Exchange Act of 1934, to bring entities that deal exclusively in government securities under regulatory control for the first time. The bill, entitled the “Government Securities Rulemaking Board Act of 1985,” would require all government securities dealers to register with the SEC, although the Federal Reserve and the SEC would have authority to exempt certain dealers. Congress apparently believes that registration ultimately would provide a device for enforcement of the bill and would provide tools for keeping government securities dealers from trading if they previously were involved in fraud, or if they violated any other provisions of the bill. The bill would establish a self-regulatory organization called the Government Securities Rulemaking Board (GSRB), which would fall under Federal Reserve oversight. The GSRB would have only rule-making authority and would have no enforcement powers. Under the bill, the GSRB would have five months to adopt rules in specific areas involved in the recent failures of government securities dealers. The GSRB would adopt rules for capital requirements and repo transactions, and would improve the transfer and control of securities under RP agreements. How- ever, the GSRB would consider the possible impact that any of its rules might have on the liquidity of the RP market.

Conclusions
Recent proposals to regulate the government securities market seek to prevent some of the problems that led to the failures of secondary government securities dealers. However, such regu- lation would only provide additional safeguards that prudent investors already can use. No amount of regula- tion can prevent fraud completely. Many of the losses that resulted from unregulated, undercapitalized dealers were due to investors’ carelessness and to misplaced trust.

The bill was designed to use existing agencies for inspections and enforce- ment of the GSRB’s rules to minimize the cost of regulation. Primary enforcement authority would be given to the SEC because it already has primary responsibility to enforce the 1934 Act. The bank regulatory authorities would be given primary inspection and enforcement authority over govern- ment securities dealers that are banks. Compliance by nonbank brokers and dealers would be enforced by the self- regulatory organizations (the NASD and the exchanges). There is no regulatory exchange for all government securities brokers and nonbank dealers would be required to be members of organizations such as NASD or the exchanges.

In addition to the House-passed bill, Senator Alfonse D’Amato (R-NY) intro- duced a bill in 1985 that is similar to the House version. The only substanti- ve difference is the bill would not establish a self-regulatory organization, but would give the Federal Reserve new rule-making authority. Also, the Treasury Department has submitted a proposal to Congress, yet to be intro- duced, that would give the Treasury rule-making authority without estab- lishing a self-regulatory agency.

ECONOMIC COMMENTARY
The Government Securities Market and Proposed Regulation
by James J. Balazsy, Jr.

9. When-issued trading is the secondary market trading of new Treasury securities between the time of announcement of the new securities by the Treasury and the subsequent day the securi- ties actually are issued.

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The Government Securities Market
Besides investors, participants in the government securities market include the Treasury Department, the Federal Reserve System, and primary and secondary dealers. The Treasury Department, through its fiscal agent, the Federal Reserve Bank of New York, sells government securities at competitive auctions. Most of the trading in government securities is done by government securities dealers who are individuals or corporations who trade government securities for their own account.

The Federal Reserve Bank of New York (FRBNY) to implement the Federal Re- serve's monetary policy. The New York bank, through its trading desk, influ- ences the nation’s supply of bank reserves by buying or selling large amounts of government securities.

Proposed legislation would bring the market under closer regulation in an effort to prevent future failures of government securities firms that could have repercussions throughout the financial system and that could inhibit the conduct of domestic monetary and fiscal policies. This Economic Commentary exam- ines the participants in the government securities market, and discusses the desirability of minimum regulation, the importance of avoiding excessive regu- lation, and recent proposals to regulate the market.

Participants
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Primary dealers are those with whom the FRBNY is willing to deal when con- ducting the Federal Reserve’s monetary policy. Currently, there are 36 primary dealers who are so designated if they meet certain criteria outlined by the Federal Reserve Bank of New York.

Despite the lack of express statutory authority, the FRBNY oversees primary dealers, who must submit daily, monthly, and annual reports showing their transactions, positions and capital.

In addition to the primary dealers, it is estimated that there are 400 to 500 second- ary dealers in the market. The exact number is unknown because there is no strict definition of a government securities dealer, and no requirements for federal registration. However, secondary dealers are important to the market’s liquidity — that is, they in- crease the ability of investors to buy and sell government securities — because they act as a sales force and as financial agents for the primary deal- ers. Secondary dealers also trade with investors who don’t buy large enough quantities of securities to deal with the primary dealers.

Secondary dealers contact municipal treasurers and other institutions with readily available cash in order to bor- row to finance their positions (inventories of securities), and they may act as intermediaries in arranging financing for the primary dealers. Many second- ary dealers obtain financing for pri- mary dealers through repurchase agree- ments (repos or RPs), but never hold

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1. For a complete description of the criteria used by the Federal Reserve in designating primary dealers, see Statement of E. Gerald Corrigan, President, Federal Reserve Bank of New York, before the Committee on Banking, Housing and Urban Affairs, and Monetary Affairs of the House Commit- tee on Government Operations, May 15, 1985.
The absence of capital or margin requirements for dealers who trade only government securities eliminates one major cause of the leverage risk in the capital markets. For example, when Drysdale Government Securities Inc., a large dealer, handled $65 billion of government securities with a capital base of only $20 million, which was well below the $270 million in interest payments owed on the borrowed securities. The absence of margin requirements permits the firm to build up significant inventories of government securities with relatively little capital and makes it possible to handle mostly borrowed funds. This practice may encourage the dealer to take excessive risks because, if losses are sustained, the dealer’s creditors have proportionately more to lose than the dealer. Dealers may increase their inventories when they expect interest rates to fall and security prices to rise. However, inventory losses can be sustained by the dealers and their creditors. The proposed capital and margin requirements supposedly would diminish such risks by providing a cushion against unfavorable movements in interest rates.

One of the most common problems in the government securities market during the recent wave of bankruptcies was the failure of market participants to adequately secure the government debt. It is a frequent event that a government security is delivered in a repossession or reverse repurchase transaction. The absence of a repossensing condition and margin requirements in a repo transaction makes it easy for a dishonest dealer to pledge the same government security to multiple transactions. While this increases the leverage of the dealer and the potential for market-making (including increased arbitrage) that has been reduced market participation, it also reduces the dealer’s cost of maintaining a market for the securities. The proposed capital and margin requirements will make it impossible for a dealer to effect a repossensing condition and ensure that the deal is not only a repossession but a repurchase transaction. The proposed capital and margin requirements also require that the proposed capital and margin requirements must be maintained at all times, the ease with which new dealers can enter the market adds to the market’s efficiency and liquidity. A new regulatory system is needed to provide capital and margin requirements that are proportionate to the risks of the transactions. The proposed capital and margin requirements will provide the necessary safeguards to protect investors from the risks of the transactions.