The Government Securities Act of 1986

A Case Study of the Demand for Regulation

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On October 28, 1986, President Ronald Reagan signed into law the Government Securities Act, bringing all dealers in the U.S. government securities market under federal regulation for the first time. Previously unregulated dealers now have to register with the government and comply with rules establishing minimum capital requirements, financial responsibility standards, and customer-safekeeping arrangements.

Why, in the sixth year of office, did a popular president committed to deregulation subject "the world's largest and most efficient securities market" (in the words of numerous government officials) to direct federal regulation? This essay addresses that question. While the answers may not come as a great surprise to long-time students of regulation, they do provide a graphic demonstration of how and why the pressure to regulate continues to find expression in federal legislation, even in instances where few measurable benefits can be demonstrated.

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Background

The Securities Act of 1934, which brought all significant private-sector stock and bond underwriting and trading under federal oversight, specifically exempted U.S. government securities from its key provisions. But the U.S. Treasury, as the issuer or guarantor of government securities, has had substantial power to shape the institutions and practices of that market. The Federal Reserve, as the Treasury's fiscal agent in dealing with the market, enjoys substantial powers. Other federal agencies have varying degrees of indirect control. For example, as participants in the dealer market, commercial and investment banks are subject to federal oversight through the various banking agencies and the SEC, and participants in the exchange-traded futures and options markets for government securities are subject to regulation by the Commodity Futures Trading Commission.

For many years, however, a distinguishing characteristic of the U.S. government securities market was the substantial number of firms, some quite large, that were free from any formal government supervision since they dealt exclusively in U.S. government securities. This diverse dealer base, with no regulatory requirements for firms and individuals that wished to become dealers, clearly assisted the U.S. Treasury in its efforts to sell government debt at the lowest possible cost. With the rapid increase in the volume of government debt in the early 1980s, the number of firms active in this market increased substantially. By 1985 the number of unregistered firms was generally estimated at 200 to 300.

The Primary Dealers

At the center of the government securities market stand the roughly 40 primary dealers—those dealers with whom the Federal Reserve Bank of New York has a business relationship. Primary dealers, and those who aspire to become primary dealers, submit daily and monthly reports to the New York Fed and receive on-site inspections of their operations.

The New York Fed enters into substantial daily transactions with market participants. It acts as fiscal agent for the Treasury Department as well as for more than 100 foreign official institutions. In addition, monetary policy is conducted through transactions for its own account. In choosing with whom to do business, the Fed over the years has developed various criteria. Quite understandably, one of the most important of these focuses on the financial strength of the firm.

The Fed presumably would not deal with a financially unstable firm, and since the names of firms with which it deals are matters of public record, the public assumes that these primary dealers are "safe" firms. As a spokesman for the primary dealers conceded to Congress in June 1985, "We know that these primary dealers are being surveilled on a day-to-day basis by the Federal Reserve. The Fed is, in a sense, providing the credit check." The market perception of primary dealers' creditworthiness extends to a belief that the Federal Reserve would not permit a primary dealer to fail. In fact, the Fed has acted in the past to ease temporary financing difficulties for some of these firms.

The value of primary dealer designation is also confirmed by the primary dealers' exclusive access to real-time, video-screen-based information and trading systems provided by interdealer brokers. Transactions over these systems are agreed to "blind" without prior knowledge of the name of the counterparty. It is argued, therefore, that all those with access must have an unimpeachable credit standing, which is provided by the Fed's "primary dealer" designation.

The Storm Breaks

As the volume of U.S. government debt and guaranteed obligations swelled during the early 1980s, a number of government securities dealers developed problems. By 1985 there had been several well-publicized failures—most notably, Drysdale (1982), Lombard-Wall (1982), and Lion (1984). The losses associated with these failures were borne by commercial banks and a few public authorities, such as municipalities. The public felt few secondary repercussions, although the Federal Reserve did take steps in the Drysdale and Lombard-Wall affairs to minimize problems within the financial community.

For many years a distinguishing characteristic of the U.S. government securities market was the substantial number of firms that were free from any formal government supervision since they dealt exclusively in U.S. government securities. This diverse base enabled the Treasury to sell government debt at the lowest possible cost.

Securities dealers subject investors to the greatest risk with repurchase agreements, or "repos" in market terminology. Essentially, investors lend short-term money to dealers to finance their inventories of government securities. Investors are at risk if the value of the dealer's securities drops significantly (as a result of an increase in interest rates, for example), and wipes out the firm's capital. Investor risk is supposed to be controlled through agreements that identify each advance of funds with the purchase by the investor of a specific government security from the dealer and its subsequent repurchase at an agreed-upon date. An important variant on the repurchase agreement is the "reverse repo," in which the investor

temporarily sells a security to a dealer in return for cash. If the amount of cash received is less than the value of the security, the cash borrowing is, in effect, overcollateralized.

While an ostensibly air-tight procedure, in practice a repurchase agreement has several weaknesses. It is relatively cumbersome and costly (especially for investments of only a few days or weeks) to transfer formally the securities involved from the dealer to the investor. Several other parties may also be involved in the process and numerous accounting entries required. Consequently, many dealers offer to provide "safekeeping" services for their investors, and simply send a receipt to the investor and point out that if third-party custody is required, it will reduce the net yield on the transaction.

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Not surprisingly, such circumstances create temptations. For example, a firm might "sell" a security with a market value less than the customer's advance. It could use the same securities to secure more than one customer's funds or could even issue receipts without possessing any security. In the case of overcollateralized reverse repos, the dealer could sell the securities received to a third party for substantially more than he has advanced to the customer. Such temptations become particularly acute if a securities firm has incurred losses on its trading activities.

For large investors, the obvious defense against dishonest or unsound practices is to acquire solid information about the dealer, such as audited financial statements, length of time in business, and the reputation of the principals. Alternatively, investors could require delivery of the security and simply accept a lower yield. And, if the mechanics of this process are too costly, the investor could simply deposit his money at a bank. The lure of higher yields, however, has often been a deterrent to doing financial homework.

By early 1985, the combination of rapid growth in the government securities market, yield-hungry investors in a period of falling interest rates, and careless investment practices by many participants had created conditions ripe for market disturbances. Two such developments occurred in rapid succession in March and April. On March 4, 1985, ESM Government Securities failed, with potential losses for customers on the order of $300 million. It was followed by Bevill, Bresler & Schulman (BBS) on April 7, with indicated customer losses of $235 million.

The BBS failure was the less important of the two. BBS was an SEC-registered broker-dealer that conducted its government securities transactions through an unregistered affiliate. The firm had been investigated and censured by the SEC in 1980 for a variety of selling and trading rule infractions. BBS investors included savings and loans, commercial banks, and other dealers. Three smaller government securities firms also failed or were liquidated as a result of their exposures to BBS.

The ESM failure had a far more significant impact on the financial community. ESM was an unregistered dealer, although it was filing monthly reports (that turned out to contain false information) with the New York Fed. ESM's parent firm had also been investigated by the SEC shortly after it was established in 1977, but the investigation was dropped after four years as a "stale" case.

Most of ESM's repurchase agreement investors were city and county governments investing surplus funds. Subsequent investigations showed that ESM had been insolvent for some time before March 1985. With the complicity of a partner at its accounting firm and undisclosed "borrowings" from its investors, ESM managed to conceal its losses and negative net worth for an extended period. When one of its important customers began to have doubts and gradually withdrew its business, however, the coverup unravelled.

The failure of ESM precipitated the failure, four days later, of the Home State Savings Bank in Ohio. Home State, a $1.4 billion institution, had been borrowing heavily from ESM for years and used overcollateralized reverse repos to secure "cheap" funding. Without continued funding from ESM, Home State also collapsed. It is important to emphasize, however, that the collapse of ESM did not cause the failure of a healthy savings bank. Home State's heavy exposure to ESM was a symptom of its own underlying financial weakness. In fact, in 1983, the Ohio state examiner of Home State had described it as "a veritable time

bomb," and Home State was probably also insolvent long before March 1985.

Home State's failure led, in turn, to the insolvency of Ohio's state-chartered savings banks' mutual deposit guarantee fund. Seventy state-chartered thrift institutions were temporarily closed. This generated sensational headlines in international financial newspapers and a short period of sharp fluctuations in the gold and foreign exchange markets.

Finally, ESM's failure led many customers of the smaller unregistered dealers to transfer their business to larger firms, particularly primary dealers. In June 1985 the SEC reported: "A number of commentators and panelists at the Commission's Open Forum [on the failures among securities dealers] noted that many investors have begun a 'flight to quality.' Some have chosen to deal only with dealers recognized as 'primary dealers' by the FRBNY, instead of making independent determinations of the capital adequacy and creditworthiness of dealers. Other investors have restricted their dealings to 'regulated' dealers, such as primary dealers, banks, and registered broker-dealers." While this fallout was not widely noted at the time, it would play an important role in precipitating passage of the Government Securities Act.

A Practical Exercise in Public Choice

Congressional hearings were held throughout 1985. The resulting record allows us to identify the positions of all the primary participants in the development of the Government Securities Act. It is useful in reviewing the debates over the proposed legislation to sort the various parties into one of five roles in the government securities market: the originators of securities, the customers, the dealers, the regulators, and to a lesser extent, elected officials. A rudimentary model of the demand for and supply of regulation can then predict the expected positions of the various players.

The originators (or sellers) of securities include the Treasury Department, government-sponsored agencies (chiefly involved in housing), and agents of the originators, such as mortgage bankers. In this public choice model those selling securities would be expected to oppose additional regulation, as it would tend to increase their borrowing costs. If regulation appeared unavoidable, the sellers of securities would want to play a major role in defining the new regulations.

The customers of government securities include all individuals and institutions that buy these securities, especially the Federal Reserve Bank of New York. The buyers of securities would be expected to have mixed reactions toward proposed regulation. Concerns about the possibility of less competition for their business and the possibility that regulation would encourage more intense dealer scrutiny of customer creditworthiness would lead to opposition, as the costs of transacting business would be increased. Offsetting these factors would be a reduced need for customers to monitor dealers' transactions to protect against fraud. Regardless of the positions taken by other customers, the New York Fed would want to remain unimpeded by the new regulation in controlling its business relationships with the primary dealers.

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Government securities dealers (or the middlemen) include commercial banks, SEC-registered dealer-brokers, and unregistered dealer-brokers. An equally important distinction is between primary dealers (New York Fed counterparties) and secondary dealers (all others). Already regulated dealers would be expected to favor regulation for their unregulated competitors, particularly if it imposed no new burdens on their own operations. Unregulated dealers would be expected to oppose a new oversight program unless they became convinced that profits would increase as regulation restricted new competitors.

The regulators in 1985 included the SEC, the FDIC, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Home Loan Bank Board. Regulators would be expected to be interested in expanding their turf. At a minimum they would insist that nothing be done to diminish their responsibilities.

Finally, elected officials would be interested in "doing something" if it would result in a net increase in votes or political campaign funds.

Although this rudimentary model predicts reasonably well, it does not capture some specifics of the dynamics of the environment in 1985 and 1986. Until late 1985, Treasury officials attempted to stave off legislation. The department suggested that changes in its securities ownership recordkeeping system ("book entry") could address many of the abuses uncovered in the repo market's safekeeping process. Meanwhile, Treasury officials worked to develop a fragile executive branch consensus that if Congress did enact legislation, Treasury should have the primary responsibility for developing any regulations.

Treasury's position was fully understandable. An increase of one-tenth of one percent (10 basis points) in the interest rates paid on Treasury securities would add $2.2 billion yearly to government borrowing costs. Thus, any increase in borrowing costs to Treasury would affect the federal budget with numbers large enough to catch the attention of Congress. Nonetheless, after it appeared that the House would pass legislation that would give rulemaking responsibility to a legislatively sanctioned self-regulatory organization, such as the National Association of Securities Dealers or Municipal Securities Rulemaking Board, Treasury changed its position. Treasury officials began to more actively support legislation that would put Treasury in control of any new regulations.

Stronger opposition to regulation, on grounds of its possible cost, came from the Department of Housing and Urban Development because of its concerns about the increased cost of issuing mortgage-backed securities. The Mortgage Bankers Association (MBA), speaking for a group heavily involved in originating government-

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backed mortgage securities, maintained that there was no need for additional legislation in view of existing regulatory authority and the market's capacity to self-adjust. If legislation were to be passed, however, the MBA wanted dealer regu-

From the Wall Street Journal, Cartoon Features Syndicate.

"You're under arrest for disturbing the peace!"

lation to be in the hands of the Federal Reserve rather than in a legislatively sanctioned self-regulatory organization or the Treasury. "An SRO," the MBA declared, "may cement in place the domination of the mortgage-backed securities market by a few large broker-dealers to the detriment of smaller firms." And if the Treasury were to have the regulatory authority, "it would be in a position to favor itself, disadvantage its competitors, and pressure its customers." In other words, the MBA feared direct Treasury borrowings would be favored over government-backed housing-related finance.

Government securities dealers generally preferred regulation. (An exception was Dillon Read, a large secondary dealer.) The majority of both registered and unregistered primary dealers accepted the principle of additional regulation and only expressed the desire that the Federal Reserve be the rulemaking authority. While this position is not surprising, the static rudimentary model of regulation fails to predict the strong views coming from the unregulated sector. The secondary dealer panel at the SEC's Open Forum on the failures among securities dealers strongly supported regulation. In testimony before the Subcommittee on Domestic Monetary Policy of the House Banking Committee, SEC Chairman John Shad reported that of all the dealer panels, "the secondary dealers were the most emphatic . . . in requesting regulation, because they feel they have been hurt more than others by the widely publicized fact that ESM and BBS were not regulated. . . . The secondary dealers feel they have sort of

been tarred by this, and that regulation would increase investor confidence." Chairman Shad did not, however, take advantage of his appearance before the subcommittee to point out that in May 1985 an SEC-registered dealer had failed, with potential investor losses on the order of $16 million.

Despite the sizeable losses many investors had incurred, they were generally skeptical of regulation, as indicated in testimony by the Government Finance Officers Association, representing perhaps the largest single group of individuals directly affected. (Several city managers and finance directors were forced to resign as a result of their investments with ESM and BBS.) The association stated that "to preserve efficient money markets, . . . [it] encourages Congress and federal agencies to use restraint in adopting additional legislation and regulation." This polite manner of saying, "No, thank you," was elaborated on by an association official in testimony: "Government finance officers have experienced firsthand the inefficiencies that often result from well-intentioned but cumbersome legislation and regulation in the securities marketplace, and remain somewhat skeptical about the idea that regulation can preclude investment losses." The Government Finance Officers' position was not atypical. In testimony reporting positions taken at the SEC's Open Forum, Chairman Shad noted, "It surprised me that . . . [investors] were the least supportive of legislation. They were very critical."

The official executive branch position was, as noted, that Treasury should be in charge of any new rulemaking Congress deemed necessary. But the loose discipline of the executive branch over the SEC and Federal Reserve allowed these independent agencies to express somewhat different views to Congress. For them, the issue was not whether there should be regulation, but who should administer it. Neither agency wished to see Treasury in full control. Although the SEC (and numerous private-sector groups) wanted the Fed to be put in charge, the Fed itself was less interested in undertaking the task. The Fed did, however, want legislation to permit the New York Fed to continue to dominate the primary dealer oversight process. The Fed's position probably reflected its desire to avoid becoming ensnared in issues that might compromise its independence on monetary policy issues.

Elected officials uniformly supported legislation. The mayor of Beaumont, Texas, which thought it had $7.5 million of securities with ESM, put part of the blame for the city's loss on its outside auditors and called for federal regulation. Similarly, no member of the House or Senate questioned the need for legislation, despite the views of important investors, such as the government finance officers. Both Republicans and Democrats, particularly those from Ohio, Florida (headquarters of ESM), and New Jersey (home of BBS), warmly endorsed the final bill. Many supporters cited the failure of Home State and the ensuing collapse of the S&L deposit guaranty fund as the basis for their support.

Disagreement about the lead regulatory agency prevented final legislation from passing in 1985. The House passed a bill in late 1985 designating a self-regulatory organization as the rulemaking authority. The Senate bill, which emerged in the summer of 1986, provided for Federal Reserve oversight. But Treasury prevailed in the end, gaining rulemaking authority with an unusual "sunset" provision designed by a suspicious Congress to facilitate a review of Treasury's actions.

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No recorded votes were taken on passage of the legislation in either house. The final version of the Government Securities Act was signed by Ronald Reagan in late October. Calling the act an important piece of legislation, he contended that the choice of Treasury as the rulemaker would minimize confusion and would help ensure that the federal debt would be financed at the lowest possible cost to the taxpayer.

Summing Up

The Government Securities Act of 1986 is a classic product of two traditional sources of the demand for regulation—business firms and politicians. Unregistered secondary security dealers were losing customers to large registered firms and primary dealers who achieved their "safe" status as a result of their acceptance by the New York Fed as suitable counterparties. Although the direct influence of the unregistered dealers is difficult to measure, clearly they were interested in acquiring a federally registered status.

Politicians, meanwhile, felt obliged to respond to events that had occurred within their districts. Although the Ohio, Florida, and New Jersey delegations probably felt the most pressure, the BBS and ESM failures caused nationwide losses, particularly for municipal governments. In addition, the failure of Home State seriously muddied the issue. The plight of 70,000 Ohioans temporarily denied access to their savings deposits established an erroneous association between the problems of the thrift industry (which would surface with a vengeance several years later) and those of the government securities market. Largely undeservedly, oversight of the government securities market became a consumer protection or "widows and orphans" issue.

The supposed beneficiaries of the act, the professional investors, were either lukewarm or opposed to the legislation. But their views were muted in the final legislative process, in part because Treasury, the party that would end up paying most of the added costs, was never willing to spend large amounts of political capital to oppose the legislation. (A major tax reform bill, also moving through Congress in 1986, was the chief legislative concern of Treasury at the time.)

In the final analysis, the ease with which the Government Securities Act was adopted (once the regulatory turf war was settled) may reflect an acceptance of the inevitable by many of the parties. With the exception of the foreign exchange and commercial paper markets, the government securities market was the last major financial sector to remain unregulated. A number of dealer witnesses pointed out that they already faced extensive oversight in their corporate stock and bond activities and in municipal securities underwriting and trading, so that they had no strong business objections to the regulation of yet another market.

At the same time, legislators sought to supply a federal response to the problems of the savings and loans in Ohio. The popular linkage between the failure of ESM and the problems in Ohio made passage of the act a visible response that voters and campaign contributors (perhaps including dealers desirous of regulation) could appreciate. And in states and communities where the ESM and BBS failures had resulted in investment losses for local governments, incumbent politicians who voted for the act armed themselves against challengers who might ask, "What did you do about this mess?"

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The Government Securities Act is compelling evidence that the underlying sentiment for federal regulation is alive and well. Elected politicians continue to find that the presumption of federal legislative responses to crises is helpful to their careers. Business interests, faced with vanishing customers, still seek federal intervention. In the case of this act, these behavioral patterns were reinforced by the already extensive formal federal regulation of the securities markets and the quasi-regulated nature of the primary dealers.

Selected Readings

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