

**JOINT STUDY
OF THE REGULATORY SYSTEM
FOR GOVERNMENT SECURITIES**

**DEPARTMENT OF
THE TREASURY**



**SECURITIES AND
EXCHANGE COMMISSION**



**BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM**



MARCH 1998

**JOINT STUDY
OF THE REGULATORY SYSTEM
FOR GOVERNMENT SECURITIES**

**DEPARTMENT OF THE TREASURY
SECURITIES AND EXCHANGE COMMISSION
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

MARCH 1998



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 26, 1998

The Honorable Albert Gore, Jr.
President
United States Senate
Washington, DC 20510

Dear Mr. President:

The Government Securities Act Amendments of 1993 ("GSAA," Pub. L. 103-202, 107 Stat. 2344) direct the Secretary of the Treasury, the Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System to evaluate certain rules for government securities. Paragraph (a) of Section 112 of the GSAA specifies that we evaluate, with respect to any government securities rules promulgated after October 1, 1991, and any national securities association rule changes applicable to government securities transactions approved after that date, the effectiveness of such rules and evaluate their impact on the government securities market. We were also directed to evaluate the effectiveness of surveillance and enforcement and to submit any recommendations we consider appropriate concerning the regulation of the government securities market.

Pursuant to these directives, we hereby submit our joint report, which is entitled Joint Study of the Regulatory System for Government Securities.

We are also transmitting the report to the Speaker of the House.

Sincerely,

Robert E. Rubin
Secretary of the
Treasury

Arthur Levitt, Jr.
Chairman of the
Securities and
Exchange Commission

Alan Greenspan
Chairman of the
Board of Governors
of the Federal
Reserve System

Enclosure

JOINT STUDY
OF THE REGULATORY SYSTEM
FOR GOVERNMENT SECURITIES

TABLE OF CONTENTS

I. INTRODUCTION	1
II. GOVERNMENT SECURITIES REGULATIONS.....	2
A. BACKGROUND	2
B. GSA RULES ISSUED BY TREASURY.....	3
1. Buy-in Rules	3
2. Early Warning Levels for Capital Decreases	4
3. Minimum Capital Requirements and Notification of Large Capital Withdrawals	5
4. Risk Assessment Rules	6
5. Large Position Rules	7
6. Financial Institution Recordkeeping Rule.....	8
C. SEC RULES: Disclosure of Non-SIPC Coverage.....	9
D. NASD RULES	9
1. Suitability	9
2. Government Securities Examinations.....	11
E. BANK REGULATORY AGENCY RULES: Sales Practice Rules	12
F. SUMMARY OF GOVERNMENT SECURITIES REGULATIONS	13
III. SURVEILLANCE AND ENFORCEMENT.....	14
A. SEC/JOINT INITIATIVES	14
B. FRBNY MARKET SURVEILLANCE INITIATIVES.....	15
1. Routine Monitoring and Analysis	15
2. Public Awareness.....	15
3. Primary Dealer Position Reports.....	16
C. TREASURY INITIATIVES.....	16
D. SUMMARY OF SURVEILLANCE AND ENFORCEMENT	17
IV. TRANSPARENCY.....	18
V. CONCLUSION	19

I. INTRODUCTION

The Government Securities Act Amendments of 1993 (GSAA)¹ direct the Secretary of the Treasury, the Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System to conduct a joint study of the regulatory system for the government securities market and to submit a report to Congress. The specific statutory provision requiring the joint study, paragraph (a) of Section 112 of the GSAA, reads as follows:

“SEC. 112. STUDY OF REGULATORY SYSTEM FOR GOVERNMENT SECURITIES.

(a) Joint Study -- The Secretary of the Treasury, the Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System shall --

(1) with respect to any rules promulgated or amended after October 1, 1991, pursuant to section 15C of the Securities Exchange Act of 1934 or any amendment made by this title, and any national securities association rule changes applicable principally to government securities transactions approved after October 1, 1991 --

(A) evaluate the effectiveness of such rules in carrying out the purposes of such Act; and

(B) evaluate the impact of any such rules on the efficiency and liquidity of the government securities market and the cost of funding the Federal debt;

(2) evaluate the effectiveness of surveillance and enforcement with respect to government securities, and the impact on such surveillance and enforcement of the availability of automated, time-sequenced records of essential information pertaining to trades in such securities; and

(3) submit to the Congress, not later than March 31, 1998, any recommendations they may consider appropriate concerning --

(A) the regulation of government securities brokers and government securities dealers;

(B) the dissemination of information concerning quotations for and transactions in government securities;

(C) the prevention of sales practice abuses in connection with transactions in government securities; and

(D) such other matters as they consider appropriate.”

This report is submitted in compliance with the above requirement.

¹ Pub. L. No. 103-202, 107 Stat. 2344.

II. GOVERNMENT SECURITIES REGULATIONS

A. BACKGROUND

The U.S. government securities market is the largest and most liquid securities market in the world. Daily trading in government securities among members of the Government Securities Clearing Corporation (GSCC) averaged \$157 billion for 1997.² By contrast, the average daily trading volume of equities on the New York Stock Exchange (NYSE) was \$23 billion for 1997. The liquidity, integrity, and efficiency of the market are essential for the Department of the Treasury (Treasury) to borrow at the lowest possible cost and for the Federal Reserve System to effectively execute monetary policy through its open market operations. To protect investors and to ensure the maintenance of a fair, honest, and liquid market, the Government Securities Act of 1986 (GSA) was enacted.³ The GSA established, for the first time, a federal system for the regulation of the government securities market, including previously unregistered and unregulated broker-dealers.

The GSA granted Treasury authority to promulgate rules pertaining to: (1) transactions in government securities effected by government securities broker-dealers, including financial institutions that are government securities broker-dealers; and (2) custodial holdings of government securities by depository institutions. The GSAA,⁴ among other things, permanently reauthorized Treasury's rulemaking responsibilities, granted Treasury authority to prescribe large position recordkeeping and reporting rules, and authorized the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (Board) (collectively, the bank regulatory agencies), and the National Association of Securities Dealers, Inc. (NASD)⁵ to develop sales practice rules for the government securities market.

The GSA, rather than creating a separate agency to enforce the regulations, relied, for the most part, on the existing federal regulatory structure when assigning oversight and enforcement responsibilities. For previously regulated entities, examination and oversight of government securities activities were assigned to the federal agencies (i.e., Securities and Exchange Commission (SEC) and bank regulatory agencies) and self-

² Average daily volume is based on the number of government securities purchase transactions, excluding financings, that were compared by GSCC for its members during 1997. Members of GSCC include the primary dealers.

³ Pub. L. No. 99-571, 100 Stat. 3208. The GSA amended several existing statutes, most notably to add Section 15C to the Securities Exchange Act of 1934 (15 U.S.C. 78o-5).

⁴ See *supra* note 1.

⁵ The NASD is the parent organization of NASD Regulation, Inc. (NASDR), which was established in 1996 as a separate, independent subsidiary of the NASD. In carrying out its mission, NASDR has assumed a substantial portion of the NASD's responsibilities of being a self-regulatory organization.

regulatory organizations (i.e., NASD and NYSE) with which the entity had an existing regulatory relationship.

Since the GSA was enacted in 1986,⁶ Treasury has issued rules for government securities broker-dealers pertaining to financial responsibility (i.e., capital), protection of customer securities and funds, traditional securities recordkeeping, risk assessment recordkeeping and reporting, large position recordkeeping and reporting, financial reporting, and audits. Under its GSA authority, Treasury has also promulgated rules concerning custodial holdings of government securities by depository institutions that are not government securities broker-dealers. To avoid excessive and duplicative regulation, many of the GSA rules incorporate existing SEC and bank regulatory agency rules.

Since the enactment of the GSAA, the NASD, bank regulatory agencies, and SEC have also issued various rules pertaining to government securities transactions, including sales practice rules (NASD and bank regulatory agencies) and the disclosure of non-coverage by the Securities Investor Protection Corporation (SIPC) to customer accounts of non-bank broker-dealers that specialize in trading government securities (15C firms). These rules, together with the rules issued by Treasury since the enactment of the GSAA⁷ regarding government securities transactions, are summarized below. At the end of this section (see section II.F.), the rules are evaluated in accordance with the GSAA directives set forth in the introduction of this report.

B. GSA RULES ISSUED BY TREASURY

1. Buy-in Rules

When the GSA regulations were first developed and issued in 1987, they included a requirement that government securities broker-dealers take prompt steps to obtain possession or control of customers' fully-paid and excess margin government securities that have been in a fail-to-receive status for more than 30 calendar days through a "buy-in" or similar procedure.⁸ However, mortgage-backed securities were not subject to the buy-in requirements as a result of: (1) industry concerns over the difficulties and problems of buying in such securities, and (2) a recognition that the SEC had already suspended enforcement of the buy-

⁶ The GSAA amended the GSA in December 1993 and provided Treasury with additional rulemaking authority.

⁷ The three agencies note that, although the GSAA directs them in this report to evaluate rules promulgated for the government securities market since October 1, 1991, Treasury's GSA rulemaking authority expired on October 1, 1991, and was not reauthorized until December 17, 1993.

⁸ A buy-in is the procedure followed by a broker-dealer desiring to settle a trade that is past due (i.e., past its agreed upon settlement date). The broker-dealer may file a buy-in notice with its self-regulatory organization. A copy of the notice is also served on the broker-dealer from whom the securities were to be received. If the securities are not delivered, they can be bought in from another source for cash.

in requirement as it applied to mortgage-backed securities. Between 1987 and 1991, Treasury and the staff of the SEC worked together to better understand the complexities and unique features of the mortgage-backed securities market. As a result, in April 1991, Treasury published a proposed rule to apply buy-in requirements to mortgage-backed securities for certain fails-to-receive and to apply buy-in requirements to customer sell orders for all government securities.⁹ However, Treasury could not issue these rules in final form until February 28, 1994,¹⁰ because of the expiration of its GSA rulemaking authority on October 1, 1991.

Treasury buy-in rules apply to all government securities broker-dealers, including financial institutions that have filed notice, or are required to file notice, as government securities broker-dealers (FIs). Specifically, the buy-in provisions require government securities broker-dealers to purchase or otherwise obtain:

1. mortgage-backed government securities that are in a fail-to-receive status for more than 60 calendar days, and
2. all government securities that are needed to complete a customer sell order (other than a short sale) if the securities have not been received from the customer within:
 - a. 30 calendar days after the settlement date for all government securities except mortgage-backed securities, or
 - b. 60 calendar days after the settlement date for mortgage-backed securities.

The buy-in requirements are an integral part of customer protection because they help ensure that customer positions are covered and encourage broker-dealers to close out transactions promptly. These provisions therefore reduce the number and average age of failed transactions, thereby enhancing the liquidity and safety of the government securities market.

2. Early Warning Levels for Capital Decreases

On October 26, 1994, Treasury issued an amendment to the GSA rules which, among other things, eased the regulatory and reporting burdens on 15C firms by eliminating the requirement that they submit certain supplemental

⁹ 56 FR 15529 (April 17, 1991).

¹⁰ 59 FR 9403 (February 28, 1994).

financial reports when capital levels decline below certain thresholds.¹¹ The specific amendment included the elimination of the requirement that 15C firms file financial reports within 24 hours of a capital deficiency and the requirement that 15C firms submit monthly financial reports when their capital falls below certain early warning levels. The 15C firms are still required to transmit notice to the SEC and their designated examining authority within 24 hours if their capital becomes deficient. Further, 15C firms are still required to submit notice if their capital falls to certain early warning levels.

The amendment: (1) paralleled an SEC amendment to its reporting requirements that was adopted in July 1993, (2) codified an SEC staff no-action letter issued in August 1993 that allowed 15C firms to discontinue the supplemental financial reports (the letter was issued at the request of Treasury due to the expiration of its rulemaking authority), and (3) ensured the consistent application of this regulatory treatment to all classes of government securities broker-dealers registered with the SEC.

3. Minimum Capital Requirements and Notification of Large Capital Withdrawals

On March 1, 1995, Treasury published an amendment to its financial responsibility rules¹² by raising the minimum capital requirements and establishing written notification requirements for certain large capital withdrawals (Treasury's financial responsibility rules apply to 15C firms). Additionally, the amendment contained a conforming change to the recordkeeping requirements of the GSA rules, necessitated by the revisions to the minimum capital levels. The amendment paralleled rule changes previously adopted or proposed by the SEC.

The amendment to the Treasury financial responsibility rules raised the minimum dollar capital levels for 15C firms from a two-tiered requirement of \$5,000 or \$25,000, based on the type of business conducted by the 15C firm, to a four-tiered range between \$25,000 and \$250,000. The Treasury minimum dollar capital requirements are based on certain SEC capital provisions (i.e., Treasury's liquid capital after deducting haircuts is comparable to the SEC's calculation of net capital). The close relationship between the Treasury and SEC capital rules caused the two agencies to work together in examining the need to raise their respective minimum capital requirements. In the case of the SEC, its minimum net capital levels had remained unchanged for over 14 years. Treasury concluded that minimum capital level increases, which were implemented by the SEC to provide for the effects of inflation during the 14-year period and in recognition of

¹¹ 59 FR 53728 (October 26, 1994).

¹² 60 FR 11022 (March 1, 1995).

the growth in the size and complexity of the securities industry, should be applied to the 15C firms as well.

The amendment to the Treasury financial responsibility rules also required written post-withdrawal notification of certain significant capital withdrawals as well as written prior notification for larger withdrawals. The timing of the notification is determined by the aggregate size of total withdrawals relative to a 15C firm's excess liquid capital over a 30-calendar day period. The notification must be provided to the SEC and the 15C firm's designated examining authority.

By raising the capital adequacy standards of 15C firms and providing regulators with notification of potential capital problems, the amendment achieves the primary objective of the capital rules -- to protect customers and creditors of 15C firms from monetary losses and delays that can occur if a firm fails. The regulatory regime for capital may be further enhanced by a proposed SEC capital rule¹³ for non-bank government securities broker-dealers.¹⁴ Treasury, in consultation with the SEC, is considering the possible application of the proposed rule to 15C firms.

4. Risk Assessment Rules

Treasury published risk assessment rules on April 26, 1995,¹⁵ under the authority of the Market Reform Act of 1990 (the Reform Act).¹⁶ The rules, which paralleled the SEC's temporary risk assessment rules that had been issued in July 1992, amended the GSA recordkeeping and reporting provisions that apply to 15C firms. The recordkeeping amendment required 15C firms to maintain information concerning the financial and securities activities of affiliates whose business activities had the potential to materially impact the financial or operational condition of the 15C firms. The reporting amendment required 15C firms to file quarterly reports with the SEC of the information required to be maintained under the recordkeeping rules.

The Treasury risk assessment authority under the Reform Act was granted in response to the bankruptcy of the Drexel Burnham Lambert Group, Inc., in February 1990. The Drexel failure had demonstrated that financial difficulties or liquidity problems of parent companies or affiliates of broker-dealers could have a material and adverse impact on the broker-dealers themselves; risk assessment

¹³ Securities Exchange Act Release No. 39455 (December 17, 1997), 62 FR 67996.

¹⁴ Firms registered with the SEC under Section 15 of the Exchange Act (15 U.S.C. 78o).

¹⁵ 60 FR 20396 (April 26, 1995).

¹⁶ Pub. L. No. 101-432, 104 Stat. 963.

rulemaking authority was therefore intended to provide regulators with access to information concerning the financial risks posed to 15C firms -- and to the securities markets as a whole -- as a result of certain activities of parent companies or affiliates. Consistent with the statute and its legislative history, the risk assessment rules focus on regulatory access to information regarding derivatives and other potentially risky transactions conducted by entities that are not subject to the federal securities laws. The collection and analysis of such information put regulators in a better position to monitor market developments that threaten the safety and liquidity of the government securities market.

The staff of the SEC has indicated that, in the near future, it plans to propose amendments to its temporary risk assessment rules. Treasury is now consulting with the staff of the SEC to determine what, if any, modifications to the Treasury risk assessment rules may be warranted to make the rules more effective.

5. Large Position Rules

The GSAA granted new authority to Treasury to prescribe rules requiring any entity (including a hedge fund, insurance company, investment company, or pension fund) that controls a “large” position in certain recently-issued Treasury securities to keep records and file reports of such positions. The statutory authority for the large position rules was granted in response to certain disruptions and improprieties that occurred in the government securities market in 1990 and 1991. The rules improve the information available to Treasury and other regulatory agencies regarding price anomalies and concentrations of control of specific Treasury securities. As a result, the rules assist regulators in conducting surveillance of the government securities market.

Issued on September 12, 1996, and effective on March 31, 1997, the rules established an “on-demand” reporting system -- as opposed to a regular, ongoing system of reporting.¹⁷ Large position reports must be filed with the Federal Reserve Bank of New York (the FRBNY) only in response to a notice issued by Treasury that identifies a particular Treasury security and specifies the dollar threshold (i.e., at least \$2 billion) triggering the reporting requirement. The large position recordkeeping rules were intended to ensure that each entity that is potentially subject to a call for large position reports maintains appropriate recordkeeping systems to support the compilation and aggregation of such a report, should the entity be required to submit one.

To ensure that large position recordkeeping systems, aggregation processes, and reporting systems work properly, Treasury has announced that it

¹⁷ 61 FR 48338 (September 12, 1996).

intends to issue one test call for large position reports annually. The first such test was announced on June 9, 1997, for entities that controlled at least \$2.5 billion of a 10-year Treasury note that was issued in February, 1997. Overall, post-test discussions with various market participants indicated that the press release announcing the request for large position reports was distributed in a timely manner, and the compilation and aggregation of positions went smoothly (see section III.C. of this report for more details).

The development and implementation of the large position rules reflect the careful balance achieved between meeting the objectives of the statute (i.e., providing regulators with access to certain reports and records) and minimizing costs to, and burdens on, affected entities. This balance was achieved by: (1) developing an on-demand reporting approach, as opposed to a routine, on-going reporting system; (2) establishing a \$2 billion threshold, at or above which the recordkeeping requirements are triggered and below which reports would not be required; (3) implementing a recordkeeping system that relies largely on existing recordkeeping requirements for entities that were already subject to securities recordkeeping rules, with only a modest, basic recordkeeping requirement for entities that were not subject to federal securities recordkeeping rules; and (4) borrowing a concept from the Treasury auction rules that was familiar to many market participants -- the components of the net long position calculation.

6. Financial Institution Recordkeeping Rule

On February 18, 1997, Treasury published an amendment to the recordkeeping requirements for FIs.¹⁸ The amendment eliminated some confusion and ambiguity that existed because of the interrelationship between two sets of recordkeeping rules that FIs must follow -- recordkeeping rules issued under the GSA and recordkeeping rules of the bank regulatory agencies. The amendment changed the requirement under the GSA rules to state that FIs must adhere to the recordkeeping rules of their appropriate bank regulatory agency, along with certain other GSA recordkeeping rules, regardless of the number of government securities transactions conducted. FIs formerly had an exemption from the bank regulatory agency and GSA recordkeeping rules if they conducted fewer than 200 transactions annually involving government securities. However, the exemption was subject to differing interpretations. To correct this situation, Treasury worked closely with the bank regulatory agencies to ensure that a conforming rule change made by each of these agencies to their respective securities recordkeeping rules would be consistent with Treasury's GSA regulations. Treasury's clarification of the application of the GSA recordkeeping rules, together with the conforming rule changes made by the bank regulatory agencies, will enable the bank regulatory agencies to apply uniform recordkeeping standards to the banks they examine.

¹⁸ 62 FR 7153 (February 18, 1997).

Further, as a result of the amendment, FI recordkeeping standards are more consistent with such standards for 15C firms and other non-bank government securities broker-dealers.

C. SEC RULES: Disclosure of Non-SIPC Coverage

All broker-dealers registered as government securities brokers and dealers under Section 15C of the Securities Exchange Act of 1934 (Exchange Act)¹⁹ are excluded from membership in SIPC. On November 10, 1994, the SEC amended Rule 10b-10²⁰ (its confirmation rule) under the Exchange Act to require 15C firms to disclose that they are not SIPC members in transaction confirmations “to ensure that customers are not led to believe that their accounts are subject to protection beyond what actually is the case.”²¹ The SEC stated that the confirmation is the most useful vehicle for conveying this information to customers on a transaction-specific basis, particularly in situations where a customer is dealing with affiliated broker-dealers and one or more of the affiliates is not a SIPC member.

D. NASD RULES

1. Suitability

The concept of suitability, rooted in notions of fiduciary duty to customers and just and equitable principles of trade, plays an important role in the investor protection scheme of the federal securities laws. Prohibitions against making unsuitable recommendations arise under the securities rules of all self-regulatory organizations. As part of the obligation of fair dealing, all broker-dealers are required to have a reasonable basis for believing that their securities recommendations are suitable for the customer in light of the customer’s financial needs, objectives, and circumstances.

The NASD has articulated the suitability principle in Rule 2310,²² which has applied to members’ recommendations since the inception of the NASD. This rule requires that in recommending to a customer the purchase, sale or exchange of any security, a member must have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any,

¹⁹ 15 U.S.C. § 78o-5.

²⁰ 17 CFR 240.10b-10.

²¹ Securities Exchange Act Release No. 34962 (November 10, 1994), 59 FR 59612, 59617.

²² Recommendations to Customers (Suitability), NASD Rule 2310 (formerly NASD Article III, Section 2 of the Rules of Fair Practice).

disclosed by such customer as to its other securities holdings and financial situation and needs. However, the NASD was barred from applying its rules to exempted securities, including government securities, by express provisions in Section 15A of the Exchange Act.²³

The GSAA eliminated the statutory limitations on the NASD's authority to apply sales practice rules to transactions in exempted securities, including government securities, other than municipals. To implement the expanded sales practice authority granted by the GSAA, the NASD proposed to merge its Government Securities Rules into corresponding sections of its Rules of Fair Practice to provide NASD members with one set of sales practice rules. On August 20, 1996, the SEC approved the NASD's proposal.²⁴ As part of this proposal, the NASD also decided to provide further guidance (an interpretation) to members on their suitability obligations for all securities, including government securities but excluding municipals, and established guidelines for its members regarding how members may fulfill their "customer-specific" suitability obligations when making recommendations to institutional clients.

The NASD's Suitability Interpretation²⁵ is predicated on a determination that the two most important considerations in determining the scope of a member's suitability obligation in making recommendations to an institutional customer are: (1) the customer's capability to evaluate investment risk independently, and (2) the extent to which the customer is exercising independent judgment. The Suitability Interpretation further describes factors that may be relevant in a member's evaluation of these two important considerations. The NASD has emphasized that these factors are guidelines that will be used to determine whether a member has fulfilled its suitability obligations with respect to a specific institutional customer transaction and that the absence or inclusion of any of these factors is not dispositive of the suitability determination.

The NASD recognizes the varied nature of investor profiles, even among investors that meet some definition of "institutional investor." Its Suitability Interpretation accommodates a wide range of relationships because it does not establish rigid thresholds or requirements, but rather provides its members with reasonable factors by which an NASD member can determine the nature of its relationship with a customer. The Suitability Interpretation recognizes that there can be instances in which an institutional customer possesses a general capability to understand certain kinds of investments, but does not have the requisite

²³ 15 U.S.C. § 78o-3.

²⁴ Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100.

²⁵ Suitability Obligations to Institutional Customers, IM-2310-3 (approved in file SR-NASD-95-39, Release No. 37588).

capability to understand the particular investment under consideration. In such a circumstance, the NASD notes that a broker-dealer's suitability obligation would not be diminished based solely on the financial condition of the customer.

The SEC believes that the NASD's Suitability Interpretation is a reasoned approach to the concept of suitability, which fosters an environment for dialogue between broker-dealers and customers regarding the nature of their relationship, and, therefore, promotes the protection of the investors. Further, the SEC believes that the NASD's determination to apply certain of its general rules, formerly applicable only to equity or corporate debt securities, to government securities is consistent with the Exchange Act, and that the NASD has made a reasonable determination regarding which of its general rules should be applicable to government securities.²⁶

While the NASD has found some rules not to be applicable to the government securities market, other noteworthy provisions will be considered for further review. First, the NASD acknowledges that its current "front running" interpretation applies only to equity securities. However, the NASD is committed to reviewing the application of its front running interpretation to the government securities market.²⁷ Second, the NASD has not applied its prohibitions against trading ahead of customer limit orders and trading ahead of research reports to the government securities market. As with the front running interpretation, the NASD will review the application of these interpretations to the government securities market.²⁸ In the interim, the NASD has represented that actions for front running or trading ahead in the government securities market may be brought under its rules requiring members to adhere to just and equitable principles of trade.

2. Government Securities Examinations

On August 25, 1997, the SEC approved a rule change by the NASD to require representatives who sell government securities, including over-the-counter options on government securities, to pass a qualification examination.²⁹ The examination will ensure that persons associated with NASD members have

²⁶ For a complete list of NASD rules applicable to government securities, *see* Release No. 37588, 61 FR 44100, 44103-44104 (Table 2). The NASD currently is examining a modification of its mark-up policy as it applies to debt securities, including government securities.

²⁷ *See* Securities Exchange Act Release No. 36973 (March 14, 1996), 61 FR 11655.

²⁸ *See Id.*

²⁹ Securities Exchange Act Release No. 38969 (August 25, 1997), 62 FR 46535.

attained specified levels of competence and knowledge prior to soliciting or selling government securities for the account of a broker, dealer or customer.

E. BANK REGULATORY AGENCY RULES: Sales Practice Rules

Section 106 of the GSAA provided the bank regulatory agencies with the authority to issue rules with respect to transactions in government securities “to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade.”³⁰ To adopt rules under this authority, the bank regulatory agencies are required to consider the sufficiency of existing rules applicable to FIs and to consult with, and consider the views of, the Secretary of the Treasury.

Following proposals by the NASD to extend its existing sales practice rules to transactions involving government securities, the bank regulatory agencies met with Treasury to consider whether the adoption of sales practice rules for FIs was appropriate. The bank regulatory agencies previously had adopted joint policy statements concerning retail securities sales practices generally, and individual agencies had policies related to wholesale transactions. The bank regulatory agencies determined, however, that there would be advantages in terms of consistency to applying the same sales practice rules to FIs that were applied to broker-dealers generally. The bank regulatory agencies jointly proposed sales practice rules for FIs in April 1996.³¹ In March 1997, the bank regulatory agencies adopted these rules in final form.³²

The rules adopted by the bank regulatory agencies parallel the language of two NASD Conduct Rules, commonly referred to as the “business conduct” and “suitability” rules.³³ The bank regulatory agencies also adopted an interpretation applicable to FIs concerning responsibilities for institutional customers under the suitability rule that is essentially identical to the interpretation adopted by the NASD.

As adopted by the bank regulatory agencies, the business conduct rule requires an FI to “observe high standards of commercial honor and just and equitable principles of trade” in the conduct of its business. The suitability rule requires that, in recommending a transaction to a customer, an FI must have “reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of facts, if any, disclosed by

³⁰ Pub. L. No. 103-202, Section 106(a) at 15 U.S.C. § 78o-5(b)(3)(A).

³¹ 61 FR 18470 (April 25, 1996).

³² 62 FR 13276 (March 19, 1997).

³³ The Conduct Rules also include a number of other sales practice rules concerning issues such as pricing, transaction fees, and publication of quotes that were not adopted by the bank regulatory agencies. The bank regulatory agencies requested comment as to whether rules similar to other NASD rules should be considered, but determined based on the comments received that the adoption of additional rules was not warranted at the present time.

the customer as to the customer's other securities holdings and as to the customer's financial situation and needs." The suitability rule also provides that, for customers that are not institutional customers, an FI must make reasonable efforts to obtain information concerning the customer's financial and tax status and investment objectives before executing a transaction recommended to the customer.

The bank regulatory agencies also adopted an interpretation of the suitability rule concerning obligations to institutional customers that parallels an interpretation adopted by the NASD. Under the bank regulatory agencies' interpretation, a bank must determine: (1) the institutional customer's capability for evaluating investment risk, generally, and the risk of the particular instrument offered; and (2) whether the customer is exercising independent judgment in making investment decisions. Factors cited by the interpretation as relevant to determining an institutional customer's capacity to evaluate risk include the customer's experience, use of outside advisors, level of understanding of the particular instrument under consideration, ability to evaluate market developments, and the complexity of the instrument. The interpretation also cites factors relevant to determining whether the customer is making independent investment decisions, including agreements concerning the nature of the relationship between the customer and the bank, use of other market professionals by the customer, and the extent to which the customer has supplied information concerning its portfolio and objectives.

The bank regulatory agencies' interpretation states that, while it is potentially applicable to any institutional investor, it is most relevant in determining the suitability of a transaction for an institution with at least \$10 million invested in securities in its portfolio or under its management.

F. SUMMARY OF GOVERNMENT SECURITIES REGULATIONS

The Treasury, SEC, and Board believe the aforementioned rules, all of which were promulgated since October 1, 1991, have been effective in carrying out the purposes of the Exchange Act. A key factor in developing and implementing rules that met the purposes of the Exchange Act was the extensive consultation that occurred among the three agencies, other regulatory organizations (the NASD, FDIC, and OCC), trade associations, and various market participants.

In their consultative roles, regulators were able to develop rules that were consistently applied to all classes of government securities broker-dealers. Moreover, regulators were able to pool their knowledge of the government securities market so that the rules to enhance customer protection had no apparent adverse effect on the market's liquidity and efficiency and the cost to the taxpayer of Federal borrowing.

In particular, the promulgation of sales practice rules and large position rules involved extensive consultation at all stages of their development. There were a number of complex issues involved in applying these new rules to government securities

transactions (e.g., deciding how government securities broker-dealers would meet their suitability obligations). However, the agencies believe the consultative process contributed greatly to the efficacy of the rules by prompting regulators to take a measured approach to resolving the major issues.

The large position rules were developed by Treasury, with the participation of the FRBNY, other regulators, and market participants. Treasury believed that market participants' involvement in the rulemaking initiative from the outset would facilitate a greater understanding of, and support for, the final rules when implemented. As a result, Treasury issued an Advance Notice of Proposed Rulemaking on January 24, 1995, a proposed rule on December 18, 1995, and the final rule on September 12, 1996. Throughout the rulemaking process, Treasury also met with industry groups to discuss various aspects of the rules. Further, to provide additional guidance and clarification of the rules, Treasury has posted a number of frequently asked questions and answers on its Internet website.

Most of the other rules issued since October 1, 1991, were also developed not only through interagency coordination and consultation, but with input and feedback from affected market participants. Most of the rules were finalized only after the affected entities were given ample time to raise issues and express their concerns. In most cases, proposed rules were revised to incorporate industry comments into the final rules. This process helped to foster rules that are consistent with the purposes of the Exchange Act and do not result in excessive burdens on the industry.

III. SURVEILLANCE AND ENFORCEMENT

A. SEC/JOINT INITIATIVES

In early 1992, the Working Group for Treasury Market Surveillance (Working Group) was formed by the FRBNY, SEC, Commodity Futures Trading Commission, Treasury, and Board. The Working Group coordinates the agencies' monitoring of trading in the when-issued and other secondary markets for Treasury securities, as well as activities in the related financing or repurchase agreement (repo) markets and Treasury futures markets.

Under the framework of the Working Group, the primary responsibility for day-to-day surveillance of the Treasury securities markets is given to the staff in the Markets Group at the FRBNY. Accordingly, while the SEC monitors suspicious price/yield and volume movements and overall market conditions using its own automated systems, the SEC relies heavily on the FRBNY to collect and assess, initially, dealer position data and other types of market information to help facilitate a collective determination on whether a particular price/yield or volume situation is indicative of possibly fraudulent or manipulative activity. Once this type of information is collected by the FRBNY and distributed to the agencies in the Working Group, the information is analyzed to

determine if there appear to be significant concentrations of positions at particular firms. Parties are often contacted by the FRBNY staff in order to obtain their explanations of overall trading strategies. This information is evaluated against other available information and then the Working Group decides whether further inquiries are warranted. As warranted, the SEC would investigate and, if appropriate, prosecute for violations of the federal securities laws.

The SEC's investigative efforts will be enhanced by Treasury's large position rules and a requirement under the GSAA that all government securities brokers and dealers furnish the SEC, on request, records (automated or manual) of government securities transactions, including the date and time of execution of trades.

B. FRBNY MARKET SURVEILLANCE INITIATIVES

1. Routine Monitoring and Analysis

Members of the FRBNY Markets Group staff monitor the condition of the government securities market generally and analyze trading in the Treasury securities market in particular for indications of potential disruption or questionable trader behavior. They monitor quantitative indicators such as relative cash-market values, pressure on particular issues in the financing market (i.e., "specials" rates), transaction volumes and position reports provided by the primary dealers. They also gather commentary from traders, market researchers and newswire services. They occasionally hear claims of potentially questionable trader behavior, in response to which they follow up with calls to the trader in question or his or her managers, obtain information about their activities, and pass this information along to other members of the Working Group for discussion and possible investigation by market regulators.

The staff also monitors the government securities that the FRBNY receives when conducting open market operations to ensure that the System Open Market Account does not acquire securities that appear to be difficult for other market participants to borrow in the financing market or to purchase outright.

Staff members also participate in bi-weekly conference calls with representatives of the other members of the Working Group, during which they provide additional information about market developments and make themselves available to answer questions.

2. Public Awareness

Officers and staff of the FRBNY Markets Group speak from time to time with compliance officers and managers of trading desks about traders' behavior

and market practices in general, and their impact on market efficiency. Markets Group officers have delivered several speeches to the public since December 1996 in which they have outlined trading operations or activities and circumstances that might indicate market inefficiency.

3. Primary Dealer Position Reports

The primary dealers report positions with respect to when-issued Treasury coupon securities daily throughout when-issued trading periods. They report their net positions, purchases, sales and net forward-settling financing commitments as of the close of business each day of when-issued trading. Primary dealers also report aggregated positions in government, agency and mortgage-backed securities on a weekly basis, and since July 1994, have also submitted weekly reports of their positions, transaction volumes and fails with respect to specific on-the-run (i.e., the most recently issued) coupon securities. Since the primary dealers account for much of the trading activity in the Treasury securities market, their position and transaction volume reports provide a broad gauge of market conditions as well as information about specific dealers. For example, the reports may indicate how much of a given issue the primary dealers collectively have sold short and how actively the issue is traded. These reports, made available to all members of the Working Group, are valuable in assessing the reasonableness and completeness of the commentary provided by traders and others.

The primary dealers, when requested to do so by the FRBNY, submit the same report with respect to issues that appear to be trading in an anomalous manner. They submit these ad hoc reports daily until they are asked to cease reporting by the FRBNY. Daily ad hoc position reports have been requested for four individual securities since July 1994.

The advent of weekly reporting on specific issues in 1994 reduced the number of ad hoc reports requested by the FRBNY. It did so by providing the FRBNY with regular access to data concerning positions and transaction volumes with respect to on-the-run coupon securities, which are the issues for which ad hoc reports most frequently are requested.

C. TREASURY INITIATIVES

The implementation of the large position rules has improved the ability of regulators to carry out their surveillance and enforcement responsibilities in the government securities market. The requirement that market participants submit large position reports to the FRBNY on behalf of Treasury (copies also go to the SEC) within three and a half business days following a public request by Treasury permits regulators to gain timely access to information about price anomalies and concentrations of

positions in Treasury securities. Moreover, regulators can obtain early warning of potential sources of systemic risk. There is no presumption of manipulative or illegal intent on the part of a controlling entity if it is required to submit a large position report.

The large position rules apply to all U.S. and foreign entities (with the exception of foreign official organizations and the Federal Reserve Banks) that control certain specified large positions -- not just registered broker-dealers and banks. Thus, hedge funds, insurance companies, pension funds and other entities that are not supervised by the SEC or bank regulatory agencies are required to adhere to the large position recordkeeping rules (and potentially to the large position reporting rules) if they control positions in a Treasury security of at least \$2 billion. Since many of these “unregulated” entities hold relatively large positions in Treasury securities, the extension of the rules to them greatly enhances regulators’ ability to effectively monitor the market.

As mentioned earlier in this report, Treasury has announced that it will conduct at least one test call for large position reports annually to ensure that recordkeeping and reporting systems remain in compliance with the rules. The first such test call was conducted on June 9, 1997, requiring reports to be submitted for positions of at least \$2.5 billion of a 10-year Treasury note issued in February 1997. Post-test discussions among Treasury, the FRBNY, the Bond Market Association, and various large investors indicated that, for the most part, Treasury’s notice calling for large position reports was disseminated and distributed in a timely and efficient manner. In addition, many large entities that compiled and aggregated their positions responded that they completed these tasks prior to the filing deadline. This is a reflection of the extensive preparation and planning that were undertaken by the affected entities, including pilot tests of a call for large position reports, to ensure that their recordkeeping and reporting systems would be in compliance with the rules. Treasury staff has followed up with the few large entities that did not receive notification of the test call and has directed them to take the necessary actions to assure the timely receipt of future calls for large position reports and the timely and accurate aggregation and, if necessary, reporting of such positions.

In addition, in recent years, Treasury representatives have spoken at various industry conferences and seminars to provide clarifying information and guidance on Treasury securities regulations. Treasury believes its past and continued participation in these conferences and seminars strengthens compliance with its rules.

D. SUMMARY OF SURVEILLANCE AND ENFORCEMENT

The Treasury, SEC, and Board believe the initiatives described above have enhanced the effectiveness of surveillance and enforcement in the government securities market. The Working Group provides regulators with a means of gathering up-to-date information (based on commentary from traders, primary dealer position reports, and other information) on market developments and on specific traders’ transactions and

strategies. The Working Group also provides regulators with a forum for analyzing, evaluating, and discussing such information. As a result, the Working Group is able to provide regulators with timely information on potentially questionable trading practices, which could lead to the initiation of investigations or specific enforcement actions by regulators.

Treasury's large position rules have also enhanced surveillance and enforcement in the government securities market by providing regulators with relatively quick access to information about price anomalies and concentrations of positions in Treasury securities. Moreover, the application of the rules to all entities that control specified large positions in Treasury securities (not just entities subject to SEC and bank regulatory agency supervision) significantly increases the ability of regulators to monitor the market and make decisions about possible enforcement actions.

IV. TRANSPARENCY

The GSAA requires the SEC to monitor and report on private sector efforts to improve the timely public dissemination and availability of information concerning government securities transactions and quotations. There have been significant advances in transparency for government securities transactions over the past several years, primarily originating from commercial vendors. For example, GovPX is an entity formed in 1991 by primary dealers and interdealer brokers in the U.S. Treasury market. It provides 24-hour, worldwide distribution of securities information as transacted by market participants through five of the six interdealer brokers for all active and off-the-run Treasury bills, notes, bonds, basis trades, government agency securities, zero coupon securities, and money market instruments. GovPX reports the price and size of best bid and best offer, rate of return (bid and offer) and total volume (aggregate daily volume per issue and total volume). In addition, in 1996, GovPX began offering current rates and volume (intra-day updates) for repo transactions.

In the absence of a real-time bid or offer, GovPX publishes a proprietary indicative price. With coverage on over 23,000 screens, GovPX is distributed worldwide through all the major vendors of securities information, including Bloomberg, Reuters, and Bridge. In addition, other entities, like Dow Jones Markets, carry data from interdealer brokers, such as Cantor Fitzgerald.

In the government mortgage securities market, a variety of pricing and related information is available from major financial publications and from on-line data vendors. Financial publications, including *The Wall Street Journal*, *The New York Times*, *Barrons*, and various industry newsletters, publish on a daily or weekly basis representative prices for a range of current-coupon agency pass-through securities. In addition, such publications also are providing pricing information for a number of Collateralized Mortgage Obligations (CMOs), typically displayed in terms of the current spread of various CMO categories to U.S. Treasury securities having equivalent maturities.

V. CONCLUSION

As the largest, most liquid securities market in the world, the U.S. government securities market enables the government to meet its financing needs in a cost-effective manner for the taxpayer. The market continues to function smoothly, and the three agencies do not believe it is flawed in any fundamental sense. As a result, we believe no additional rulemaking authority under the GSA, as amended, is required at this time.

All of the rules evaluated in this report were issued in final form after December 17, 1993, the date the GSAA was enacted. (Treasury rulemaking authority under the GSA was allowed to lapse between October 1, 1991, and December 17, 1993.) Owing to their complexity and the need to engage in interagency consultation and to solicit public input, the two most significant rules -- sales practice rules and large position rules -- did not become effective until 1996 and 1997. Since the rules are relatively new, their full impact has yet to be realized. However, we believe the effectiveness of the rules will become more apparent over time.

The three agencies note that they studied the government securities market in great detail in the aftermath of the Salomon Brothers auction violations of 1990 and 1991 and submitted a very comprehensive report to Congress in January 1992. That joint report contained an extraordinary amount of information, which Congress was able to use as the basis for passage of the GSAA. We believe the GSAA addressed the major concerns facing the government securities market and believe that there are no significant issues that would warrant seeking additional regulatory authority at the present time.