note had moved considerably out of line from surrounding market rates, and the notes were "on special" in the repurchase agreement (repo) market.³

The second incident involved the two-year Treasury note auctioned on May 22, 1991. In that auction, Salomon Brothers Inc. (Salomon), a major participant in the market, submitted large, aggressive bids for itself and two of its customers and was awarded a large portion of the amount sold. As a result of these awards and additional purchases in the market, there was a concentration of holdings of the May two-year notes and the prices of the notes in the cash and financing markets were distorted. At that time, a number of market participants contacted the Treasury and the Federal Reserve Bank of New York (FRBNY) expressing concern about a shortage in the May two-year note.4

The apparent short squeeze was serious enough that Treasury officials informed staff of the Securities and Exchange Commission (SEC) of possible problems and trading irregularities stemming from the auction and subsequent trading. Following that notification, the Treasury and the FRBNY actively monitored the market for the May two-year notes and the SEC and Justice began investigations. The government investigations, and Salomon's internal review that was conducted in response to these investigations, ultimately resulted in a series of disclosures by Salomon in August 1991 that it had submitted unauthorized customer bids in several auctions in 1990 and 1991.5

The events involving the bidding improprieties of Salomon and the squeezes of Treasury notes also focused attention on large investment entities ("hedge funds" ⁶ being one of the more prominent types) that play a major role in the government securities market. Many of these investment funds, however, are exempt from most types of U.S. regulatory oversight.

While large investment funds have regularly placed bids in Treasury auctions in the past, it was not until late 1990 that these funds began to be awarded large amounts of securities in Treasury auctions, suggesting that they

Regulators had little, if any, authority to gain access to information about the holdings of many major investors. Investment funds, other than those required to register under the Investment Company Act, e.g., mutual funds, are not generally subject to SEC oversight.7 The SEC also has little authority to obtain regular information on the government securities activities of large investors. Treasury also has little access to information on their activities, other than auction-related information. The CFTC is the only regulatory agency with regular reporting contact with certain large investors. However, the CFTC's responsibilities extend primarily to the futures market.

B. Regulatory Agencies Responses to Market Problems

Beginning in September 1991, the Treasury, the SEC and the Federal Reserve conducted a thorough examination and review of the government securities market and published the *Joint Report* in January 1992. This report contained many legislative and regulatory recommendations for strengthening oversight of the market.8 One recommendation, which is the focus of this advance notice of proposed rulemaking, involved clarifying and expanding Treasury's authority under the Government Securities Act of 1986 (GSA) to require reporting by all holders of large positions in Treasury securities. The Treasury's authority to prescribe recordkeeping and reporting rules under the GSA, prior to the amendments of 1993, permitted a large position reporting system designed to monitor concentrations of positions at government securities brokers and dealers.

The Treasury also took administrative and regulatory actions to strengthen oversight and surveillance of the market and maintain a fully competitive

auction process.9 A few of the more significant reforms that are related to the issues addressed in this notice involved improved surveillance of the market and the establishment of an automated system of auctioning Treasury securities. A new surveillance working group (comprised of Treasury, FRBNY, SEC, Federal Reserve Board, and CFTC officials) was formed to improve surveillance and strengthen regulatory coordination. FRBNY, acting as Treasury's fiscal agent, as well as to support their monetary policy operations, has enhanced and expanded its market oversight efforts for collecting and analyzing information needed for surveillance purposes. In addition, the Treasury increased the maximum amount from \$1 million to \$5 million for noncompetitive tenders; published a thoroughly revised, comprehensive Uniform Offering Circular for Treasury securities to codify and clarify Treasury auction rules; and in August of 1992, began auctioning 2- and 5-year notes using a single price auction (or so-called "Dutch auction") experiment.

C. Congressional Response to Market Problems—Government Securities Act Amendments of 1993

The short squeezes of the Spring of 1991 and the revelations in August 1991 of wrongdoing by Salomon in the purchase and sale of Treasury securities occurred during a period when Congress was considering government securities legislation to, among other things, reauthorize Treasury's rulemaking authority under the GSA, which was set to expire on October 1, 1991. 10 These events in the government securities market sparked an extensive review of the operations of the market and the need for additional reforms to strengthen its regulation. Numerous Congressional committee hearings and legislative mark-up sessions were held in both the Senate and House of Representatives from May 1991 through the Fall of 1993.

Although, as noted, the Treasury instituted several reforms in response to the Salomon violations and short squeezes, the Treasury also requested expanded and strengthened regulatory power over the government securities market which was realized in the Government Securities Act Amendments of 1993 (GSAA), which

had highly leveraged positions. Like most investors, they typically bid through major primary dealers. The combined awards of the investment fund and the dealer which submitted such bids would often represent a significant portion of the publicly offered amount of securities.

³ A security is said the be "on special" when, due to its scarcity, a holder can enter into a repo involving that specific security at a lower rate of interest, and thus a lower financing cost, than the prevailing or general repo rate.
⁴ Information about primary dealers' positions in

⁴Information about primary dealers' positions in Treasury securities is collected routinely by the Federal Reserve Bank of New York.

⁵ See Salomon Press Releases dated August 9 and 14, 1991.

 $^{^{\}rm G}For$ a detailed discussion of hedge funds, see the Joint Report, at B–64.

Most investment interests in investment partnerships are not registered pursuant to the Securities Act of 1933; hedge fund structures are such that they claim an exemption from registering as securities dealers under Section 15(a) of the Securities Exchange Act of 1934; and a hedge fund is usually structured so as not to be an investment company under the Investment Company Act of 1940. However, the anti-fraud provisions of the federal securities laws do apply to hedge funds whether or not they are registered with the SEC.

⁸ Joint Report at xv-xvi and 6-34.

⁹ See Joint Report, at xiii-xv, for a description of the administrative and regulatory actions taken by the regulatory agencies.

¹⁰ Treasury's rulemaking authority did expire and it was without such authority from October 1, 1991, until December 17, 1993, when the Government Securities Act Amendments of 1993 (P.L. 103–202, 107 Stat. 2344 (1993)) was signed into law.