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THE GOVERNMENT SECURITIES MARKET: IN THE WAKE OF ESM*

The government [securities] market, which used to be stuffy and humdrum, has evolved over the last decade and a half into the most active, exciting, and innovative sector of the money market.1

I. INTRODUCTION

Numerous recent bankruptcies of government securities dealers have stimulated a new awareness of the world's largest securities market—the government securities market—and its lack of regulation. Recent failures of two relatively small dealers have resulted in losses of over $500 million to their respective customers.2 One of these failures nearly precipitated the collapse of the Ohio savings and loan industry.3

A continuation of dealer bankruptcies may frighten investors away from the government securities market, thus reducing the market's liquidity and undermining the government's monetary policy. This is particularly important because the government securities market is the primary tool used by the Federal Reserve Board (FRB) to control the nation's economy.4 The FRB exercises its monetary policy by purchasing and selling Treasury securities through the government securities market.5

This comment examines the structure of the government securities market, the unscrupulous practices of some of its dealers, and the need for statutory reform. The following section describes the eco-
omic conditions which led to the 1986 adoption of legislation to regulate the market. Section III examines the problems in the government securities market and distinguishes them from past problems in other securities markets. Section IV proposes alternative regulatory measures. Finally, Section V concludes that overregulation of the government securities market will emasculate the most important securities market in the world.

II. BACKGROUND

The government securities market is by far the largest securities exchange in the world.6 With daily trading volume exceeding $40 billion,7 the government securities market dwarfs its more well-known counterparts; for example, daily trading volume is nearly seventy times the value of all corporate securities traded on all U. S. stock exchanges.8 Furthermore, because the government securities market is the primary tool used by the United States government to finance public debt and to implement monetary policy, it is perhaps the most important securities market in the world.9

A. What is a Government Security?

An understanding of the government securities market is necessary both to appreciate the problems which have arisen and consequently to prevent them in the future. To begin an examination of the market, the term “government security” must be defined. In its most straightforward form, a government security is a United States government bond used to finance public debt.10 Like corporate bonds, government securities are traded by individuals and institutions who hope to make a profit. However, the buyer of a government security is virtually assured of safety from default because government securities are secured by the United States Treasury.

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7. Estimates of trading volume vary widely. One report conservatively estimates that volume may exceed $40 billion per day. See NEW YORK STATE ASSEMBLY COMM. ON WAYS AND MEANS, GAMBLING WITH PUBLIC FUNDS: THE LION CAPITAL BANKRUPTCY AND ITS IMPLICATIONS FOR GOVERNMENT INVESTMENT PRACTICES 41 (1985) [hereinafter NEW YORK WAYS AND MEANS REPORT]. Another observer has estimated that volume may exceed $200 billion a day. See BREAKING THE FREEWHEELERS, TIME, Apr. 22, 1985 at 47.
8. TREASURY BULLETIN, supra note 6, at 15. By comparison, average daily trading volume on the New York Stock Exchange in 1984 was $773,426,000. See NEW YORK STOCK EXCHANGE FACT BOOK 71 (1985).
government.\textsuperscript{11}

1. \textit{Treasury Securities}

Perhaps the most well-known type of government securities are Treasury securities, which are direct obligations of the federal government. They are issued in several forms, varying in denomination, maturity, and interest paid.\textsuperscript{12}

The simplest of the Treasury securities is the Series EE and HH bonds, commonly known as savings bonds. Issued by the United States Treasury, these securities are usually purchased by small investors.\textsuperscript{13} Another familiar Treasury security is the "Treasury Bill." "T-Bills," as they are called, have a maximum maturity of one year and are sold at a discount from their face value.\textsuperscript{14} The difference between the discount price and the maturity value is considered to be the interest income.

Similar to T-Bills are "Treasury Notes" which are Treasury obligations that pay interest semi-annually and usually have maturities of between one and ten years.\textsuperscript{15} The final type of Treasury securities are "Treasury Bonds" which are essentially Treasury Notes with longer maturities, usually between ten and thirty-five years.\textsuperscript{16}

2. \textit{Government Guaranteed Securities}

The more esoteric government securities are the obligations issued by federally-owned agencies which are, therefore, direct obligations of the United States government. The most well-known of these are the Government National Mortgage Association obligations, or "Ginnie Maes."\textsuperscript{17}

Securities issued by United States government sponsored agen-

\begin{enumerate}
\item M. STIGUM, supra note 1, at 430.
\item These savings bonds play virtually no role in the government securities market because they are non-negotiable and are issued in small denominations.
\item T-Bills are available in three, six, and twelve month maturities. The minimum, and most common denomination, is $10,000, but T-bills can be purchased in multiples of $5,000 above the minimum, up to a maximum of $1,000,000. FEDERAL RESERVE BANK OF KANSAS CITY, BUYING TREASURY SECURITIES AT THE FEDERAL RESERVE BANKS 3 (1984) [hereinafter FRBKC REPORT].
\item Id. at 9.
\item Id.
\end{enumerate}
cies are similar to Ginnie Maes, but differ in that they are not direct obligations of the United States government, and thus, in theory, are not as safe an investment. An example of these agency securities is the so-called "Fannie Maes," which are obligations of the Federal National Mortgage Association used to fund home loans.  

3. Money Market Instruments

The most arcane government securities are the money market instruments such as "federal funds" and "repurchase agreements." Federal funds are pools of cash which the FRB requires commercial banks to have on hand for liquidity purposes. Banks holding inadequate cash reserves may borrow from those banks which have excess reserves. These funds are usually loaned overnight with interest paid for one day. The interest is paid at the federal funds rate, which fluctuates a great deal from day to day, and is the base upon which all other interest rates are established.

Most of the problems in the government securities market have, however, originated in what one observer calls the "darkest, most mysterious corner: the netherworld of repurchase agreements." "Repos," as these agreements are called, are investment devices which have become an integral part of the world economy, enabling institutional investors and government securities dealers to exchange cash for government securities. Many cities, pension funds and universities (hereinafter referred to as "lending institutions") use repurchase agreements to lend idle cash for short periods of time, often just overnight. The rate of return on repurchase agreements

19. There are many forms of government securities, but the most important credit instruments in the money market include Treasury Bills, commercial paper, banker acceptances, certificates of deposit, repurchase agreements and federal funds. See NEW YORK WAYS AND MEANS REPORT, supra note 7, at 36, 37.
20. See Reserve Requirements of Depository Institutions, 12 C.F.R. 204 (1985) [hereinafter Reserve Requirements].
21. The interest paid is computed on a 360-day year. FRBKC REPORT, supra note 14, at 7.
22. NEW YORK WAYS AND MEANS REPORT, supra note 7, at 36.
24. 129 CONG. REC. E3184 (daily ed. June 27, 1983) (Statement by Rep. Fauntroy). "The repo market is as complex as it is crucial. It is built upon transactions that are highly interrelated. A collapse of one institution involved in repo transactions could start a chain reaction, putting at risk hundreds of billions of dollars and threatening the solvency of many additional institutions." Id.
25. There are three types of repurchase agreements: overnight repos, open repos,
is higher than the prevailing rate on Treasury Bills and can be easily structured to meet the needs of the parties.

B. Market Operation

In a typical repurchase agreement, a government securities dealer trades government securities for a lending institution's cash. The dealer agrees to repurchase securities from the lending institution the following morning at a price slightly higher than the amount of cash received, hence the name "repurchase agreement." The increase in price the dealer pays for the repurchase of securities is essentially the interest charged for the overnight use of the cash. Upon entering into the repo, the dealer is supposed to wire the government securities into the lending institution's account and in return, receive the lending institution's cash.

The dealer then sells the cash to a savings and loan (S & L) or other financial institution (hereinafter referred to as the "borrowing institution") in need of funds for liquidity purposes. In return, the borrowing institution wires government securities into the dealer's account and agrees to repurchase them the following morning at a

and term repos. Any of these can be set up as a reverse repo by a dealer using securities to obtain funds rather than investing money. With an 'overnight' repo, the investor gets a one day rate from the dealer. Typically, the money is wired through the Federal Reserve System and the securities are placed in a segregated account. The next day, the dealer wires the funds plus interest to the investor and the securities are released by the investor to the dealer.

An 'open' or 'continuing contract' repo is initiated with agreement by both the investor and dealer that an overnight contract will continually renew unless terminated by either party to the contract. The rate of interest will fluctuate with market rates, and the original contract rate may be lower as a result of the high liquidity provided to the investor.

'Term' or 'lock up' repos are set up for periods longer than overnight. The term repo rate is usually higher for longer contract periods to compensate for the decreased liquidity. Term repos are used by dealers in 'matched book transactions' to attempt to match the maturities of their assets and liabilities, or to tailor investments for a specified time period. 'Flex' repos are a specific type of term repo that encompasses variable (usually declining) sums over time.

NEW YORK WAYS AND MEANS REPORT, supra note 7, at 51.

26. FEDERAL RESERVE BANK OF NEW YORK, CAPITAL ADEQUACY GUIDELINES FOR U.S. GOVERNMENT SECURITIES DEALERS 17 n.2 (1985) [hereinafter FRBNY GUIDELINES].

27. However, the Federal Deposit Insurance Corporation (FDIC) has suggested a ninety-day limit on repurchase agreements. 47 Fed. Reg. 37,248 (1982) ( Proposed Amendment Relating to Restrictions on Non-deposit Obligations).

28. M. STIGUM, supra note 1, at 415.

29. Id.

30. Individual banks' computers are linked by wire to FRB district banks which in turn are linked to the FRB central computer. Id. at 363-64.

31. Reserve Requirements, supra note 20.
higher price. This exchange between a dealer and a borrowing institution is known as a "reverse repurchase agreement."32

The next morning, the dealer sells the securities back to the borrowing institution.33 The dealer then repurchases securities from the lending institution at a slightly lower price than the borrowing institution paid the dealer. The dealer's profit is the difference between these two amounts. Figure 1 graphically illustrates these transactions.

Assume a transaction involves $10 million in cash and $10.2 million in government securities, and the prevailing interest rate is 10%. The borrowing institution gains overnight use of the $10 million for liquidity purposes, and the lending institution earns interest on its idle funds. The government securities dealer earns an eighth of a percentage point interest on $10 million for acting as a middleman in the transaction. On an overnight transaction such as this, the dealer nets only $34.72, and the lending institution earns 10% interest for the overnight use of its funds, or $2,777.78. Because of this small gain on each transaction, dealers must enter into numerous repurchase agreements in order to be profitable.

33. The overnight repo is simply the most common. However, repos may be structured in several different ways. See NEW YORK WAYS AND MEANS REPORT, supra note 7.
This need for high volume sets the stage for dealers and lending institutions to take advantage of the market’s lack of regulation. Currently, there are no requirements for securing collateral. A wire costs a lending institution approximately forty dollars per transaction, and because lending institutions are hesitant to incur any additional costs, they sometimes fail to demand that the securities be wired into their account. This enables dealers, driven by their need for high volume, to use the same securities as collateral in more than one transaction. The inherent problem in this practice is that any one of several factors, such as market fluctuations, may force these dealers into insolvency, and ultimately harm those lending institutions who failed to require collateralization.

C. Market Participants

1. The Federal Reserve Bank of New York

The major participant in the government securities market is the Federal Reserve Bank of New York (FRBNY), the branch of the FRB responsible for selling all United States Treasury securities. The FRBNY acts like an investment banker for the United...
States government by bringing the Treasury securities to market. The FRBNY auctions all new Treasury securities, and also buys and sells government securities in the open market to carry out the FRB's monetary policy; this activity is a cornerstone of the modern American economy. Also, like an investment banker, the FRBNY has formed its own "syndicate," the so-called "primary dealers."

2. The Primary Dealers

The primary dealers are the firms given the privilege of purchasing a large volume of securities directly from the federal government. They are comprised of large commercial and investment banks, including such firms as Salomon Brothers, Morgan Stanley, and Bank of America, but also include smaller specialized operations. Primary dealers must meet minimum capital requirements and file daily, monthly, and yearly reports regarding their trading activity with the FRBNY.

The primary dealers receive numerous benefits from their privileged status. They are in a position to gather and interpret the latest information on monetary policy, because the FRBNY purchases securities from primary dealers when it is increasing the money sup-

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See also SEC Reg. 70(c)(4), 17 C.F.R. § 250.70(c)(4) (1985).


42. See T.L. Hazen, supra note 40, at 654-61.

43. Treasury-SEC-FRB STUDY, supra note 39, at 37.


ply, and sells to them when it is tightening the money supply. Another advantage enjoyed by the primary dealers is the opportunity to sell the securities which they have purchased from the FRBNY to other "secondary" dealers who do not have the same access to the Treasury auction.

3. The Secondary Dealers

Since government securities have been exempt from regulation by the Securities and Exchange Act of 1934, the Securities and Exchange Commission (SEC) does not know who these "secondary dealers" are, or even how many exist. Thus, there may be hundreds of secondary dealers operating without any regulatory oversight. Although many are either banks which must satisfy capital requirements and the rules of the banking regulators, or brokerage firms which must follow SEC capital requirements, there re-

46. Id. at 13 n.6.
47. New York Ways and Means Report, supra note 7, at 42.
48. When used in this title, unless the context otherwise requires, the term 'exempted security' or 'exempted securities' includes securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States; such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors; municipal securities, as defined in section 3(a)(29) of this title.
49. The SEC is the federal agency with which registration statements must be filed on new issues of securities and which supervises the operation of securities exchanges and related aspects of the securities business. See J. Weston & E. Brigham, Managerial Finance 1076-77 (7th ed. 1981).
50. Estimates range from 200 to 300 dealers in this unregulated category. However, the number could be even larger. See GAO Report, supra note 44, at 12-13. See also SEC Comments Request, supra note 2, at 15,905.
51. In addition to the informal oversight activities of the FRBNY for primary dealers in the government securities area, all activities of banks, including their government securities activities and investment practices, are subject to the direct regulatory oversight of the appropriate regulatory authority for the bank (the FRB, the Comptroller of the Currency, or the Federal Deposit Insurance Corporation). Moreover, the investment activities of many institutional entities in the government securities market are subject to review by regulatory bodies that supervise them. For instance, the FHLBB [Federal Home Loan Bank Board] provides regulatory oversight over savings and loan associations and other thrift institutions, the National Credit Union Association (NCUA) over credit unions, the Department of Labor over pension funds, and state insurance commissions over insurance companies.
52. This is the so-called "uniform net capital rule." SEC Reg. 15c3-1, 17 C.F.R. § 240.15c3-1 (1985).
main a large group of secondary dealers operating in a regulatory void.\(^8\)

This lack of regulation has enabled these secondary dealers to take risks that dealers in regulated securities markets are not permitted to assume. This is not the case on the organized exchanges where all traders are required to register. However, government securities are not traded on an organized exchange like the New York Stock Exchange. Rather, they are traded much like securities on the over-the-counter market\(^64\) in that the dealers are linked by telephone and computer, instead of standing together on a trading floor.\(^55\) Trading activity on the floors or in the pits of the major stock, option, and commodity exchanges is relatively easy to monitor due to the physical proximity of the traders. However, when traders are physically separated, as in the government securities market, the task of monitoring them becomes more difficult. This difficulty is compounded even further because registration of government securities dealers is not required.\(^6\) The lack of a registration requirement has enabled individuals who possess very little knowledge\(^57\) about the market to operate as dealers without supervision of their business practices or financial stability.\(^58\)

D. Recent Failures of Government Securities Dealers

The SEC estimates that losses to investors due to the 1985 collapse of two secondary dealers alone surpassed $500 million.\(^9\) Unfortunately, these failures do not represent a new problem. The last several years have seen the failure, or near failure, of numerous government securities firms: Winters Government Securities and Hibbard and O'Conn or Government Securities\(^60\) in 1977, Lombard-Wall Government Securities\(^61\) and Drysdale Government

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53. However, a small number of secondary dealers report voluntarily. SEC COMMENTS REQUEST, supra note 2, at 15,905.

54. The over-the-counter market is regulated by the National Association of Securities Dealers (NASD), a self-regulatory organization which has rulemaking inspection and enforcement authority subject to SEC oversight. T.L. HAZEN, supra note 40, at 258.

55. Id.

56. See supra note 48.

57. See infra note 58.

58. See, e.g., SEC v. Miller, 495 F. Supp. 465 (S.D.N.Y. 1980), as an example of how easily one can enter into the government securities market. (The defendant in this action converted his Iowa trucking company into a government securities dealership with less than $2 million in assets. Within a few years he had $18 million in liabilities.).

59. SEC COMMENTS REQUEST, supra note 2, at 15,904.

60. HOUSE REPORT, supra note 45, at 18.

Securities in 1982, and Lion Capital and RTD Securities Inc. in 1984. All of these failures and near failures involved the repo market.

1. The Ohio Savings Loan Crisis

In early 1985, ESM Government Securities (ESM), a Florida-based dealer, was forced into insolvency with over $300 million in losses. The panic set off by this failure eventually forced Ohio Governor Richard Celeste to declare the first banking holiday since the Great Depression.

ESM had extensive dealings in repurchase agreements with Home State Savings and Loan, a Cincinnati S & L controlled by Marvin L. Warner, former United States Ambassador to Switzerland. In essence, the ESM-Home State transactions were repurchase agreements entered into without adequate collateral; ESM had been using the same securities as collateral in numerous transactions for many years and had also issued inaccurate financial statements.

The magnitude of the panic in Ohio created by ESM's failure was so great because Home State was backed only by state, not federal, deposit insurance. When it became clear that Home State would suffer enormous losses from its dealings with ESM, Home State closed its doors. This was a potential threat to all state-insured Ohio S & L's because the losses incurred by Home State could have exhausted Ohio's deposit insurance fund. Thus, a run on the S

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63. NEW YORK WAYS AND MEANS REPORT, supra note 7, at 1.
64. HOUSE REPORT, supra note 45, at 18.
65. For an examination of the bankruptcy implications, see Note, Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities, 37 VAND. L. REV. 401, 419 (1984).
68. Id.
69. Kerwin, Gauging the Fallout from E.S.M., BARRON'S, Mar. 25, 1985, at 64.
70. The SEC had in fact charged ESM with fraud eight years earlier. Under the guise of learning more about the government securities market, an SEC investigator was sent to ESM to observe ESM's operation. The SEC thereafter charged ESM with fraud. The suit was, however, dismissed because the SEC must first have evidence of fraud in order to investigate an unregulated dealer such as ESM. Wallace, Home State and ESM: The Regulators Knew Plenty, BUSINESS WEEK, Apr. 8, 1985, at 34.
71. Id.
& L's began, and Governor Celeste was forced to close seventy-one state-insured lenders in order to halt the panic.

2. BBS Failure

Later in 1985, another government securities dealer was forced into receivership. Bevill, Bresler & Schulman Asset Management (BBS), a small New Jersey dealer, experienced difficulties similar to those of ESM; BBS had also been using its securities as collateral in more than one transaction. These practices eventually led to losses of $140 million.

E. Legislation to Regulate the Market

The fraudulent nature of these recent losses has resulted in a call for closer scrutiny of the government securities market. Those in favor of regulation have argued that the ESM and BBS bankruptcies could have been prevented had there been a reporting structure in place. They point to the fact that the SEC had suspected irregularities at ESM as much as eight years prior to ESM's failure but was prevented from pursuing an investigation because it was unable to prove fraud. In any other securities market, the SEC could have stepped in immediately by virtue of its regulatory powers.

The proponents of regulation also have argued that unless the government securities market is strictly regulated, it may not survive because the market's participants will seek out only the largest and safest firms with which to do business. Competition would thus be substantially reduced, augmenting the influence of the already powerful primary dealers.

Opponents of regulation have asserted that solving the problems facing the market through government regulation would disrupt the market to such an extent that its viability might be jeopardized.

73. Id.
74. Breaking the Freewheelers, TIME, Apr. 22, 1985, at 47. Some estimates have ranged even higher. SEC COMMENTS REQUEST, supra note 2, at 15,907 (estimates that losses were $223 million).
76. See Wallace, supra note 70.
77. The so-called "flight to quality" may result in a situation in which investors deal only with the most well established firms. See SEC COMMENTS REQUEST, supra note 2, at 15,907.
78. Any antitrust implications raised by this bifurcated system are beyond the scope of this comment.
They maintain that the government securities market is the last truly free securities market and should remain that way.  


In the wake of the ESM and BBS failures, legislators were quick to propose new regulatory legislation. Several pieces of federal legislation were introduced in 1985 and 1986. After much debate and the addition of several amendments, a compromise piece of legislation was finally signed into law in October 1986. The Government Securities Act of 1986 ("the Act") defines government securities brokers and dealers in detail and for the first time provides for regulation of these dealers. However, despite the detailed descriptions of who the dealers are, the Act contains some very large loopholes. First, the Act provides a general exception for "any person insofar as he buys or sells such securities for his own account." In addition, futures traders who deal in government securities are exempted from the Act if the SEC determines that such activities are "incidental" to the traders' business. It will be at the SEC's discretion to decide what will constitute incidental business.

The Act provides that the Secretary of the Treasury shall propose final rules within 270 days of the signing of this bill into law. The rules which the Secretary adopts will be enforced by numerous government agencies. The Act requires that if a dealer is not already registered with the SEC or is not a "financial institution" then that dealer must register with the SEC. Dealers already registered with the SEC and financial institutions must file a written notice with the appropriate regulatory agency: a national bank must file with the Comptroller of the Currency; a state-chartered bank must file with the FRB; a state-chartered bank which is not a member of the

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81. Id. at §§ 78c(a)(43)-(44).
82. Id. at § 78c(a)(44)(A).
83. Id. at § 78c(a)(44)(D).
84. Id. at § 78c (effective date 270 days after Oct. 28, 1986).
85. Id. at § 78c(a)(46).
86. Id. at § 78o-5.
87. Id. at § 78o-5(a)(1)(B)(i).
88. Id. at § 78(a)(34)(G) (defines "appropriate regulatory agency").
89. Id. at § 78(a)(34)(G)(i).
90. Id. at § 78.
Federal Reserve System must file with the Federal Deposit Insurance Corporation; and a federally-chartered S & L must file with the Federal Home Loan Bank Board. These various agencies will also be responsible for both examining the books of the regulated dealers and enforcing the rules which are adopted by the Treasury Department.

III. ANALYSIS

A. The Act Presents an Old Solution to a New Problem

The need for some constraints on the government securities market seems obvious. However, the Act addresses the government securities market's problems in the same manner which other securities markets' problems have been addressed in the past, by attempting to place a government regulator in the middle of the market. This atavistic solution, which was so useful in the 1930's, is not the best course of action today or for the future. The Securities Act of 1933, the Securities and Exchange Act of 1934, and their progeny were aimed at protecting the financially unsophisticated investor. The emphasis of this line of legislation was to prevent fraud and manipulation of securities created by the dissemination of inaccurate information to investors. However, these unsophisticated investors are not present in the government securities market.

1. 1930's Legislation Distinguished

The type of fraud the 1930's legislation protected against is not the same as that which the government securities market is currently experiencing. The participants in the government securities market are not small or unsophisticated investors but rather are institutions run by professional money managers. Sophisticated financial managers are much better suited to assess the financial viability of the institutions with whom they are dealing than are small investors buying a few shares of “XYZ Corporation.” In essence, the partici-
pants in today's government securities market are the most sophisticated of investors, and consequently, their need for governmental protection is minimal.

The government securities market becomes treacherous only when the participants in the repo market fail to collateralize their transactions.97 Otherwise, these contracts involve less risk than corporate securities, since it is unlikely that the United States government will default on its obligations.98 The only other risks present in the government securities market are those of legitimate market fluctuations which are, of course, not a regulatory concern. Many of the problems which this market has experienced could be solved if the participants would simply take possession of their collateral. Hence, any attempt to solve the market's problems should begin by making collateral easier to obtain.

2. The Need for an Efficient Market

The United States government finances its debt by selling Treasury securities on the government securities market.99 If the equilibrium existing in the market were to be upset by the added costs of regulation,100 the Treasury Department would face a crisis in selling the nation's bonds. Home loans, student loans, and farm financing, for example, would be much more difficult to obtain. Moreover, if the United States were unable to sell its securities, it would, in effect, be bankrupt.

Thus, regulatory interference will likely reduce the market's efficiency.101 Its present degree of efficiency is very desirable and stems partly from the highly liquid nature of government securities. There is around-the-clock trading activity in government securities which makes it possible for investors to buy and sell whenever necessary. This efficiency is one of the market's strongest features and, therefore, must be protected if the government securities market is to survive.

97. See supra notes 59-65 and accompanying text.
98. M. Stigum, supra note 1, at 430.
100. Interest rates on government securities would rise to compensate investors for holding less liquid securities or to enable dealers to recapture their costs. An increase of just one-tenth of a percentage point in the interest rates on government securities would cost taxpayers $1 billion a year. That's far greater than the sums lost by customers of ESM and BBS. Worthy, supra note 23, at 81.
101. The government securities market is currently one of the most efficient markets in the world. See SEC Comments Request, supra note 2, at 15,905.
In conjunction with the need for liquidity, the importance of foreign investment should be considered. Foreigners invest billions of dollars a day in the United States through the government securities market. Since government securities are very safe, extremely liquid, and yield a high return, the government securities market is a favorite of foreign investors. However, if the features which foreign investors currently find so attractive are disturbed, the investment alternatives available in Western Europe and Japan will appear more lucrative. A loss of foreign capital of this magnitude would greatly exacerbate the United States balance of trade problems.

IV. PROPOSAL

A. Changes Without Overregulating

Overregulating the government securities market may cause a ripple effect which could create problems worse than those which the regulation is intended to correct. The most feared of these effects - increased costs and a loss of investors - could destroy the viability of this delicate market. Thus, the primary source of government debt financing and the most efficient tool for exercising monetary policy would be lost.

Regulation per se is not undesirable; however, overregulation will not solve the market's current problems. Therefore, in adopting rules to regulate the government securities market, the Treasury Department should consider the following suggestions to enable the market to perform at its current level of efficiency and also prevent fraud.

1. Reduce the Cost of Collateralization

Reduction of collateralization costs is necessary. The primary reason that unscrupulous dealers have been able to use the same securities as collateral in more than one transaction is that the institutions with whom they are dealing do not secure proper collateralization. These institutions do not secure collateral because they are reluctant to incur any additional transaction costs.

Some observers argue that if a supposedly sophisticated financial institution was so imprudent as to fail to demand collateral, then

103. Id.
104. See supra notes 34-35 and accompanying text.
it would deserve the resulting losses.\textsuperscript{105} However, it would be possible to eliminate the prospect of this type of fraud by simply making it easier and less expensive to secure collateral. This could be accomplished by any combination of actions ranging from federal or state subsidies to a licensing fee for the dealers.

Certainly the federal government has an interest in stabilizing this system. Federal subsidization would not only enable the federal government to keep this market, upon which it depends for its debt financing and monetary policy, functioning in an honest and efficient manner, but subsidization would probably be less expensive than creating and maintaining a new regulatory apparatus.

The states' interest in such a plan is also significant. When a government securities dealer goes bankrupt, a state may face serious problems, such as those experienced in Ohio.\textsuperscript{106} Another reason that states should be interested in helping finance the cost of securing collateral is that municipalities, school boards, and other local entities are some of the most active participants in the market. If the market is to remain a viable source of income for these institutions, some protections must be created.\textsuperscript{107}

The government securities dealers can also contribute to the financing of wire costs through licensing fees and other revenue raising taxes. Not only would these fees and taxes raise the needed monies but they would also provide a way to identify the secondary dealers. Moreover, the dealers have an interest in helping finance wire costs: to prevent more radical regulation which would reduce their autonomy, or even destroy the market upon which their livelihood depends.

2. Insure Qualified Dealers

Another possible change which the Treasury Department should consider and which would place a relatively small burden on the dealers is to require proof of dealer qualification. Dealers should have to demonstrate that they possess the basic knowledge needed to

\textsuperscript{105} See Bleiberg, Scandals in Governments: Federal Regulation Will Do More Harm Than Good, BARRON'S, Apr. 15, 1985, at 84.

\textsuperscript{106} See supra notes 66-71 and accompanying text.

\textsuperscript{107} See generally NEW YORK WAYS AND MEANS REPORT, supra note 7. See also Statement of Assemblyman A. Kremer: "How many times do local governments have to be burned before they realize they just can't handle complicated investment situations." Scherschel, Do Government Securities Need Tighter Controls?, U.S. NEWS AND WORLD REPORT, Apr. 8, 1985, at 84.
trade government securities.\textsuperscript{108} Requirements for dealer qualification were not included in the Act but could easily be facilitated through the administration of a written examination, similar to those examinations now given to participants in other securities markets.\textsuperscript{109} These examinations would not necessarily prevent fraud but they would ensure that those who hold themselves out as government securities dealers have at least a rudimentary knowledge of the subject with which they are dealing.

3. \textit{A Regulatory Body}

Implementation of the above suggestions will, of course, require a regulatory body. Under the Act, the Treasury Department is responsible for enacting the rules and various government agencies are responsible for executing the regulatory duties. However, because each agency will be in charge of regulating a specific group of market participants, the potential for different interpretations and applications of the Treasury Rules is very likely.

A better approach would be for the Treasury Department to create a governing board consisting of representatives of the various regulatory agencies and the industry, and confer in this board arbitration and interpretive powers. In this way, the rules would be more consistent and less subject to the vagaries of individual interpretation.

B. \textit{Proposed Changes Retain Market's Efficiency While Addressing Its Current Problems}

The changes which this comment proposes would allow the government securities market to maintain its viability without imposing overly cumbersome requirements. This market can thus continue to function with the efficiency it has demonstrated in the past. If the changes suggested in this comment were adopted, failures such as ESM and BBS would not likely be repeated because the transactions would be collateralized. There would be no disincentive to demand

\textsuperscript{108} One observer estimates that there are only about 300 people trained to trade government securities. M. STIGUM, \textit{supra} note 1, at 462.

\textsuperscript{109} For example, stockbrokers must pass either the "Series 7" General Securities Representative Examination to conduct a general securities business, or a more specialized examination or examinations to qualify to conduct specific limited types of business. Similarly, supervisory personnel must pass the relevant principal examinations. These examinations generally parallel the categories of examinations applicable to stockbrokers, with additional examination, such as one for financial and operational principals. \textit{See, e.g.}, NASD By-Laws, Article 1, §§ 1-2.
collateral, as there currently is due to the wire charges. In addition, the governing board would be aware of the participants' activities because they would be tested and licensed. Thus, the anonymity which the unscrupulous dealers have found so convenient, would no longer exist.

V. CONCLUSION

In the last few years, the government securities market has become one of the most important parts of the American economy, while remaining essentially unregulated. However, in the early 1980's several bankruptcies of unregulated dealers, culminating in the near collapse of the Ohio savings and loan industry, prompted legislators to scrutinize the market more closely. The resulting regulatory legislation is essentially the same type of regulation that was so effective during the Great Depression. However, the government securities market differs greatly from the markets that existed in the 1930's. The speed, size, and efficiency of government securities transactions would baffle a 1930's stock trader. The efficiency of this market is possible only because it has not had regulatory constraints imposed upon it. Rather than looking to the past to solve the market's problems, a new approach is needed. Correction of a few faulty links, such as uncollateralized transactions and unqualified dealers, is necessary, instead of an entire overhaul of the market.

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