bank dealers. By working closely together, Treasury and SEC can ensure that government securities market rules, such as sales practice rules, are as similar as possible to comparable rules in other regulated securities markets.

We believe Treasury's rulemaking authority should be continued and extended to provide assurances that new rules concerning sales practices and broker information access do not harm the market. However, Treasury's authority should be subject to a sunset provision so that the need for a separate rulemaker can be reconsidered once the issues in need of attention have been addressed.

Recommendations to Congress

We recommend that Congress

- continue Treasury's current regulatory authority over the activities of government securities brokers and dealers,
- assign Treasury new authority to adopt sales practice rules governing government securities brokers and dealers and to adopt any rules needed to ensure public access to government securities screen brokers' information, and
- provide for a sunset on Treasury's authority so that the continued need for Treasury's rulemaking role can be reevaluated.

Agency Comments

The Department of the Treasury supported our recommendation that Congress should continue Treasury's rulemaking authority over the government securities market and the activities of government securities brokers and dealers.

Government Securities Market Components and Activity

Market component	Description	Activity
I. Initial sale of securities		
A. Treasury	The Treasury, through the Federal Reserve System (principally the Federal Reserve Bank of New York) acting as Treasury's fiscal agent, sells new securities to the public to raise new funds and refinance existing debt.	Over $1.9 trillion outstanding as of December 31, 1989.
B. Agency	Federally sponsored agencies issue securities to the public through dealer selling groups.	About $412 billion outstanding as of December 31, 1989.
C. Mortgage-backed	Lending institutions pool mortgages and obtain, through GNMA, FNMA, or FHLMC, the securities collateralized by the mortgages. Government guarantees timely payment of interest and principal for GNMAs, and timely interest and ultimate payment of principal for securities issued by FNMA and FHLMC.	About $931 billion outstanding as of December 31, 1989.
II. Secondary Markets trading		
A. Outright purchase and sale	Dealers buy and sell securities in an over-the-counter market, with transfers made through clearing banks and the Fed-wire network.	About $131 billion average daily transactions by primary dealers in 1989.
B. Repurchase agreement contracts	Dealers obtain financing and securities from and for customers in an over-the-counter market. Also used by the Federal Reserve Open Market Committee for conduct of monetary policy.	About $776 billion average outstanding agreements per day reported by primary dealers for 1989. About $6 billion average transactions per day in 1989 reported by Federal Reserve Open Market Account.
III. Derivative products		
A. When-issued commitments	Over-the counter market used by dealers to lock in purchase and sale orders for announced but not yet issued—used to take or hedge position risk.	N/A
B. Forward commitments	Over-the-counter market used by dealers to lock in purchase and sale orders at least 5 days in advance of delivery—used to take or hedge position risk.	Total unknown. $11.6 billion average daily transactions in 1989 reported by primary dealers.
C. Over-the-counter options	Over-the-counter market used by dealers to purchase the right to buy or sell securities at a given price for a set period of time. Recently supplemented by a proprietary trading system called Delta Options.	N/A
D. Exchange-traded futures	Traded on several exchanges including the Chicago Board of Trade (notes and bonds and some mortgage-backed securities); MidAmerica Commodity Exchange (bills, notes, and bonds); New York Cotton Exchange and Assoc. (notes); and Chicago Mercantile Exchange (bills). Futures are used to lock in purchase and sale orders in advance of delivery and to take or hedge position risk.	Per CFTC, average daily dollar value of contracts traded was over $38 billion in fiscal year 1989 (ending Sept. 30, 1989).
E. Exchange-traded options	Traded on Chicago Board Options Exchange (bonds). Options are used to purchase the right to buy or sell securities at a given price for a set period of time.	Average of 555 contracts per day in calendar year 1988, per CBOE.
F. Exchange-traded options on futures	Traded on several exchanges: Chicago Board of Trade (notes and bonds); Chicago Mercantile Exchange (bills); New York Cotton Exchange Assoc. (notes). Dealers purchase the right to buy or sell futures contracts at a given price for a set period of time.	Average of 47,027 contracts per day in fiscal year 1989, per CFTC.

Primary Dealers and Examining Authority as of June 28, 1990

Specialized	Examiner
Bank of New York Securities, Inc.	NASD
CRT, Gov't Securities, Ltd.	NASD
Discount Corporation of New York	NASD
Harris Gov't Securities, Inc.	NASD
Merrill Lynch Gov't Securities, Inc.	NASD
Sanwa-BGK Securities Co., L.P.[a]	NASD
SBC Government Securities, Inc.	NASD
Shearson Lehman Gov't Securites, Inc.	NASD
Diversified	
Barclays De Zoete Wedd Sec. Inc.[a]	NASD
BT Securities Corp.[a]	NASD
Carroll McEntee & McGinley, Inc.	NASD
Chase Securities, Inc.[a]	NASD
Chemical Securities, Inc.[a]	NASD
Citicorp Securities Markets, Inc.[a]	NASD
First Chicago Capital Markets, Inc.[a]	NASD
Fuji Securities, Inc.	NASD
Greenwich Capital Markets, Inc.[a]	NASD
Aubrey G. Lanston & Co., Inc.	NASD
Bear, Stearns & Co., Inc.	NYSE
Daiwa Securities America, Inc.	NYSE
Dean Witter Reynolds, Inc.	NYSE
Dillon, Read & Co., Inc.	NYSE
Donaldson, Lufkin & Jenrette Securities Corp.	NYSE
The First Boston Corporation	NYSE
Goldman, Sachs & Co.	NYSE
Kidder, Peabody & Co., Inc.	NYSE
Manufacturers Hanover Securities Corp.[a]	NYSE
J.P. Morgan Securities, Inc.[a]	NYSE
Morgan Stanley & Co., Inc.	NYSE
The Nikko Securities Co. International, Inc.	NYSE
Nomura Securities Inter., Inc.	NYSE
Paine Webber, Inc.	NYSE
Prudential-Bache Secur., Inc.	NYSE
Salomon Brothers, Inc.	NYSE
Smith Barney, Harris, Upham & Co., Inc.	NYSE
S.G. Warburg & Co. Inc.	NYSE
U.B.S. Securities, Inc.	NYSE
Wertheim Schroder & Co., Inc.	NYSE
Yamaichi International (America), Inc.	NYSE

(continued)

Specialized	Examiner
Banks	
Bank of America NT&SA	OCC
Continental Bank, N.A.	OCC
Security Pacific National Bank	OCC

[a]Bank holding company subsidiary authorized by the Federal Reserve Board pursuant to Section 20 of the Glass-Steagall Act.

How Broker Trading Systems Operate

Government securities brokers arrange transactions between their customers, usually securities dealers, who are seeking to buy or sell securities. Customers provide quotation and trade execution instructions via telephone lines to the brokers. This information and the trading activity that results is then transmitted to a network of video display screens that brokers have installed in the customers' trading rooms. Each government securities broker's screen displays the best bid and offer quotation available from its customers for the issues shown. These quotations are binding commitments for the quantities and prices specified and, as such, constitute a market for each issue displayed.

Most brokers segment the government securities market as a whole into various trading centers, or "desks," which function independently of each other. Each desk specializes in a market segment, such as Treasury bills, Treasury coupon securities of short or long maturity, zero coupon securities, agency securities, or mortgage-backed securities. Typically, brokers have separate screen pages showing the more actively traded issues in each market segment as well as derivative summary pages showing activity in key issues across the maturity spectrum.

Brokers display similar information on each page but use various formats. Screen pages that customers see show securities' maturity dates, coupon rates (when applicable), issuing agency (when applicable), the best bid and ask prices quoted by customers for each issue, and the quantities of securities each customer who provides a quote is committed to sell or buy at the quoted price. As of January 31, 1990, the screens neither identified the customers whose quotations were displayed nor did the screens reveal the depth of the market, i.e., the number and size of other orders waiting to be executed at the displayed price. Figure III.1. shows a representative broker-screen page.

Figure III.1: Sample Broker Screen for Treasury Securities, 2-Column Format

Coupon Rate	Maturity Date	Price Bid	Price Asked	Quantity Bid	Quantity Asked	Coupon Rate	Maturity Date	Price Bid	Price Asked	Quantity Bid	Quantity Asked
12 5/8	5/86	100.30-101.02		2	X 1	9 7/8	12/86	101.20-24		5	X 1
13 3/4	5/86	104.08-		3	X	10	12/86	-101.30			X 3
13	6/86	104.08-12		10	X 5	9 3/4	1/87	101.10-14		6	X 8
14 7/8	6/86					9	2/87	100.10-14		1	X 7
12 5/8	7/86	104.05 HIT		8		10	2/87	*101.21-25		2	X 5
8	8/86	99.29-01		3	X 5	10 7/8	2/87	102.29-01		12	X 8
11 3/8	8/86	103.00-04*		5	X 5	12 3/4	2/87	TAK 102.07		7	
12 3/8	8/86	104.00-04		3	X 8	10 1/4	3/87	102.03-07		7	X 15
11 7/8	9/86	-103.28+			X 8	10 3/4	3/87	102.27-31		1	X 5
12 3/4	9/86	104.05-09+		10	X 6	9 3/4	4/87	101.09-11		20	X 25
11 5/8	10/86	103.19-19+		30	X 50	9 1/8	5/87	100.06-08		9	X 5
6 1/8	11/86	97.20-98.20		1	X 1	12	5/87	105.00-04		2	X 5
10 3/8	11/86	102.06-10+*		15	X 10	12 1/2	5/87	105.20 HIT		10	
11	11/86	102.29-01		1	X 1	14	5/87	-108.05			X 6
13 7/8	11/86	106.12+-16		7	X 10	8 1/2	6/87				
16 1/8	11/86	-109.21			X 10	10 1/2	6/87	102.19-23		2	X 3

Notes:

A "+" indicates an additional 1/64 is included in the price.

A "*" indicates that the first bidder/seller still has the right to trade more before others can execute at that price.

When a bid has been hit, the word "hit" appears on the screen; when the price asked has been taken, it appears as "tak." In each case the "hit" or "tak" flashes to draw the viewer's attention to the trade.

Source: Harris Trust and Savings Bank, The U.S. Government Securities Market, 2nd edition, (New York Institute of Finance) 1986, p. 63. (Notes and column headings added by GAO.)

Nearly all brokers execute trades in the same way, observing an informal code of market conventions that developed as screen brokers began to operate in the early 1980s. The key elements of the trading process still followed by nearly all of the brokers are described below:

- Customers have direct phone lines to the various desks at each of the broker firms. Each desk is a circular or horseshoe configuration of computer and phone consoles staffed by 10 to 25 employees (brokers) handling one or more computer screen pages that show a certain segment of the market. Each broker handles one to three customers depending on activity level. When customers wish to buy or sell a security, they call

their broker at one firm or, if they choose to split their order, at more than one firm. The customer can either hit a bid or take an offer already shown on the screen or tell the broker to post a new bid or offer on the screen.

- Brokers call out their bids and offers as received from customers when the new bid is higher (or offer lower) than one already shown or if it is an acceptance of a posted price. (Otherwise, the brokers keep informal notes of customer quotations for later action should the market change.) Either the brokers or data entry staff at each desk enter this information so it is displayed on an internal computer screen or overhead projector. Simultaneously, similar information is transmitted via computer for instant display on each customer's video display screen. Code numbers or initials are used on the broker firms' internal systems to identify the customers who are buying and selling the securities. These codes are not visible to the customers.
- As a bid is hit or offer taken, brokers representing other customers shout their intention to be a buyer or seller at that price and are assigned a priority by the supervisor of the particular trading forum. The two customers who made the initial trade are given the right of first refusal for additional trades at that price. Generally, they are allowed about 20 seconds to decide (less time in very active markets) and will instruct their broker accordingly. If both customers continue to trade, their brokers will call out additional quantities, and the size of the trade will be worked up. Once the initial customers finish, other brokers may call out their customers' orders joining either the buy or sell side of the transaction according to the established priority. Generally, this priority is based on a first-come-first-served basis although we were told that some broker firms at times give priority to their larger, more active customers. Brokers compete with one another because their compensation depends in part on the volume of business each generates.
- When a bid is hit or an offer taken, "hit" or "tak" will be displayed on the screens and begins to flash. It will continue to flash and increase in size until all transactions at that price are completed. After a few seconds of inaction, this annotation will disappear.[1] Brokers will then display the new best bid and ask prices provided by customers.
- Usually, the customer who acted on the displayed quotation pays the price plus a commission, if buying, or receives the sale price less a commission, if selling. Commissions are typically a percentage of the dollar size of the transaction, such as $39 per million for Treasury notes and bonds.

[1] A completed transaction on a broker screen could, therefore, involve from one to several buyers or sellers.

- When a trade is completed, brokers verbally confirm the trade terms with their customers, and the broker firm prepares separate written confirmations to the buyers and sellers. The respective confirmations show the broker firm as the seller and purchaser of securities, thus maintaining customer anonymity.

Clearing and Settling the Transaction

Before the development of the Government Securities Clearing Corporation in 1988, broker firms often accumulated confirmations with particular customers during the trading day and offset purchases and sales in the same security so that only instructions for the net cash or securities transfer were sent to the clearing bank. This process by each broker firm was designed to reduce broker and customer clearing costs.

With the development of GSCC, both brokers and dealers submit trade confirmations in batch form at the end of the day so that GSCC can compare the confirmations, validate the trade, and net transactions on a systemwide basis among all brokers and dealers involved. This process is expected to eventually replace the transaction pair-off process used by each broker. However, because not all broker customers belong to GSCC, both processes were operating at the time we completed our work.

Regulatory Agencies and Market Participants Contacted During This Study

Federal Agencies and Related Organizations

Department of the Treasury, Office of Domestic Finance and the Government Securities Unit within the Bureau of the Public Debt

Securities and Exchange Commission, Division of Market Regulation

Federal Reserve System, Division of Bank Supervision and Regulation, Division of Monetary Affairs, and Federal Reserve Bank of New York, Dealer Surveillance Unit

Federal Deposit Insurance Corporation, Division of Bank Supervision and Regulation

Office of the Comptroller of the Currency, Investment Securities Division

Office of Thrift Supervision, Office of Policy and Federal Home Loan Bank of Chicago, Examination Division

Department of Housing and Urban Development, Government National Mortgage Association, Office of the Comptroller

Federal National Mortgage Association

Federal Home Loan Mortgage Corporation

Commodities Futures Trading Commission, Division of Trading and Markets

Self Regulatory Organizations (SRO)

National Association of Securities Dealers, Inc., (Wash. and NY) Financial Responsibility Surveillance

New York Stock Exchange, Market Finance Regulation

American Stock Exchange

National Futures Association

Chicago Board of Trade

Chicago Board Options Exchange, New Products Planning

Associations Representing Market Participants

American Bankers Association (ABA)
Credit Union National Association (CUNA)
Government Finance Officers Association (GFOA)
Government Securities Brokers Association (GSBA)
Information Industry Association (IIA)
Public Securities Association (PSA)
National Association of Federal Credit Unions (NAFCU)

Government Securities Dealers

Barclays De Zoete Wedd Government Securities, Inc.
Carroll McEntee and McGinley, Inc.
Chemical Bank
Chemical Securities Inc.
CRT Government Securities, Ltd.
Discount Corporation of New York
First Boston Corporation
First Tennessee Bank National Association
G.X. Clarke
Goldman, Sachs and Co.
J.P. Morgan Securities
Manufacturers Hanover Trust Co.
Merrill Lynch Government Securities, Inc.
Morgan Stanley & Co. Inc.
O'Connor and Associates
Salomon Brothers Inc.
Shearson Lehman Hutton Inc.
U.S. League, Government Securities, Inc.
Westpac Pollock, GSI

Screen Brokers

Brokerage Corporation of America
Cantor Fitzgerald Securities, Inc.
Chapdelaine and Co. Government Securities, Inc.
Fundamental Brokers, Inc.
Garvin Information Systems, Garban
Hilliard Farber and Co., Inc.
Liberty Brokerage, Inc.
RMJ Securities Corp.
TGB Corporation

Information Vendors and Analytical Services

ADP Brokerage Information Services Group
Bloomberg Financial Markets
Knight-Ridder Financial Information
Quotron Systems, Inc.
Reuters Information Service Inc.
Telerate Inc.

Clearing Corporations

Government Securities Clearing Corporation
The Options Clearing Corporation

Other

The Securities Investor Protection Corporation

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

July 3, 1990

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for providing us the opportunity to review and comment on your draft report on the effectiveness and implementation of the Government Securities Act of 1986. Since we have previously provided technical comments on the report to Stephen Swaim, our response will be limited to three items -- extension of Treasury's rulemaking authority over the government securities market, Treasury's capital rule for government securities brokers and dealers, and expanded access to broker screen information.

We support your recommendation that Congress should continue Treasury's rulemaking authority over the government securities market and the activities of government securities brokers and dealers. We believe Treasury is best situated to regulate the government securities market due to our expertise and understanding of the market, our direct interest in ensuring that the market remains efficient, liquid and resilient so that Treasury securities can be sold at the lowest cost, and our ability to bring together the views of all interested parties so that regulations are promulgated in a uniform and consistent manner for all participants in the market. Treasury's continued role as rulemaker will guarantee that the interests of the regulatory community as well as the market participants are well represented.

With regard to your recommendation that the separate Treasury capital rule applicable to government securities brokers and dealers should be phased out, an informal staff level working group has recently been established, comprised of representatives from the Securities and Exchange Commission (SEC), the Federal Reserve Bank of New York and Treasury. This working group will identify, research and analyze the issues that need to be resolved in order to develop a uniform capital rule that would apply to the government securities activities of both registered

government securities brokers and dealers and other registered brokers and dealers. Pending the outcome of this study, Treasury and the SEC will continue to take advantage of opportunities to minimize the differences between our respective capital rules.

Treasury concurs with your assessment that expanded access to broker screen information would serve the public interest. We support your recommendation that Congress should mandate public access and provide Federal rulemaking authority to prescribe regulations, as needed, to ensure that information access is expanded.

As you know, Treasury, the SEC, and the Board of Governors of the Federal Reserve System are required to submit a joint report to Congress by October 1, 1990, evaluating the effectiveness of the Government Securities Act. We will offer our recommendations at that time.

We trust that our comments prove useful.

Sincerely,

Michael E. Basham

Michael E. Basham
Acting Assistant Secretary
(Domestic Finance)

Comments From the Securities Investor Protection Corporation

SECURITIES INVESTOR PROTECTION CORPORATION
805 FIFTEENTH STREET, N.W. SUITE 800
WASHINGTON, D.C. 20005-2207
(202) 371-8300

OFFICE OF THE GENERAL COUNSEL

June 27, 1990

BY HAND

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

This is in reply to your letter of May 25, 1990 in which you asked for SIPC's comments on the General Accounting Office's ("GAO") draft report on the Government Securities Act of 1986 ("GSA").

The GAO draft report makes a number of recommendations, including two of particular interest to SIPC, namely, the extension of SIPC protection to customer accounts at specialized government securities dealers and the continuation of Treasury's rulemaking authority for all government securities dealers. While the GAO draft report does state that there is no reason why these specialized government securities dealers should not support the integrity of the market that derives from SIPC protection, it, however, does not make a specific recommendation about whether the revenues from the securities activities of these government securities dealers should be subject to SIPC assessment, as is most securities revenue generated by other SIPC members.

Now on p.60.

Now on pp. 29 and 60.

The draft report (at 100) notes that Congress, in passing the GSA, did not require government securities specialist dealers to become members of SIPC. See H.R. Rep. No. 99-258 at 25 (1985); S.Rep. No. 99-426 at 20 (1986). The report (at 42 and 100 n.18) notes that as of July, 1989 there are 63 government securities specialist firms (16 brokers and 47 dealers) who are registered with the Securities and Exchange Commission and are not SIPC members. These firms are registered under section 15C of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78o-5. The report (at 105) recommends that "Congress amend the Exchange Act to require that all nonbank government securities dealers provide SIPC coverage if they do business with customers for whom such coverage normally applies in SEC-registered securities markets."

Now on p. 64.

The report (at 3) further notes that the GSA established Treasury as the rulemaker with authority to write rules for government securities dealers until October 1, 1991. The report (at 145) recommends that Treasury's authority should be continued for a limited period of time.

Now on p. 2.

Now on p. 92.

SIPC would like to make a few introductory comments about the Securities Investor Protection Act of 1970 ("SIPA"), the membership of broker-dealers in SIPC,

the registration of municipal securities dealers with the Securities and Exchange Commission ("SEC") under the Securities Acts Amendments of 1975, and the registration of government securities broker-dealers with the SEC under the GSA.

When Congress enacted SIPA in 1970 and established SIPC to protect customers of SIPC member broker-dealers for the cash and securities which those members are holding for customers, Congress mandated clear membership requirements for SIPC. Pursuant to SIPA section 3(a)(2)(A), 15 U.S.C. §78ccc(a)(2)(A), all broker-dealers, with minor exceptions, registered with the SEC under section 15(b) of the Exchange Act, 15 U.S.C. §78o(b), are automatically members of SIPC.

In 1975 when Congress mandated that municipal securities dealers register with the SEC and extended SIPC protection to these firms' customers, these firms registered under section 15(b) of the Exchange Act and thus became SIPC members. Certain municipal securities dealers, not requiring membership in the SIPC protection program, registered under section 15B of the Exchange Act, 15 U.S.C. §78o-4, and did not become SIPC members.

As noted above, the GSA required the registration of government securities dealers with the SEC under either section 15(b) or section 15C of the Exchange Act. Many government securities dealers registered under section 15(b) and became SIPC members. Only 63 did not. They registered under section 15C.

The GAO draft report is silent as to whether the 63 government securities dealers, which the report recommends become SIPC members, would register with the SEC under section 15(b) of the Exchange Act as does every current SIPC member. One may surmise, however, that the draft report contemplates both the SIPC membership of these 63 government securities dealers and their continued registration under section 15C of the Exchange Act, because of the report's recommendation that the Treasury continue to write the rules for these 63 entities.

This would be the first time that Congress would consider making entities, which are not registered under section 15(b) of the Exchange Act and which are not subject to the full rulemaking authority of the SEC, members of SIPC. SIPC believes that such a major departure from prior practice must be thoroughly thought through, explored, and discussed.

Of special concern to SIPC is the likelihood of having SIPC members subject to different financial responsibility rules. Up to now, the financial responsibility rules governing the more than 10,000 SIPC members have been uniform and have been written by the SEC.

One final concern SIPC would like to raise is the fairness of extending SIPC membership to these specialized government securities dealers without requiring them to pay their fair share of SIPC assessments. SIPA section 16(9)(K), 15 U.S.C. §78lll(9)(K), restricts the assessment on commissions earned from transactions in Treasury bills to only a percentage of such commissions based on SIPC's loss experience with respect to such instruments over at least the preceding five years. No other basis for assessments is restricted in this manner. SIPC believes that, if the specialized government securities dealers are to be given SIPC membership, the restriction on assessments must be eliminated or substantially modified. In this

regard we note with approval the following comment in the GAO draft report (at 102) regarding the responsibilities of these specialized government securities dealers: "We also see no reason why specialist firms should be able to avoid the responsibilities for supporting the integrity of the market that derives from SIPC insurance." SIPC believes that such responsibilities include shouldering a fair share of the assessment burden which supports a properly funded SIPC protection program.

Very truly yours,

Theodore H. Focht
President and General Counsel

THF:KHB:rm

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