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THE GOVERNMENT SECURITIES ACT OF 1986: BALANCING INVESTOR PROTECTION WITH MARKET LIQUIDITY

The United States Department of the Treasury (the Treasury) may issue interest-bearing securities to borrow money in order for the United States government to meet expenditures not covered by tax revenues. The Treasury auctions these securities on a regular basis to government securities dealers. By trading among themselves and in the retail market these dealers distribute the Treasury debt. The government securities market is assured

3. To sell marketable public debt, the Treasury, through the 12 Federal Reserve district banks and their branches acting as fiscal agents for the United States, sells securities to the public through a competitive auction process. 31 C.F.R. § 309.13 (1986). The Treasury auctions three and six month Treasury bills to the public each week and fifty-two week bills every four weeks. All bills carry a minimum denomination of $10,000. The Treasury sells its bills at a discount from face value, and accepts the highest bids in terms of price. The Treasury also auctions Treasury notes and bonds, which pay interest semiannually and mature in two to thirty years. The Treasury sells notes and bonds on a regular schedule, with particulars about each issue announced in advance to the public. GAO REPORT, supra note 2, at 10; see M. STIGUM, supra note 2, at 431-34.
4. M. STIGUM, supra note 2, at 440.
5. The government securities market is comprised of securities issued by the Treasury (e.g., bonds, bills, notes) and by federal government agencies (e.g., Government National Mortgage Association, Federal Home Loan Bank System, Federal National Mortgage Association, and Federal Home Loan Mortgage Association). See generally id. at 214-16. For the purposes of this Note, however, "government securities" denotes Treasury issued securities unless otherwise stated.

"The Treasury securities market is comprised of the cash market and the derivative markets. The cash market is one in which outright ownership of particular securities is exchanged for cash or in which securities are pledged as collateral for loans. Derivative markets involve ownership of future rights or obligations of securities." GAO REPORT, supra note 2, at 18; see M. STIGUM, supra note 2, at 30-31. Reference in this Note to the "Treasury securities market" is solely to the cash market. The Treasury securities market contributes to the stability and liquidity of the entire United States financial system. In fact, the "Treasury securities market

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a preeminent place among world securities markets because of its role in effecting fiscal policy\(^6\) as determined by the Treasury, and monetary policy\(^7\) as determined by the Board of Governors of the Federal Reserve System (Federal Reserve Board or FRB). This market is also the largest securities market in the world.\(^8\) Government securities are guaranteed by the United States,\(^9\) and therefore were exempted from regulation under the Securities Act of 1933 (the Securities Act)\(^10\) and the Securities Exchange Act of 1934 (the Exchange Act).\(^11\) As a result, dealers engaged solely in the sale of government securities have been primarily unregulated at the federal level.\(^12\)

In recent years tremendous investor losses have occurred in the govern-

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7. Congress directed the FRB and the Federal Open Market Committee to maintain long-run growth of the monetary and credit aggregates to ensure increased production, maximum employment, and price stability. 12 U.S.C. \(\$\) 225a (1982). The FRB carries out its monetary policy through its Open Market Desk of the Federal Reserve Bank of New York (FRBNY). By buying and selling Treasury securities, the FRB influences the growth of the money supply and changes in market interest rates, and thus influences the direction of economic activity. The federal government also uses the market to raise short-term funds to carry out its day-to-day cash management activities. See S. REP. No. 426, 99th Cong., 2d Sess. 4 (1986).

8. The market in U.S. government and agency securities is the largest and most efficient securities market in the world. In 1984, the monthly trading volume of the 36 primary dealers (as of Dec. 11, 1986, there were 40 primary dealers; see infra note 36) that report to the Federal Reserve Bank amounted to over $1.5 trillion, which is approximately 15 times the total volume of all transactions in corporate securities traded on all the nation's securities exchanges and over-the-counter markets. 132 CONG. REC. H9253 (daily ed. Oct. 6, 1986) (statement of Rep. Wirth); see Request for Comments on the Oversight of the U.S. Government and Agency Securities Markets, Exchange Act Release No. 21,959, 50 Fed. Reg. 15,905 (Apr. 23, 1985) [hereinafter SEC Release No. 21,959].

9. All Treasury securities are backed by the full faith and credit of the United States. However, because the "agency" security market includes a wide range of instruments and issuers, some agency securities are backed by the full faith and credit of the United States and some are not. See Failure of Bevill, Bresler & Schulman, A New Jersey Government Securities Dealer: Hearing Before the Subcomm. of Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations, 99th Cong., 1st Sess. 161 (1985) [hereinafter BBS Hearing] (statement of E. Gerald Corrigan, President, FRBNY).

10. The Securities Act of 1933, \(\$\) 3(a)(2), 15 U.S.C. \(\$\) 77c(a)(2) (1982), provides, inter alia, that "the provisions of this subchapter shall not apply to any of the following classes of securities: . . . Any security issued or guaranteed by the United States." Id.


12. Both acts define government securities as exempt for purposes of their registration and periodic reporting provisions. However, such transactions are not exempt from the antifraud provisions of both acts. See In re Fidelity Financial Corporation and Fidelity Savings and
ment securities market due to dealer failures. Although the Securities and Exchange Commission (SEC) generally has regulatory authority over broker-dealers in corporate and municipal securities, and the FRB has regulatory authority over dealer banks, dealers who trade only in government securities have operated outside the federal system of financial supervision.

Most of these dealer failures occurred among dealers operating outside the federal regulatory structure.

Alarmed by these losses, Congress enacted the Government Securities Act of 1986 (the Act), placing the government securities market under complete federal regulation. In enacting this legislation, Congress amended the Exchange Act by adding section 15C. The basic goal of this section is to close gaps in the regulation of the government securities dealers. Congressional concern in regulating this market was due in large part because this market is directly tied to the national economy. Congress feared that domestic and foreign confidence in the United States financial system might be threatened by continued dealer failures. Therefore, to ensure the integrity and efficiency of this market, Congress brought all government securities brokers and dealers under federal supervision.

Paralleling the registration provisions for clearing agencies, and broker-dealers in securities generally, the Act compels all unregistered government securities brokers and dealers to register with the SEC. The Act also requires all currently registered brokers and dealers to file a notice with the appropriate agencies. The Act authorizes the Treasury, in consultation with the SEC and FRB, to issue rules relating to financial responsibility, recordkeeping, reporting, and financial statements rules. Such rules are

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13. Since 1982, investors have lost almost $900 million in this market because of dealer failures. GAO REPORT, supra note 2, at 3.
15. Id.
19. Id.
20. Id. at H9255 (statement of Rep. Luken).
24. Id. § 78o-5(a)(1)(B)(i).
25. Id. § 78o-5(b).
intended to prevent fraudulent and manipulative acts and practices and to protect both the integrity of the marketplace and investors in government securities.\textsuperscript{26} To avoid duplicative rulemaking, the Act requires the Treasury to consider the sufficiency of existing laws and rules of appropriate regulatory agencies\textsuperscript{27} and permits the Treasury to develop classifications of registrants and to exempt some of them.\textsuperscript{28} Congress believed, however, that primary dealer status should not in itself be a sufficient reason for exempt status.\textsuperscript{29}

This Note will discuss the major participants and their roles in the government securities market, including dealers, inter-dealer brokers, and regulators. These participants actually make the market in government securities; their roles, therefore, are integral to the distribution of the federal debt. Next this Note will examine repurchase agreements, which are the primary transaction through which dealers finance their positions in government securities and are partly responsible for the high liquidity in this market. However, through their use, dealers have also incurred enormous losses. Accordingly, this Note will address both the role of repurchase agreements in the market and the recent dealer failures. This Note will also address the Act’s legislative history to provide the background for a discussion of the Act’s regulatory provisions. No federal regulation can guarantee complete protection from fraudulent practices in any securities market. This Note will therefore offer strategies an investor can adopt to protect himself from investment risks inherent in the market. Finally, because these provisions are more preventive in nature than remedial, this Note will conclude by examining the effect the Act would have had in preventing the two most prominent dealer failures.

I. MAKING MARKETS IN GOVERNMENT SECURITIES

A. The Dealers and the Brokers

The dealer-participants in the government securities market include the primary dealers, the inter-dealer brokers, and the secondary dealers. Primary dealers are those dealers with whom the Federal Reserve Bank of New York (FRBNY) conducts its monetary policy.\textsuperscript{30} The inter-dealer brokers facilitate trades done among the primary dealers themselves in the wholesale

\textsuperscript{26} Id.
\textsuperscript{27} Id. § 78o-5(b)(3)(C).
\textsuperscript{28} Id. § 78o-5(a)(4), (b)(3)(A), (B).
\textsuperscript{30} See infra notes 33-40 and accompanying text.
secondary market. The secondary dealers are all the remaining dealers in government securities. The Treasury finances the federal debt through a competitive auction process. The primary dealers purchase at auction about fifty-five percent of the securities sold. They are designated primary dealers by virtue of their "business relationship" with the FRBNY. In deciding whether to add a dealer to its primary dealer list, the FRBNY looks at several factors, including volume of market-making activity, financial strength of the firm, and depth and experience of management to continue participating as a market-maker. There are currently forty primary dealers. These dealers must report their daily market activity in government securities to the FRBNY. The FRBNY expects primary dealers to stand ready to buy and sell government securities even during adverse market conditions. By continually making markets, primary dealers maintain the liquidity in government securities for other investors. These dealers also provide the FRBNY and the Treasury with information on the types of new government securities offerings that their customers will probably favor in the future.

Although the primary dealers are the exclusive trading partners of the FRBNY, they also trade in government securities among themselves and the secondary dealers in the wholesale secondary market. Trading among the primary dealers is done through inter-dealer brokers, rather than through dealer-to-dealer trading. This method of trading is referred to as "blind bro-

31. See infra notes 41-47 and accompanying text.
32. See infra notes 49-57 and accompanying text.
33. See supra note 3 and accompanying text.
35. Regulation of Government Securities: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 99th Cong., 1st Sess. 72 (1985) [hereinafter Senate Hearing] (statement of E. Gerald Corrigan, President, FRBNY); BBS HEARING, supra, note 9, at 162 (statement of E. Gerald Corrigan, President, FRBNY).
36. For a listing of the primary dealers, see List of Primary Dealers Reporting to the Market Division of the Federal Reserve Bank of New York (Dec. 11, 1986).
37. GAO SURVEY, supra note 34, at 11.
38. See M. STIGUM, supra note 2, at 431. The Treasury does not pay commissions to dealers who make markets in Treasury securities. Dealers hope to cover their expenses by the difference between the price they pay to the Treasury and the price they receive from resales to their customers. GAO SURVEY, supra note 34, at 11.
39. GAO REPORT, supra note 2, at 26.
40. Id. at 23.
42. See Quint, Big Five U.S. Securities Dealers, N.Y. Times, June 9, 1983, at D1, col. 2;
kering" because the brokers display quotes on electronic screens without displaying the source of the quotes. Thus, dealers “hitting a bid” through these brokers do so without knowing the identity of the party on the other side of the trade. The participants do know, of course, that they are dealing with other primary dealers. This anonymity permits these dealers to trade without disclosing the size of their trades or investment strategies. Inter-dealer brokers, together with the primary dealers, comprise the largest segment of the market for government securities.

Secondary dealers include firms registered with the SEC, previously unregistered firms, and banks. The approximate number of secondary dealers is between 200 and 300. Although their exact numbers are unknown, secondary dealers are by far the largest group of government securities dealers. However, the trading volume of the secondary dealers is relatively low. One FRBNY official has estimated their trading volume at roughly twenty-five percent of total market activity, with the other seventy-five percent being the trading volume of the primary dealers. Secondary dealers are not subject to direct FRBNY oversight. However, in early 1984, the FRBNY requested that secondary dealers voluntarily submit position, transaction, and financing data on a monthly basis in order to improve monitoring of the market.


43. M. STIGUM, supra note 2, at 316.
45. Id.
46. *Id.* at 316.
47. *Id.* at 316.
49. *Id.* at 26.
50. The exact number of secondary dealers is not known, partly because a number of them are not registered with any federal agency. Sources suggest, however, that there may be as many as 400 to 500 firms. See *Senate Hearing*, supra note 35, at 54 (statement of E. Gerald Corrigan, President, FRBNY); see also *GAO SURVEY*, supra note 34, at 12 (estimating 300 secondary dealers); *GAO REPORT*, supra note 2, at 26 (estimating between 200 to 300 secondary dealers); SEC Release No. 21,959, supra note 8, at 15,905 (estimating 200 secondary dealers).
52. Secondary dealers are not required to submit trading or financial data to the FRB and are not subject to FRBNY dealer surveillance visits. *GAO REPORT*, supra note 2, at 26.
53. In providing the FRB with the dealers' positions and volume of transactions, these reports were expected to assist the FRB in its routine monitoring of the market and help it determine whether new regulations would be recommended. Statement Regarding New Reports by Government Securities Dealers, FRBNY (Feb. 29, 1984), reprinted in *BBS Hearing*, supra note 9, at 192-94.
Secondary dealers provide a variety of services to the market. They help the Treasury distribute debt by bidding at Treasury auctions for both their customers' accounts and their own. They lower the search costs for investors by seeking the best prices available from primary dealers. They increase liquidity and provide competition to primary dealers by quoting bid and ask prices to customers. Finally, they open the market to smaller investors through consulting services.

B. Repurchase Agreements—The Primary Market Instrument

Both primary and secondary dealers often take trading positions that are several hundred times their capital. The investment transaction that enables these dealers to finance such positions is the repurchase agreement (repo). As a result, repos have become the primary means of financing the United States government securities market. Although repos have spurred the market's growth, they have also been the bane to many investors who did not fully appreciate their inherent risks.

Repurchase agreements are a legitimate and integral part of the government securities market. A repo uses securities as collateral to obtain funds. An investor who seeks cash, will temporarily sell his securities to an investor who has cash, thus, in effect, providing the securities as collateral to obtain the needed cash. The investor obtaining the cash agrees to repurchase the same or substantially the same securities at a specified point in the future, and to pay interest on the use of the cash.

A reverse repurchase agreement (reverse repo) is a mirror image of a repo and may be used to obtain an interest return on available funds. Thus, an investor purchases securities and simultaneously agrees to sell them back at

54. GAO Report, supra note 2, at 23.
55. Id.
56. Id.
57. Id.
58. See M. Stigum, supra note 2, at 40.
60. Id. at 44.
61. Federal Reserve Bank of New York, It's 8:00 A.M., Do You Know Where Your Collateral Is? (1985) (This FRBNY informational pamphlet was issued to increase investor awareness).
62. GAO Report, supra note 2, at 102.
63. Id.
65. GAO Report, supra note 2, at 102.
a later time and at a higher price. In dealer parlance, a transaction is generally considered a repo when viewed from the perspective of the seller of the securities and a reverse repo when viewed from the perspective of the purchaser of the cash.66 Certain participants, notably savings and loans, investment companies, and the FRBNY, reverse the terminology, so that the purchaser of funds is considered to be conducting a repurchase agreement.57

Repos are a vital cash management tool for state and municipal governments, financial institutions, and corporations.68 Government securities dealers finance their inventories through repos,69 and the FRB Open Market Committee implements monetary policy through repo transactions entered into by the FRBNY.70 The FRB not only uses repos to inject cash reserves into the banking system to meet a temporary need, but it also uses reverse repos to temporarily withdraw reserves from the banking system.71

There are basically two types of repo markets: wholesale repos and retail repos.72 Typically, the wholesale repo is transacted in large denominations between institutional investors, usually for a short period of time, often overnight.73 Thus, dealers who must run highly leveraged operations use the wholesale repo market to obtain short-term funds.74 The activities of the FRBNY and the primary dealers are part of this market.

Retail repos frequently represent fractional interests in government securities.75 Since 1979, depository institutions have been required to issue retail repos.

66. See M. Stigum, supra note 2, at 42. "What a given transaction is called depends on who initiates it; typically, if a dealer hunting money does, it's a reverse." Id.
68. See Judiciary Comm. Report, supra note 59, at 45.
Receipts of taxes and the proceeds of bond issues in the case of state and local governments, cash flows from corporate operations and liquidity needs of thrift institutions and money market funds often fail to coincide with the planned expenditures of such funds, thereby creating the need for such entities to invest idle funds for short periods in as risk-free manner as possible.

Id.

69. Id. at 46. "[T]he repo market has become the principal means of financing [dealers'] positions... Repos also enable other dealers to obtain these newly-issued securities from the Primary Dealers." Id.
70. Id. at 46 ("[T]he repo market plays an important role in the conduct of monetary policy."); see supra note 7 and accompanying text.
71. See M. Stigum, supra note 2, at 240.
72. See generally Note, supra note 41, at 403.
73. See Repurchase Agreements and Federal Funds, Fed. Reserve Bull., May 1978, at 354 ("[R]epos are in general transacted for very short-term periods" and "[g]enerally transacted in denominations of $5 million or more.").
74. See Note, supra note 41, at 404.
repos under certain FRB guidelines. Accordingly, the FRB will recognize those transactions in amounts under $100,000 and for terms of less than ninety days to be retail repos. Although investors in wholesale repos are institutional investors, investors in retail repos include a high percentage of individual investors.

C. The Regulatory Framework

Prior to the Act, no single federal agency had overall rulemaking or supervisory authority over the government securities market. The federal agencies involved in regulating the participants included the FRB, the SEC, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Savings and Loan Insurance Corporation (FSLIC). The type of dealer being regulated determined which federal agency, if any, had authority over it.

All dealers in government securities fell into three general groups. One group, was and continues to be, subject to full regulation by the SEC because these dealers also trade in “nonexempt securities.” Though the SEC could not prescribe rules directly governing the activities of government securities dealers, it could enact rules for registered broker-dealers to “ensure the protection of customer accounts and to promote dealer responsibility.” Thus the SEC, without a specific mandate to do so, could regulate a dealer’s government securities transactions only within the context of the dealer’s total operations.

A second group of dealers was, and still is, regulated “because these dealers are also banks or subsidiaries of bank holding companies.” Regulatory agencies include the OCC for national banks, the FRB for bank holding companies and state banks that are members of the Federal Reserve Sys-


78. See generally Note, supra note 41, at 405.

79. GAO REPORT, supra note 2, at 56-58.

80. See infra notes 86-88.


82. GAO REPORT, supra note 2, at 59.

83. Id.

84. Id.

85. Id.

86. Exchange Act § 3(34)(A)(i), (B)(i), (C)(i), (D)(i), (F)(i), 15 U.S.C. § 78c(34)(A)(i), (B)(i), (C)(i), (D)(i), (F)(i).
tem,87 and the FDIC for other, federally insured, state banks.88 The regulatory oversight of bank dealers focuses on the safety and soundness of the banking industry as a whole.89

A third group of government securities dealers traded only in exempt securities, was not involved in banking and therefore, not subject to any formal regulatory oversight.90 These dealers were either separate entities not affiliated with a bank or were affiliated with a nonfinancial firm or a diversified financial corporation.91 Nine of the primary dealers were included in this group. Although primary dealers are "well vetted by the FED,"92 the FRBNY readily admits that its relationship with the primary dealers is a "business relationship rather than a regulatory one."93 The FRBNY had no express statutory authority over these dealers, but rather served an "informal watch-dog function . . . [with] some elements of traditional regulatory functions."94

D. Dealer Failures and Their Losses

From the group of unregulated government securities dealers came two of the most recent and largest dealer failures in market history: ESM Government Securities (ESM) and Bevill, Bresler & Schulman (BBS). ESM failed in 1985 with losses that have been estimated at $300 million, making it the largest failure in market history.95 A month after ESM was forced into re-

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89. GAO REPORT, supra note 2, at 60.
90. Id.
91. Id.
92. M. STIGUM, supra note 2, at 436-37.
93. Senate Hearing, supra note 35, at 62 (statement of E. Gerald Corrigan, President, FRBNY).
94. Id. at 63. The Act requires formal registration of all dealers, including the primary dealers. See § 102(b), 15 U.S.C.A. § 78o-5(a)(1)(A).
ceivership, BBS collapsed, having incurred losses of up to $235 million. Many small institutional investors such as municipalities, school boards, and thrift institutions suffered as a result of these failures. These well-publicized failures have not only made this "gentleman's market" more well known to the average person, but they have also brought an end to Congress' laissez-faire approach to the market's regulation.

ESM Government Securities, Inc. (GSI) acquired securities, in part, through unsecured borrowing and then used these securities to enter into repurchase agreements and other transactions to achieve trading gains. By speculating incorrectly on interest rate movements, GSI had acquired millions of dollars in losses. Much of these losses were absorbed by the parent firm, ESM Group, Inc., thus hiding the losses from the clients of GSI. ESM Group, Inc. in turn transferred these losses to an affiliate, ESM Financial Group, Inc. (Financial). GSI's books did not show any transaction losses while the books of the parent company hid the loss amount as inter-company loans. Financial owed GSI $200 million but had assets of only $50 million, which resulted in GSI's inability to repay

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96. **GAO REPORT**, supra note 2, at 150.

97. Two such municipalities were the City of Beaumont, Texas, which incurred losses of up to $64 million, and the City of Pompano Beach, Florida, whose losses are estimated to be $11.9 million. Seven school districts in New York incurred losses of $7 million, leaving them without sufficient funds for the school year. See **Reauthorizations**, supra note 95, at 3 (statement of Sen. D'Amato); see also Letter from Danny O. Crew to the SEC (May 17, 1985) (comment letter to the SEC from the Assistant City Manager of Pompano Beach, Florida).

98. Trading in this market is conducted in an "environment of sophisticated investors who trade hundreds of millions of . . . dollars on the basis of a 'gentleman's agreement' with an entity about which they couldn't care less." SEC v. Miller, 495 F. Supp. 465, 484 (S.D.N.Y. 1980). See M. Stigum, supra note 2, at 437 ("It is inconceivable that any of these firms would ever renege on a trade. In a market that operates on the principal [sic] my word is my bond, no dealer could afford the damage that reneging on a trade would do to its reputation.")

99. Throughout the hearings on the Act, many commentators asserted that little regulation is the best regulation for this market. The SEC, in its report to Congress, stated "if legislation is to be adopted, the Commission would recommend only legislation drafted narrowly to address areas in which there have been demonstrated abuses." See **SEC REPORT**, supra note 95, at 228.


101. **GAO REPORT**, supra note 2, at 149.

102. Id.

103. Id.

104. See **RECEIVER REPORT**, supra note 100, at 43.
The BBS affair actually involved two separate entities, Bevill, Bresler & Schulman, Asset Management Corporation (AMC), an unregulated government securities dealer, and Bevill, Bresler & Schulman, Inc. (BBS, Inc.), a registered broker-dealer. BBS, Inc. had been voluntarily reporting its positions under the FRB capital guidelines on a monthly basis. However, the BBS, Inc. reports did not reflect the activities of its related firms where the losses actually occurred. The fact that BBS, Inc. was a registered broker-dealer did not help prevent its loss because its unregistered affiliate, AMC, was carrying on government securities activities not subject to federal regulation. Because of the inter-relation of these two firms, the failure of the nonregistered dealer precipitated the fall of the registered broker-dealer.

II. THE HISTORY OF THE LEGISLATION AND ITS OUTCOME

A. Congressional Concerns and the New Law

Many of the failed dealers operated outside the federal regulatory structure because they dealt solely in exempt government securities. As a result of these failures, many savings and loans, municipalities, and other public institutions lost millions of dollars. In response to these dealer failures, Congress sought to provide for a formal system of regulation of government securities dealers and brokers by enacting the Government Securities Act of 1986.

The Act directs the Secretary of the Treasury to adopt rules to ensure that all government securities dealers operate with adequate capital, and account for and maintain customers' funds and securities. The Treasury

106. BBS Hearing, supra note 9, at 4-26 (statement by Saul S. Cohen, Trustee).
107. Id.
108. Id.
109. See supra note 97.
111. Id. § 78o-5(b)(1)(A). The lack of adequate capitalization of dealers in the government securities market has been a significant problem; the largest failures have involved dealers that operated for substantial periods of time while insolvent. Commentators to an SEC request also raised concerns regarding the need for limitations on the levels of risk and leverage taken on by government securities dealers. SEC REPORT, supra note 95, at 230.
112. Under the Act, the Treasury may promulgate rules relating to custody and use of customers' deposits or credit balances; transfer and control of government securities subject to repos and similar transactions. In promulgating such rules, the Treasury will establish standards for the safeguarding and use of customer securities held by a nondealer depository institution as a fiduciary or in a similar capacity. 15 U.S.C.A. § 78o-5(b)(1)(A).
must also promulgate recordkeeping rules and regulations directly affecting market safety, such as collateralization of repurchase agreements. In addition, the law requires that dealers register with or notify designated federal agencies that they deal in government securities.

B. Regulation—A Panacea or a Problem?

In formulating the legislation, Congress addressed the threshold question of whether regulation was actually needed. The government securities market is made up of institutional investors, who, under nonexempt securities concepts, would not ordinarily require the protection of federal law given to less sophisticated investors. Because of this market's sensitivity to any regulation, Congress was cautious in interposing federal regulation where some argued that it has the potential to create more harm than good. In addition to those critics who believed that the federal government should maintain its laissez-faire approach in this area, there were others who, while agreeing that some regulation was needed, advised Congress to enact narrowly tailored legislation.

Many of the participants in this market supported the need for some regu-

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113. Id. § 78o-5(b), (c). The accounting profession had been criticized for falling down on its auditing responsibilities in the wake of the ESM and BBS collapses. See Klott, Auditors Criticized in House, N.Y. Times, Apr. 18, 1985, at D7, col. 1; Berton, Accountants Seek to Tighten Auditing of Government Transactions, Wall St. J., Apr. 17, 1985, at 8, col. 1. Though the Act does not specifically call for auditing rules, the Treasury has already agreed to the need for such rules. 132 CONG. REC. H9250 (daily ed. Oct. 6, 1986) (statement of Rep. Dingell).


115. Under the Act these agencies will be the OCC in the case of a national bank; the FRB in the case of a state member bank of the Federal Reserve System; the FDIC in the case of a bank insured by the FDIC (other than a member of the Federal Reserve System or a federal bank); the FHLBB in the case of a federal savings and loan association and federal savings banks; the FSLIC in the case of an institution insured by the FSLIC (other than a federal savings and loan association, or federal savings bank); and the SEC in the case of all other government securities brokers and government securities dealers. Government Securities Act of 1986, § 102(b), 15 U.S.C.A. § 78c(a)(34)(G) (West Supp. 1987).


117. See SEC REPORT, supra note 95, at 227; House Hearings, supra note 95, at 374 (statement of John R. Shad, Chairman, SEC) ("[T]he . . . market we are talking about is a professional market where by and large, all the parties have professional advice and assistance."); see also supra note 57.

118. Rules that would make government securities harder to sell or add substantial costs to dealers would cause interest rates to rise. An increase of just one-tenth of a percentage point in the interest rate would cost the Treasury $1 billion a year. See Worthy, The Troubled Market in Federal Securities, FORTUNE, May 13, 1985, at 81.

Despite their earlier positions, support for such legislation even came from the government agencies most affected by the Act. Many participants sought greater regulation to maintain the integrity of the market and, therefore, to increase its liquidity. Oddly, a fear of reduced market liquidity caused other market participants to oppose regulation, claiming that the market will correct itself. However, this position offers nothing in the way of preventive action. Future problems are not adequately addressed merely because the market has been able to adjust to current problems. As one SEC Commissioner stated, ad hoc corrections would not allow for flexible responses, let alone encourage smooth and efficient market operations.

Market participants were also concerned about investors' confidence in the market. Investor confidence is especially crucial in the government securities market, because of the system of blind-brokering. The system enables billions of dollars to be traded daily with nothing more than a simple promise from a voice at the end of the telephone. The integrity and honesty of one's trading counterpart are, therefore, important elements of this market. Lack of confidence in the financial soundness of firms operating in the market can be costly to the Treasury if it translates into higher interest rates. On the other hand, regulation that would require dealers to keep

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120. See SEC Release No. 21,959, supra note 8, at 15,904. The majority of responses to the SEC release supported some form of regulation of the government securities markets. Of the 79 comment letters received by the SEC, 56 supported some form of regulation for the government and agency securities markets, 12 opposed any form of further regulation, and 11 expressed no opinion. SEC REPORT, supra note 95, at 291; see GENERAL ACCOUNTING OFFICE, U.S. GOVERNMENT SECURITIES, DEALER VIEWS ON MARKET OPERATIONS AND FEDERAL RESERVE OVERSIGHT 3 (fact sheet prepared for the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs, 99th Cong., 2d Sess. (1986)).

121. See House Hearings, supra note 95, at 429 (statement of Paul Volker, Chairman, FRB); Debt Units Facing New Rules, N.Y. Times, Apr. 10, 1985, at D1, col. 3 (statement of FRB governor in charge of bank regulation suggesting "something has to be done"); 132 CONG. REC. H9250 (daily ed. Oct. 6, 1986) (statement by Rep. Dingell).

122. See House Hearings, supra note 95, at 90, 109, 134.

123. See id. at 350 (statement of John J. Niehenke, Acting Assistant Secretary, Treasury).

124. A purely voluntary surveillance approach "cannot be counted on to minimize fraudulent behavior or excessive risk-taking at the expense of third parties." House Hearings, supra note 95, at 430 (statement of Paul A. Volker, Chairman, FRB).

125. See id. at 312 (statement of Aulana L. Peters, Commissioner, SEC).

126. See supra notes 41-48 and accompanying text.

127. Id.

128. House Hearings, supra note 95, at 437 (statement of Paul Volker, Chairman, FRB) ("[T]he danger here . . . is that one could imagine circumstances in which confidence in market practices and in the dealers themselves was impaired to the point that it would affect the liquidity of the market and, therefore, affect interest costs."). But see id. at 353 (statement of John J. Niehenke, Acting Assistant Secretary, Treasury) (recent dealer failures have not had a discernible effect on Treasury yields).
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ket. Other Congressmen questioned the Treasury’s selection as the rulemaking authority because of the “business relationship” between the FRBNY, the Treasury and the primary dealers. These opponents recognized a potential conflict of interest, which could affect the Treasury’s ability to regulate the market effectively.

Nevertheless, the legislation’s ultimate goal of preventing losses resulting from dealer failures can be achieved by the current policies of the Treasury and the Act. The Treasury, in opening up its book-entry system, will provide safekeeping of securities to more participants at a lower cost to the investor. Under the Act, the Treasury must promulgate its rules in consultation with the SEC and the FRBNY. These three agencies currently work together closely, and there is no reason to doubt their continued relationship.

III. RESTORING MARKET INTEGRITY THROUGH INCREASED REGULATION

A. Registration and Disclosure Requirements

The Act brings all government securities dealers under the aegis of federal regulation by requiring them to register with appropriate regulatory agencies. For example, the nine unregulated primary dealers must register with the FRBNY, while the unregulated secondary dealers are required to register with the SEC. The SEC’s registration requirements ensure that

142. See House Hearings, supra note 95, at 176, 413, 427; see also Senate Hearing, supra note 35, at 62 (statement of E. Gerald Corrigan, President, FRBNY).
143. See House Hearings, supra note 95, at 197 (statement of Rep. Rinaldo) (questioning the appropriateness of vesting the Treasury, as seller of Treasury securities, with the rulemaking authority).
144. Id. One Congressman likened it to “putting a madam in charge of a vice squad.” Id. at 413 (statement of Rep. Swift).
145. In July of 1986, new issues of Treasury securities became available only in book-entry form, thereby eliminating definitive registered securities. Id. at 363. Furthermore, the Treasury is considering expanding its commercial book-entry system to provide access by all Treasury securities dealers to direct securities accounts at the Federal Reserve. Currently only depository institutions have direct access to these book-entry accounts. Id. at 364-65.
147. Id. §§ 78c(a)(34)(G); 78o-5(a)(1)(A),(B).
the securities market operates in a fair and orderly manner.\textsuperscript{150} Additionally, registration allows the SEC to monitor broker-dealer compliance with its bookkeeping, recordkeeping, periodic financial reporting, and financial responsibility rules.\textsuperscript{151} This reporting system enables the SEC to find violations of financial and related rules at an early stage. Self-regulatory organizations, such as the National Association of Securities Dealers for registered broker-dealers, can also respond with disciplinary proceedings in the event a dealer fails to conform to the rules.\textsuperscript{152} Under the Act, previously unregistered government securities dealers must register with the SEC but follow rules promulgated by the Treasury.\textsuperscript{153}

The Act's requirement of broker-dealer registration is intended to protect the individual investor. Congress found that despite the institutional nature of the broker-dealers there were many participants in the market who would benefit from the additional registration and oversight provisions.\textsuperscript{154} Secondary dealers sometimes trade with inexperienced investors entrusted with large public funds.\textsuperscript{155} Without this legislation, such investors might seek out "higher quality" firms, or drop out of the market altogether.\textsuperscript{156} Increased surveillance by federal agencies and greater registration requirements placed upon the dealers will create a safer market for participants. The amount of risk to which an investor will be exposed should decrease. Nevertheless,


\textsuperscript{152} Id. at 803.

\textsuperscript{153} Id. at H9251 (daily ed. Oct. 6, 1986).

\textsuperscript{154} Id. at H9252 (Summary of Treasury Book-Entry Proposal); see House Hearings, supra note 95, at 79.

\textsuperscript{155} For example, in Clallum County, Washington, which lost $10 million in the ESM failure, the treasurer was a dairyman. These investors may require greater protection than the "typical Wall Street sophisticate." House Hearings, supra note 95, at 79 (statement of Rep. Swift). The SEC in its request for comments, also questioned whether the traditional presumption of sophistication of those investors with significant assets is applicable to investors in the government securities market. SEC Release No. 21,959, supra note 8, at 15,912.

\textsuperscript{156} Some secondary dealers feared that investors were choosing to deal only with primary dealers on the assumption that they were regulated by the FRB. See Transcript of the Commission's Public Forum on Government Securities Markets, May 21, 1985, at 143 (statement of Stephen Barrett, Managing Director, Alex Brown & Co.) [hereinafter Commission's Public Forum]. Ultimately, this "flight to quality" could adversely affect the liquidity of the government securities market. See id. at 223 (statement of Edward Geng, Senior Vice President, Federal Reserve Bank of New York). See generally Ross, Shad Predicts More Securities Failures, Wash. Post, Apr. 18, 1985, at B3, col. 4; Big Treasurys Investors Become More Careful After Two Firms Fail, Wall St. J., Apr. 12, 1985, at 1, col. 5; Quint, When Little Guys Buy Treasury Debt, N.Y. Times, Dec. 18, 1983, at C10, col. 3.
firms and their customers will continue to be exposed to some market, credit, and other risks.\footnote{157}

\section*{B. Maintaining Adequate Capital and Customer Accounts}

The Act also requires dealers to operate with adequate capital and to account for and maintain customers' funds and securities.\footnote{158} Net capital rules, similar to those of the SEC,\footnote{159} ensure that firms operate with sufficient liquidity "to cover their current indebtedness to their customers and enable the dealers to satisfy custome[rs] claims for cash or securities."\footnote{160} The SEC's net capital rule prohibits broker-dealers from incurring indebtedness in excess of 1500\% of their net capital.\footnote{161} The SEC rules also allow an alternative that ties the broker-dealer's net capital to customer receivables rather than liabilities.\footnote{162} This alternative rule allows broker-dealers to maintain net capital equal to the greater of $100,000 or two percent of total debit items.\footnote{163} Similarly, the FRB requested in April of 1985, that unregulated firms maintain liquid capital equal to 1.2 times their estimated potential losses from sudden price changes.\footnote{164} The FRB also announced the policy behind its

\footnote{157. \textit{BBS Hearing, supra} note 9, at 106 (statement of John R. Shad, Chairman, SEC) ("The market risk depends on the fluctuations in interest rates. The credit risk depends on the reputation, credit worthiness and financial condition of the other party to the transaction, whether adequate collateral is obtained, the concentration of dealings with the contra-party, and the receipt of adequate margin."); \textit{see American Institute of Certified Public Accountants Report of the Special Task Force on Audits of Repurchase Securities Transactions, reprinted in BBS Hearing, supra} note 9, at 932.  


160. \textit{See Joint Report, supra} note 151, at 786.  

161. 17 C.F.R. § 240.15c3-1(a) (1987).  


163. 17 C.F.R. § 240.15c3-1(f) (1987). The SEC has amended its net capital requirements with respect to the excess margin held by broker-dealers in reverse repos. The rule requires broker-dealers to increase this net capital by 10\% of the excess market value of Treasury securities subject to reverse repos with any one party over 105\% of the contract price. This 105\% parameter only applies to reverse repos using Treasury securities; the parameter is 110\% for mortgage backed securities and 120\% for other securities. 17 C.F.R. § 240.15c3-1(a)(9) (1987); \textit{see Financial Responsibility Rules, 52 Fed. Reg. 22,295, 22,297 (1987) (release announcing adoption of amendments to the net capital rule) (to be codified at 17 C.F.R. § 240).}  

capital adequacy standards as "providing additional protection against unforeseen losses, helping to maintain public confidence in particular institutions and in the banking system, partially protecting depositors from a threat of insolvency, and supporting reasonable growth of such institutions."\(^{165}\)

In announcing its proposed net capital requirements, the Treasury modeled its rule after the FRBNY's rule.\(^{166}\) The Treasury believes the FRBNY rule, as opposed to the SEC rule, is better suited for broker-dealers solely in government securities because it "recognizes certain types of risk as well as risk mitigating hedging techniques."\(^{167}\) The Treasury's temporary rule requires government securities broker-dealers to maintain liquid capital at least equal to 120\% of total "haircuts"\(^{168}\) and in no case of an amount less than \$25,000.\(^{169}\)

Maintaining customers' funds and securities can be done simply by keeping segregated accounts.\(^{170}\) Rules relating to segregation of accounts are currently used by registered broker-dealers.\(^{171}\) Broker-dealers either hold the securities in segregated accounts at their clearing bank or they merely earmark the customers' securities on their own books.\(^{172}\) Hold-in-custody arrangements are more prevalent, however, with physical securities rather than the book-entry type.\(^{173}\)

In order to protect an investor in these hold-in-custody arrangements, one commentator urged the adoption of a rule similar to the SEC's customer protection rule.\(^{174}\) This rule requires that broker-dealers obtain and maintain possession or control of all customer fully paid and excess margin secu-

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\(^{167}\) Id.

\(^{168}\) A "haircut" is a requirement that a broker-dealer reduce the value of securities on its balance sheets to reflect the risk of loss associated with those securities. M. THOMSETT, INVESTMENT AND SECURITIES DICTIONARY 125 (1986); see M. STIGUM, supra note 2, at 700.


\(^{170}\) Letter from Goldman, Sachs & Co. to the SEC (May 17, 1987) (response letter supporting segregation by the dealer); but see Letter from Irving Trust to the SEC (May 17, 1987) (response letter preferring to take possession or to enter into custodial agreements).

\(^{171}\) See Letter from Goldman, Sachs & Co. to Rep. Wirth (June 7, 1985), reprinted in House Hearings, supra note 95, at 514.

\(^{172}\) BBS Hearing, supra note 9, at 257 (statement of E. Gerald Corrigan, President, FRBNY).

\(^{173}\) Id. at 258.

\(^{174}\) Letter from Goldman, Sachs & Co., supra note 170 (favoring the adoption of a SEC-type customer protection rule).
ities, and that broker-dealers maintain records properly identifying the owner of all customer securities they hold.\textsuperscript{175} The Treasury's temporary rule does essentially that. The Treasury's temporary rule adopts, with certain exceptions, the SEC rules for broker-dealers relating to custody of securities.\textsuperscript{176}

It is an enormous administrative convenience for the dealer when the customer does not take possession of his securities. It reduces the dealer's transaction cost and also saves the investor the cost of establishing his own account at a clearing bank. Because costs are lower, a dealer will often pay additional interest if it retains possession.\textsuperscript{177} An investor should look beyond these appealing interest rates and focus on the risk of leaving his securities with the dealer. Investors with ESM lost their money because they did not take control of the collateral they had purchased.\textsuperscript{178} Instead, they kept their collateral with ESM's clearing agent in the mistaken belief that the securities were segregated and held for their benefit.\textsuperscript{179} Segregated accounts might be adequate protection for investors dealing with reputable firms, however, prior to the Act an investor could not be assured that the unregistered firm with whom he was dealing was financially sound.

If an investor wishes greater protection of his securities than a segregated account can offer, he may employ one of four additional custody arrangements.\textsuperscript{180} Investors can require dealers to transfer or deliver the investor's securities by having the securities deposited (1) with a trustee under a trust receipt arrangement, (2) with a custodian bank acting as agent for both the investor and the dealer under a tripartite agreement, (3) with a clearing firm or bank acting as the investor's agent under an independent custodial agreement, or (4) with the investor directly.\textsuperscript{181}

The underlying securities can be transferred to a trustee under a trust re-

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\textsuperscript{175} 17 C.F.R. § 240.15c3-3 (1987).


\textsuperscript{177} ESM offered some of its clients 1/4 point more for not taking possession of their underlying securities. GAO REPORT, supra note 2, at 150.

\textsuperscript{178} See infra notes 232-34 and accompanying text.

\textsuperscript{179} See RECEIVER REPORT, supra note 100.

\textsuperscript{180} BBS Hearing, supra note 9, at 257-59 (statement of E. Gerald Corrigan, President, FRBNY).

\textsuperscript{181} \textit{Id.}
Here, a receipt is issued by the dealer or its clearing bank to the customer stating that specific securities are held for the customer's account. However, the trust arrangement is commonly used for physical securities. The costs of the trust arrangement, however, are often too high for the small repo investor.

One of the bailment-type custodial agreements—the tripartite repo or the independent custodian, can be as effective as the trust arrangement. The costs of these agreements are not as prohibitive as the trust agreement because the dealer's reporting requirements and his duties are not as great. Under a tripartite repo, the custodian places securities in the customer's account against funds deposited with it by the customer during the day. The following day the repo is "unwound" automatically. The custodian polices the transaction by ensuring adequate segregation and pricing of the repo securities. When the transfer of the securities is made to an independent custodian, it acts as the agent for the customer in accepting delivery of repo securities. The only contracting parties are the customer and the custodian bank, unlike in the tripartite repo, where the dealer is also a party to the contract. Moreover, the custodian does not police the terms of the independent custodial repo.

Some fear that serious transaction costs could be imposed upon the investor if the Treasury were to promulgate exclusive custodian guidelines for the broker-dealers. Because no major bank offers either of the custodial agreements on a large scale, it is difficult to determine what the costs of their mandatory use might be. In relation to the earnings of these repos, the costs could significantly reduce the benefits of these transactions.

182. See Porter, Retail Repurchase Agreements Revisited, 99 Banking L.J. 676, 694 (1982).
183. BBS Hearing, supra note 9, at 258 (statement of E. Gerald Corrigan, President, FRBNY).
184. Id.
185. Id.
186. BBS Hearing, supra note 9, at 257-59 (statement of E. Gerald Corrigan, President, FRBNY).
187. Porter, supra note 182, at 694.
188. BBS Hearing, supra note 9, at 257 (statement of E. Gerald Corrigan, President, FRBNY).
189. Id.
190. Id.
191. Id. at 259.
192. Id.
193. Id.
195. Id. at 516.
196. One commentator suggested that, in the extreme, these charges could cost it $25 mil-
Transfer of Treasury securities is done through the FRB's book-entry system over the "Fed wire." Because no physical certificate of ownership actually exists, delivery is effected simply by a Federal Reserve bank making an appropriate entry which properly debits and credits accounts in its ledger. Practically speaking, direct deposit of the securities with the investor would work only if the investor or his bank has an account with the FRBNY, as only depository institutions may maintain an account with the FRBNY. Because dealers engaged solely in government securities are not depository institutions, they may not maintain an account with the FRBNY. However, a recent FRB rule has allowed states and municipalities to establish accounts with the FRBNY for safekeeping of government securities purchased with public funds. This rule should help prevent the losses witnessed by such municipalities as Pompano Beach, Florida, which found it too costly to protect its interest by taking delivery through a clearing bank.

Because of such high costs, the Treasury is also considering expanded access to the commercial book-entry system. This proposal would include government securities dealers in the system, thus requiring all dealers to have a securities account at the FRBNY. However, some fear that a requirement to deliver the collateral for all book-entry repos would increase the volume of the Fed wire significantly, thus worsening the already con-


198. 31 C.F.R. § 306.118 (1986); see M. STIGUM, supra note 2, at 429-30.

199. Member banks are the only private entities that can access the FRB's book-entry system. 31 C.F.R. § 350 (1986). Nonbank dealers, therefore, have access to the book-entry system only through a clearing bank.

200. Id.

201. See House Hearings, supra note 95, at 364 (statement of John J. Niehenke, Acting Assistant Secretary, Treasury) (describing the Treasury's proposed book-entry expansion); see also U.S. Moves to Shield Issues Linked to Repos, Wall St. J., Jan. 22, 1986, at 64, col. 1; Capital Guidelines May Be in Force Soon, J. COMMERCE, April 2, 1985, at 4A.

202. The City of Pompano Beach, Florida, found that perfecting its securities interests was literally impossible. No New York money center bank would set up a custodian account for Pompano Beach because of its low level of investment activities. Additionally, no local bank possessed the expertise to offer the service. See Letter from Danny O. Crew, supra note 97.


204. Id.
gested system.205

C. Further Preventive Measures

Participants in this market have at their disposal further measures to prevent the loss of their investments. An additional measure of protection for an investor is the maintenance of sufficient collateral in his repo.206 The investor must obtain securities of sufficient value that equal or exceed the value of the repurchase price, while the dealer must ensure that the value of the securities does not significantly exceed the repurchase price.207 Measuring the collateral on a daily basis is referred to as “marking to market.”208 The investor may demand that the dealer put up more collateral if the deficiency is significant; conversely, the dealer may demand that the investor return any excess collateral.209 Marking to market is intended to give integrity to the buyer’s security interests and “prevents selling repurchase agreements in an amount equal to the par value of the underlying securities.”210 Investors can protect themselves against loss, if the collateral must be liquidated, by carefully monitoring their investments.

In addition to maintaining sufficient collateral to avoid investment losses, the investor should always “know [his] trading partner.”211 The FRBNY has stated that this precept was the origin of its maintaining a “surveillance” over the primary dealers.212 If the FRBNY continually needs to assess the financial strength and creditworthiness of its trading partners—among whom are the largest and wealthiest investment institutions in the world—clearly, smaller investors should be no less concerned about institutions with whom they are entrusting their funds. This maxim rang true again in recent dealer failures:213 investors with BBS mistakenly thought they were dealing with one counterparty while actually dealing with an affiliate.214 Transactions are often arranged by brokers and may involve those who are acting as an agent for a client firm.215 In such circumstances, the agent’s client is the true trading partner, not the agent himself.216 The investor would need to

205. Letter from Goldman, Sachs & Co., supra note 170; see M. Stigum, supra note 2, at 384.
206. M. Stigum, supra note 2, at 400.
207. GAO Report, supra note 2, at 114; see also M. Stigum, supra note 2, at 350.
208. GAO Report, supra note 2, at 114.
209. Id.
210. Porter, supra note 182, at 690.
211. GAO Report, supra note 2, at 112.
212. Senate Hearing, supra note 35, at 62.
213. See supra note 13.
214. See BBS Hearing, supra note 9, at 4-26 (statement of Saul S. Cohen, Trustee).
215. GAO Report, supra note 2, at 112.
216. Id.
know the financial data on the client firm to determine the true credit risk of this trade.\textsuperscript{217}

As stated by the FRB, the use of a written repo would further reduce the investor's exposure to undisclosed risk.\textsuperscript{218} The endorsed agreement would stand as some evidence of the investor's rights in protecting his investment.\textsuperscript{219} The Public Securities Association (PSA) has established a prototype repo with provisions such as "the criteria for both providing additional collateral when the pledged securities fall in value, and returning excess collateral when the pledged securities fall in value, and returning excess collateral when the pledged securities rise in value."\textsuperscript{220} The PSA agreement also provides for the method of payment and delivery, requires the segregation of collateral securities in identifiable accounts, and establishes the criteria for default which would allow the parties to either liquidate or purchase the collateral securities. This prototype agreement further establishes "the rights of any trustee or custodian holding the underlying securities; . . . the description of each party when they are acting as a 'principal' or as an 'agent' for a customer; . . . the counterparty's attestation to its creditworthiness and the validity of financial data provided."\textsuperscript{221}

The Treasury has recognized the wide acceptance of the PSA's prototype repo and now requires that an agreement be in writing and contain specific wording.\textsuperscript{222} In the case of a hold-in-custody arrangement, the Treasury requires that the repo be explicit enough "to put the less sophisticated investor on notice of the potential risks involved."\textsuperscript{223}

Concededly, not every participant in this market needs, nor is able to follow, all the preventive steps described. However, neither investor nor dealer can afford to overlook at least certain preventive measures. Indeed, the single most important safeguard an investor should observe is to understand the risks in trading securities. By availing himself of disclosure documents and industry guidelines, the investor can learn of these risks.\textsuperscript{224} No federal regulation can guarantee the worth of any security transaction—that judgment is

\textsuperscript{217} Id.
\textsuperscript{218} See Federal Reserve Board Supervisory Policy on Securities Lending (May 6, 1985), reprinted in BBS Hearing, supra note 9, at 429.
\textsuperscript{219} Porter, supra note 75, at 370.
\textsuperscript{220} GAO Report, supra note 2, at 117-18.
\textsuperscript{221} Id.
\textsuperscript{224} See supra note 70.
one reserved for each investor. 225

D. ESM and BBS—Dealer Failures the Act Might Have Prevented

Some of the investors hurt in the ESM failure had allowed ESM to deposit the securities with ESM's own clearing agent. 226 The clearing agent held these accounts for ESM and not in segregated accounts for the investors. 227 Those investors who had taken possession of the pledged securities were able to liquidate their collateral immediately and with little or no loss. 228 Additionally, investors not only provided ESM with excess collateral, but also did not "know their customer" in that many thought they were doing business with an affiliate when in reality they were dealing with the parent corporation. 229 Furthermore, the SEC believes that had its oversight been in effect, it may have been able to discover much earlier the problems that led to ESM's collapse. 230

In the BBS affair, losses linked to AMC's collapse were occasioned by improper collateralization of repo transactions. 231 As with ESM, securities underlying these repo transactions were not properly perfected and investors discovered that securities underlying their transactions were pledged by AMC in other transactions. 232 Amid these double pledgings of securities, customers would loan money and, according to practice, would not take possession of the securities. 233 Investors also sustained losses by not knowing their counterparty. 234 Many customers dealing with BBS thought they were doing business with BBS, Inc., when actually they were dealing with AMC. 235

Had the Act been in place prior to the ESM and BBS failures, much of the abuse in this market might have been deterred or reduced. 236 Nevertheless,

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225. See SEC HANDBOOK, supra note 150, at 6.
226. See RECEIVER REPORT, supra note 100, at 32; see also Brannigan, ESM Group Unit Apparently Hid Losses of as Much as $300 Million, Auditors Find, Wall St. J., Mar. 6, 1985, at 6, col. 1.
227. See RECEIVER REPORT, supra note 100, at 32.
228. GAO REPORT, supra note 2, at 149.
229. Id. at 150.
230. See House Hearings, supra note 95, at 405 (statement of John Shad, Chairman, SEC); see also Ingersoll, SEC Should be Empowered to Regulate U.S. Securities, Some in House Suggest, Wall St. J., Mar. 22, 1985, at 4, col. 2.
231. See Nash, Bevill Collapse Tied to E.S.M., N.Y. Times, Apr. 11, 1985, at D6, col. 4.
232. See BBS Hearing, supra note 9, at 6 (statement of Saul S. Cohen, Trustee).
233. Id. at 7; see also id. at 488 (statement of Robert V. Shumway, Director, Division of Bank Supervision, FDIC).
234. BBS Hearing, supra note 9, at 4-26 (statement by Saul S. Cohen, Trustee).
235. Id. at 14.
236. See JOINT REPORT, supra note 151, at 784.
it is unrealistic to expect this legislation to prevent all fraud\textsuperscript{237} or all firm failures because both can occur even under stringent regulation.\textsuperscript{238} Indeed, the regulators themselves admit that fraud cannot be totally prevented in the marketplace.\textsuperscript{239} However, in the absence of this legislation, such fraud could continue undetected until it is too late to prevent the investor's loss. This Act, through its registration and disclosure provisions, will, if nothing else, reduce the opportunities for fraud.

IV. CONCLUSION

The Government Securities Act of 1986 imposes few additional requirements on those dealers in government securities that are already regulated. It will, however, fill the gaps among those dealers that were previously not subject to any federal government controls. In general, the Act provides the guidelines for market stability and continued liquidity, in conjunction with increased protection for investors in the government securities market. Specifically, it authorizes the Treasury, in collaboration with the FRB and the SEC, to adopt disclosure requirements, audit rules and regulations, capital adequacy guidelines and account segregation or transfer rules. While the collective efforts of these agencies should go a long way toward striking the correct balance between competing interests in the government securities market, common sense and appreciation of the inherent risks in the securities market are still the best guides for the investor to avoid the same pitfalls encountered by those involved in the ESM and BBS failures.

\textit{Joseph G. Fallon}

\textsuperscript{237} Id. One federal official noted that even if the fraudulent practices witnessed in the ESM and BBS failures were eradicated, new fraudulent methods could be devised. To avoid fraud he suggested better education of investors, good internal industry guidelines and prudent investment. \textit{See Commission Public Forum, supra} note 156, at 229-30 (statement of Edward Geng, Senior Vice President, FRBNY).

\textsuperscript{238} See Memorandum from Richard G. Ketchum to John R. Shad (Apr. 9, 1985), reprinted in \textit{House Hearings, supra} note 95, at 381.

\textsuperscript{239} See \textit{id.} at 393; see also \textit{BBS Hearing, supra} note 9, at 66 (statement of John R. Shad, Chairman, SEC) (no assurance that regulations will eradicate losses); Ingersoll, \textit{SEC Should Be Empowered to Regulate U.S. Securities, Some in House Suggest}, Wall St. J., Mar. 22, 1985, at 4, col. 2.