Salomon and the Treasury Securities Auction

In early June 1991, Salomon Vice-Chairman John Meriwether had a problem. The U.S. Treasury was inquiring about the possibility that Salomon had engineered a "squeeze" in the market for $12 billion in new Treasury notes auctioned on May 22, 1991. Ordinarily, the Treasury's concern over the possibility of a squeeze was not particularly problematic. Squeezes—that is, an unpredicted shortness of supply or high demand for a security—were not uncommon and developed for a variety of reasons. Unfortunately, Meriwether had reason to believe that one of Salomon's bond traders had recently violated the Treasury's auction rules. Paul Mozer, the managing director under Meriwether overseeing Salomon's trading in U.S. Treasury securities, had disclosed to Meriwether in late April that he had broken the Treasury's limit on the size of a dealer's bid in Treasury auctions. Mozer had admitted that he submitted a bid in a February auction using the name of a customer without authorization and had managed to buy more bonds than the Treasury guidelines allowed.

The problem struck close to the heart of Salomon's business. Although Salomon was among the leaders in the traditional investment banking activity of debt and equity underwriting—acting as the intermediary between issuers of new securities (corporations and governments) and the investors who bought them—its trading in securities markets drove the firm's profitability and was a key part of its heritage. Profits from "principal transactions," largely the buying and selling of securities for Salomon's own account, generally provided 20% of Salomon's revenues, considerably more than the 10% to 12% found at most investment banks (Exhibit 1). In addition, Salomon's corporate culture revolved around trading. The CEO's desk was located on the firm's trading floor and seven of Salomon Brothers's nine vice-chairmen had come up through the trading side of the business. John Gutfreund (pronounced goodfriend), Salomon's chairman and CEO, had also worked his way up to the top of the firm as a successful trader.

Salomon and the Investment Banking Community

The primacy of bond trading at Salomon Brothers dated to the firm's founding in 1910, when the social dynamics of investment banking limited the firm's opportunities. At the time of Salomon's founding, an aristocracy of established firms such as Morgan Stanley, Kidder...
Peabody, and Kuhn Loeb controlled the traditional investment banking activity of securities underwriting. As underwriters, these banks worked closely with the finance departments of large corporations to help them raise capital by selling new equity securities (stocks) and debt instruments (notes and bonds) through each bank's sales force. In exchange for a guarantee to buy any new securities that outside investors were unwilling to buy, the investment banks received an underwriting fee. At the time of Salomon's founding, only the reigning investment banks had the connections and reputations necessary to approach potential investors and assure them of the quality of the new securities. With this distribution capability, the established investment banks could assure their corporate customers that they would be able to find enough investors for the new securities.

In contrast, the original three Salomon brothers, Arthur, Percy, and Herbert, were recent entrants to both the country and the investment banking industry and had little access to the wealthy investors who controlled much of the country's capital before the Second World War. As a result, Salomon was less able to approach the large corporations as an underwriter because it lacked adequate placement power (the ability to find investors for new securities). Instead, the firm focused on U.S. Government debt where the Treasury selected underwriters on the basis of competitive bids and Salomon could place the new securities with insurance and trust companies rather than individuals. Unlike corporations that hired underwriters for new securities, the U.S. Government did not pay underwriting fees. Instead, Salomon and other Government debt underwriters made their money by buying the securities in a Government-run auction, then reselling them to investors at a slightly higher price.

To carve a place for itself in U.S. Government debt underwriting, Salomon worked hard to build its reputation for customer service. A key element of this service was the firm's commitment to trading and making a market in the securities it sold. When it placed new U.S. Government securities with a customer, the firm stood ready to buy them back at the prevailing market price if the customer needed to sell the bonds. If another customer for the bonds could not be found immediately, Salomon carried the bonds in its inventory. This willingness to trade earned Salomon the loyalty of many of its customers.

Carrying bonds in inventory entailed considerable risk, but the trading skills that this risk forced Salomon to develop ultimately proved quite lucrative. While the bonds were held in inventory, a fall in prices could cost the firm dearly. As a result, Salomon had to hone its trading skills so that it did not get caught by changing market conditions. Conversely, an upward movement in the price of bonds held in inventory could generate substantial profits. As Salomon's knowledge of the bond markets grew, the firm expanded its trading activities beyond that which was necessary to meet the needs of its customers and began seeking trading opportunities that generated profits for the firm.

In contrast to Salomon's emphasis on trading, the more traditional firms continued to focus on corporate securities underwriting. Although these banks had to engage in some trading as a service to their customers, these activities were secondary to the underwriting and advisory services they provided to their corporate customers. The bulk of their income resulted from the fees they received for underwriting new securities. Several of these banks extended their

2. Ibid. pp. 33 & 66.

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traditional underwriting relationships with large corporations into the area of investment advice on mergers and acquisitions. For a fee, these firms would help their clients evaluate potential acquisitions or respond to merger proposals. (In the merger boom of the 1980s, this line of business proved exceptionally lucrative.)

Salomon eventually built a successful corporate underwriting business, ranking fourth among its United States-based competitors in 1990. However, its core competence remained in the buying and selling of securities for its own account. The firm's $52 billion inventory of securities dwarfed that of Merrill Lynch, the leading corporate underwriter on Wall Street, due largely to the enormous trading positions that Salomon was willing to take. Consistent with this large inventory, Salomon had a $3.5 billion capital base that was easily the largest among investment banks.

Salomon's trading orientation and culture made it possible for "star" performers to shine. Successful traders were highly compensated and favored with managerial responsibilities. For example, Lewis Ranieri rose from the trading desk to vice-chairman of Salomon because of his success in developing mortgage backed securities. Beginning in 1979, Ranieri created the market for these newly developed securities, and then built a team of traders, analysts, and salespeople who dominated the product into the mid-1980s. In its heyday, the mortgage backed securities trading desk reportedly accounted for 50% of Salomon's net earnings, generating an estimated $225 million in 1985.

In the late 1980s, the bond arbitrage group and its traders rose to prominence within the firm. In its simplest form, arbitrage involved buying securities at a low price in one market then selling them in another market at a slightly higher price, or trading to take advantage of price discrepancies between two securities. Although price discrepancies were often small and transient, firms that were willing to commit large amounts of capital could generate substantial returns from these small opportunities.

Salomon's John Meriwether, who headed the firm's arbitrage unit until the late 1980s when he was picked to head all of Salomon's fixed income securities activities, was one of the first people on Wall Street to spot the opportunities presented by sophisticated arbitrage trading. Under his direction, the arbitrage unit became an acknowledged star in the Salomon organization. In 1990, the group produced an estimated $400 million in profits for Salomon, roughly 80% of the firm's pre-tax earnings.

In spite of its contribution to Salomon's bottom line, the bond arbitrage unit had raised a considerable amount of rancor within the firm in 1990 because of a controversial compensation system it negotiated with Chairman John Gutfreund and Salomon President Thomas Strauss. Under the compensation arrangement, the twelve members of the arbitrage unit shared a bonus pool equal to 15% of the profits that the unit earned. In 1990, the group's bonus pool was reported to total $60 million. The five most senior managers of the unit shared 90% of the bonus pool, with Lawrence Hillibrand, the unit's head, receiving an estimated $23 million bonus.

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4. A mortgage backed security was an interest-paying ownership share in a pool of mortgages.
6. Fixed Income securities consist of debt securities issued by governments and corporations.
8. Ibid.
The size of the bonuses angered many managers within other areas of Salomon, whose compensation continued to be based on more subjective evaluations of how their units performed and the overall performance of the firm. Notwithstanding these managers' complaints, total compensation at the firm had risen by 22% since 1988, while Salomon's profits had fallen by 19%. By 1990, 106 people earned more than $1 million per year.9

**Salomon's Government Bond Trading**

Among participants in the market for U.S. Government securities, Salomon had the reputation as the biggest and most active trader. Approximately $20 billion in Treasury bills, notes, and bonds (short-, medium-, and long-term securities) moved through its trading operation each day.10 The firm bid aggressively for new securities in the Treasury auctions and held large inventories of those securities it believed would rise in value. In addition, Salomon often acted as the buyer of last resort when its customers needed to sell securities in weak markets. Customers might not like the price Salomon offered, but they knew the firm would submit a bid.

Salomon's large share of the Government bond trading activity allowed the firm to make money on trades where other dealers could not. Unlike equity securities, Treasury securities were not traded on an exchange where all participants in the market could easily see the going price for a given security. Government securities were traded over the telephone and often, only the two parties involved in the trade knew the price and volume of the transaction. Therefore, the largest firms that handled the most transactions had the best information about which investors were seeking to buy or sell U.S. Government securities.11 This knowledge of "who holds the bonds" allowed Salomon to see and act on opportunities before its competitors.

For example, two days before the May 22, 1991 auction for $12 billion in 2-year notes, Steinhardt Partners, a large New York money manager, approached Salomon with a request to finance a $6 billion position in the forthcoming notes. Essentially, Steinhardt had committed to buy $6 billion worth of notes and needed to borrow the money to pay for them when it took delivery after the auction (a common practice on Wall Street). This request signalled to Salomon that demand for the notes in the auction would be brisk. As a result, Salomon bid aggressively in the auction on the assumption that the notes would rise in value because the high demand would lead to an escalation in the price of the securities.12

Since 1988, Paul Mozer had directed Salomon's Treasury bond trading activities with the assistance of another managing director, Thomas Murphy. The two oversaw six traders arranged in a cluster of desks on the bond trading floor and assigned to securities of varying maturities. The close physical proximity of the bond group meant that each trader could overhear the activities of the other members of the group, and therefore, incorporate the changes in securities of one maturity quickly into trading decisions for another. Both Mr. Mozer and Mr. Murphy reported to John Meriwether, whose desk on the trading floor allowed him to observe, hear, and manage the sea of fixed income securities traders spread out over the entire forty-first floor of

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Seven World Trade Center in lower Manhattan. Mr. Meriwether, in turn, reported to both Thomas Strauss and John Gutfreund.

Mr. Mozer had joined Salomon Brothers as a corporate bond salesman in 1979 after completing a master's degree in management at Northwestern University and a bachelor's degree in economics from Whitman College in Walla Walla, Washington. After switching to U.S. Treasury securities in 1980, Paul Mozer steadily worked his way up the Salomon hierarchy until he was named a managing director in 1985, working for John Meriwether's bond arbitrage group. After only a year and one-half as a managing director, senior managers asked Mozer to head Salomon's Treasury securities trading activities.13

As the head of U.S. Government bond trading activities, Paul Mozer's energy, intelligence, and fairness earned him the respect of his colleagues at Salomon. Confident yet soft-spoken and composed under pressure, Mozer was a hard working trader who kept in constant touch with the bond markets. He also maintained close relationships with Salomon's clients. Mozer often talked to the firm's largest customers and took their orders directly rather than communicating via Salomon's bond sales force.14 His trading instinct, hard work, and close relationships with the firm's customers made him an unqualified success at Salomon and earned him a reported $10 million in bonuses between 1988 and 1990.15

The Treasury Securities Market

At $2.4 trillion, the public market for U.S. Government debt was the largest securities market in the world. On average, $110 billion in securities traded hands every day, making the Treasury securities market the most liquid as well. This liquidity—the ability to immediately find a buyer or seller for virtually any volume of securities—made Treasury securities particularly attractive to many investors and reduced the Government's borrowing costs. Each week the U.S. Treasury sold approximately $30 billion in new Treasury securities of selected maturities, ranging from 90 days to 30 years. In a typical year, the Treasury conducted over 150 separate auctions. The new securities sold in these auctions replaced maturing Government debt and funded the ongoing deficits of the U.S. Government. Once issued, Treasury securities quickly changed hands and moved throughout the globe in an active "secondary" market. In this market, the investors, brokers, and dealers holding U.S. Government debt could sell the securities to others seeking investments that were free of credit risk.

The Market for Government Securities

There were vast numbers of investors, brokers, and dealers in the market for U.S. Government securities. Investors typically bought the securities and held them to maturity or until they found more profitable investments in which to invest. The brokers generally acted as intermediaries between investors, buying from one and quickly reselling to another. Brokers invested very little of their own money in Treasury securities and held only enough securities in inventory to serve the needs of customers who wished to buy U.S. Government debt. Their earnings were based on the narrow spread that they maintained between the price at which they

14. Ibid.
purchased the securities (the bid price) and the price at which they sold them (the asked price). The dealers, in contrast, actively invested their own capital in principal transactions and attempted to make money from the changes in the price of securities over time.

The large number of players in the U.S. Government bond market forced profits down to an absolute minimum. Therefore, successful bond trading required a willingness to exploit any opportunity that presented itself. Since information was key to the market, traders ruthlessly turned any confusion or misjudgment on the part of their fellow traders into a profit for their firm's account. In the words of Salomon Chairman and erstwhile trader John Gutfreund: "It's a harsh world, where mistakes are not charitably dealt with."  

In the January 1990 auction of 40-year bonds, for example, several dealers were duped into buying the new issue when one of the large dealers started a rumor that a major pension fund would place a substantial bid for the bonds. At the time, many dealers were uncertain about the demand for an issue with a maturity considerably longer than the Treasury's benchmark 30-year bonds. The rumor that a major investor would bid on the bonds eased the concerns of many dealers and encouraged them to bid aggressively at the auction. After the auction, bond prices fell when the rumor proved to be false and customer demand for the bonds failed to materialize. Dealers who sat out the auction then earned hefty profits by buying the notes cheaply from dealers who had believed the rumor and gotten stuck with the notes.

Primary Dealers

Salomon Brothers was the largest and most active of a group of Treasury market participants designated as primary dealers by the Federal Reserve Bank. The term primary dealer referred to the fact that the Federal Reserve Bank bought and sold securities only from these dealers when it implemented money supply policy through its open market committee. The Fed also permitted primary dealers to submit bids on behalf of other investors in the Treasury's weekly auctions of new securities. As of August 1990, the Fed had 39 primary dealers with which it maintained this special relationship. In exchange for the special treatment provided to primary dealers, the Fed required these dealers to bid at every Treasury auction and to actively make a market in Treasury securities of all maturities.

From a securities dealer's perspective, the primary dealer designation provided several benefits but not necessarily higher profits. First, the title provided a measure of self-assurance because it was limited to only those firms that the Fed recognized as leaders in the U.S. Government securities market. Second, the Fed allowed primary dealers to submit bids without a deposit. Most other bidders had to deposit the full amount of their bid at the Fed or present a guarantee from a commercial bank or primary dealer. Third, the ability to bid for other buyers provided primary dealers with additional market information with which to improve the accuracy of their bidding efforts. Finally, the information about market conditions gathered in the Treasury auctions could be leveraged in the markets for many other securities that were either

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18. The Fed open market committee bought securities from primary dealers when it wished to increase the money supply and sold securities to primary dealers when it wished to decrease the money supply.
19. The Fed also permitted commercial banks and other depository institutions to submit bids on behalf of other customers.
linked or strongly influenced by the market for U.S. Government debt. Unfortunately, these benefits did not translate into consistently higher profits from Treasury securities. As recently as 1989, primary dealers as a group lost $10 million on their U.S. Government securities business. As a result a number of securities firms had withdrawn as primary dealers since the group peaked at 46 in 1988.

The Treasury Securities Auctions

At regularly scheduled weekly intervals, the Federal Reserve Bank, acting as the Treasury's fiscal agent, conducted the Treasury securities auctions by accepting competitive bids from interested bond buyers. In the auction, potential buyers submitted bids to the Fed that stated the amount of securities they were willing to purchase and the yield that they required on the securities. For example, a dealer might submit a bid for $100 million in 2-year notes at a yield of 6.51%. The yield a bidder requested was the effective interest rate at which the buyer was willing to loan money to the U.S. Government.

After receiving tenders from all interested buyers, the Fed awarded the securities to the bidders in order of lowest yield to highest. That is, the Fed first filled the bid of the buyer requesting the lowest interest rate. Next, it filled the bid of the buyer requesting the next lowest interest rate, and so forth until the entire issue had been awarded. In virtually every auction, the Fed reached a point where the bids at a given yield exceeded the number of securities still to be awarded. At this point, known as the "stop-out yield," the Fed allocated the remaining securities among all the bidders who submitted bids at the stop-out yield. These bidders received a prorated share of the remainder based on the size of their bid relative to all bids received at the stop-out yield. For example, in the February 21, 1991 auction of 5-year notes, the notes available at the stop-out yield amounted to only 54% of the amount desired at that yield. Therefore, bidders at the stop-out yield received only 54% of their bids (Exhibit 2). Because of the efficiency of this market, the interest rate spread between the lowest bidder and the highest bidder receiving securities generally ranged from .02 to .03 percentage points (2 to 3 basis points).

In spite of its size and importance, the Treasury auction was probably the least automated securities market in the United States. Bond dealers bought and sold huge volumes of securities through verbal agreements made over the telephone. These transactions were largely governed by the unwritten code of ethics among traders, "my word is my bond," a code so strong it was given the weight of a legal contract. The legality of these verbal agreements was clearly illustrated by a court case involving a savings and loan that reneged on a telephone commitment to buy mortgage backed securities from Salomon Brothers. In its case, the thrift argued that the transaction was a real estate deal and in real estate, an oral agreement was not binding. In the end, the court ruled in Salomon's favor, deciding that the deal was a bond transaction and therefore, that oral commitments were binding.

In bidding at Treasury auctions, the dealers frantically took orders from their customers over the telephone as the auction approached. Just before the 1:00 PM deadline for bids, the dealers called their runners in the lobby of the Federal Reserve Bank of New York with

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20. The yield quoted was the total yield to maturity and represented the internal rate of return generated by the future interest payments (coupons) and repayment of principal at maturity.
instructions for bidding. The runners filled out paper copies of the dealers' orders and literally stuffed them into a box at the Fed. Two hours later the Fed announced the winners of the auction.

The bidding among dealers in the auction was extremely competitive and very sophisticated. Bidders in the Treasury securities auctions always tried to bid a yield just low enough to get their orders filled. If they bid a yield too high, dealers ran the risk of not receiving any securities or only a portion of their bids, in which case, they might not have enough securities in inventory to sell to their customers. Conversely, if they bid a yield too low, the dealers would fill their orders but at a yield that might be below the average interest rate and leave them with bonds that would have to be sold at a loss. In the days and hours leading up to the auction, dealers and investors discussed their likely orders in an elaborate ritual of bluffing and betting. Each player tried to sway the others' perception of the market in a manner that would create a profitable opportunity in the auction or later secondary market. David Mullins, vice-chairman of the Federal Reserve Bank, once quipped that the U.S. Government securities market was full of "dealers who'd turn in their grandmothers for a quarter of a point."22

Given the often conflicting information prior to an auction, market share was critical to successful bidding. Those firms with the largest share in U.S. Government securities markets had the best feel for the likely yield on a new issue. This superior information, in turn, attracted more customers and extended the firm's reach into the market, enhancing further its information and position. Therefore, the major dealers sought to capture a significant share of each auction at the highest yield in order to maintain their position.

The competition for market share between the major dealers in the securities market spilled over into the markets for securities issued by quasi-government agencies like Fannie Mae and Freddie Mac.23 In the auctions for the securities issued by these agencies, dealers routinely bluffed each other and the agencies by overstating their customers' interest in the new issues. As Fannie Mae Chairman James Johnson once conceded, dealers' orders always contained "a certain amount of puffery, hype, and uncertainty."24

Regulation25

The Treasury securities auction and secondary market were governed principally by the actions of the Department of the Treasury. These actions were both informal and evolutionary, driven by the Treasury's perception of the changing dynamics of the market. In general, the Treasury would reject any bid it deemed disruptive to the auction. On August 27, 1962, for example, the Treasury rejected a bid that would have given a dealer an exceptionally high portion of an auction for 3-month Treasury bills. The next day, the Treasury announced that it would limit auction winners to a maximum award of not more than 25% of any new issue of 3- or 6-month Treasury bills. No limits were placed on the size of bids, but a bid in excess of

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23. Fannie Mae, the Federal National Mortgage Association, was created in the 1960s to insure home mortgages. It was subsequently sold to the public in the 1970s. Freddie Mac, the Federal Home Loan Mortgage Corporation, was created by the Federal Home Loan Bank (the central bank for the savings & loan system) to insure mortgages issued by S&Ls. These agencies buy mortgages, package them into securities and then resell them via securities dealers.
25. Research Associate Michael A. Santoro assisted in the preparation of this section under the supervision of Professor Lynn Sharp Paine.
25% of the auction would not be filled above the 25% award limit. Subsequently, it became generally understood that the 25% rule applied to Treasury securities of all maturities, although the Treasury never announced formally any additional rule changes. After some minor modifications in the intervening years, the Treasury announced via a press release in 1981 that it would raise the award limit to 35%.26

The market for Treasury securities was also governed to a limited extent by the Securities and Exchange Commission (S.E.C.), which implemented regulations set forth in the Securities Exchange Act of 1934 (often referred to as the Exchange Act). Section 10 of the Exchange Act gave the S.E.C. the authority to protect investors from "any manipulative or deceptive device" in the sale of securities (Exhibit 3). Under Section 10, the S.E.C. could issue rules banning specific activities as per se manipulative. In addition, the S.E.C. could bring a court action against brokers and dealers that had acted in a way that the S.E.C. believed violated Section 10, even if the dealer or broker had not broken a specific rule. The Exchange Act also gave the S.E.C. authority to issue rules governing record keeping (Section 17) and officer liability (Section 20). However, the S.E.C. believed that its authority in the Government securities markets was extremely limited and had historically deferred to the Treasury with respect to the regulation of Treasury securities.27 Thus, there were no specific S.E.C. rules explicitly governing the auction and sale of Treasury securities.

Although Congress modified the Exchange Act in 1986 to give the Treasury (but not the S.E.C.) formal rule-making authority over the market for Government debt, the Treasury chose not to issue formal, codified rules in the belief that new rules would create unnecessary costs, reduce the efficiency of the Government debt market, and ultimately increase the borrowing costs of the United States Government. Instead, the Treasury continued to rely upon informal rule announcements via press releases. These rule changes were based in part upon feedback the Treasury received during quarterly meetings with representatives of several large U.S. Government securities dealers. At these informal meetings, the Treasury suggested possible changes and asked the representatives of the dealers to comment.

The New Bidding Regulations

The Treasury's 35% limit on awards remained the only significant limit on the auction until the summer of 1990, when the regulators began to worry about the inflation in bids at the stop-out yield by the large bidders. Because the Fed awarded a prorated share of the issue to all bidders at the stop-out yield, Salomon and other large bidders used a bidding strategy that entailed submitting very large orders at the estimated stop-out yield in order to increase their prorated share. Salomon also used a similar approach in submitting bids for its customers. The strategy generally resulted in Salomon and its customers receiving the largest shares, often up to the 35% maximum, among all bidders at the stop-out yield. In 30 out of the 230 auctions of notes and bonds held between 1986 and 1990, Salomon and its customers acquired in aggregate over 50% of the securities in the auction.28 (Neither Salomon nor any of its customers received more than the 35% maximum award in any of these auctions.)

Salomon's aggressive strategy raised concerns among Treasury officials who worried that the firm's bidding might undermine the integrity of the auctions. On June 27, 1990, Salomon submitted a bid that exceeded the total value of the issue. Michael Basham, the deputy assistant secretary of the treasury for federal finance, promptly warned Salomon about submitting excessively large bids. The conflict came to a head two weeks later when Salomon submitted a massive bid of $30 billion for $10 billion in 30-year notes. The size of the bid, three times the total size of the auction, embarrassed the Treasury and prompted an immediate response from Michael Basham. He announced that, henceforth, the Treasury would not accept any bid, either for a dealer's own account or on behalf of its customers, in excess of 35% of the total auction. At the time, Michael Basham commented: "We want to maintain the competitive nature of the auction process for the taxpayers as well as the investment community.

In response, Paul Mozer blasted the Treasury for its attempts to curtail Salomon's bidding activities: "The Treasury made a rash decision without consulting the dealer community about this change. . . . Potentially, this ties the hands of the larger dealers, who, time in and time out, buy the bulk of the debt." He went on to note that curbing the big dealers' ability to take large positions in the auction could undermine their ability to provide the liquidity that was an essential component of the Treasury securities markets. Mozer's outburst rankled Basham and led to chilly relations between Mozer and the Treasury (the new rule became known on Wall Street as the Mozer/Basham rule). As a result of the bitterness, Mozer's assistant, Thomas Murphy, took over the responsibility of interacting with the Treasury.

The conflict between Salomon and the Treasury highlighted an inherent ambiguity in the Treasury's role. On the one hand, the Treasury needed to find a market for the $30 billion in new Government debt that was auctioned each week. To this end, the Treasury wanted to ensure that bidders in the auction made enough profit to compensate them for assuming the risk inherent in underwriting new Government debt. Since the large dealers like Salomon took the bulk of each auction, the Treasury had an undeniable interest in seeing that Salomon and the other large dealers earned a profit on their Government debt underwriting activities. On the other hand, the Treasury had responsibility for regulating the auctions and ensuring their fairness. If the market perceived that Salomon and other large dealers had too large an advantage in the auction, smaller dealers might choose not to participate, thus reducing competition and ultimately raising the Government's borrowing costs.

Mozer's Treasury Auction Activities

When Paul Mozer came to John Meriwether on April 27, 1991, he disclosed that he had used a customer's name without authorization. Mozer admitted that on February 21, 1991, he submitted an unauthorized bid for 35% of the $9 billion 5-year note auction in the name of Warburg, a Salomon customer, in addition to a bid for 35% in Salomon's name. Salomon's two bids turned out to be at the stop-out yield and the Fed awarded $1.7 billion in notes each to Salomon and Warburg. After the Auction, Mozer instructed the trading desk to transfer the notes awarded to Warburg to Salomon's account and to suppress the written customer bid.

32. This section draws heavily on the written statement of Salomon Inc submitted in conjunction with the testimony of Warren Buffett before the House Subcommittee on Telecommunications and Finance on September 3, 1991.
confirmation of the activity. In the end, Salomon ended up with 38% of the auction, only slightly more than the 35% limit because the unauthorized Warburg bid crowded out Salomon's own bid and lowered the proration percentage to 54%.

What brought Mozer to Meriwether's desk was the fact that the Federal Reserve had noticed that Warburg had submitted two different bids in the auction, one for its own account of $100 million and another via Salomon Brothers for $1.7 billion. When the Fed contacted Salomon to ask about the Warburg bid, Mozer instructed Thomas Murphy to tell the Fed that the bid should have been in the name of Mercury Asset Management, an operationally separate affiliate of S.G. Warburg, another primary dealer.

When the Fed forwarded the correction received from Salomon to the Treasury, the Treasury decided that the relationship between S.G. Warburg and Mercury Asset Management was close enough to limit the combined bids of both entities to 35% of the auction. In a letter dated April 17, 1991 sent to the head of Mercury, the Treasury reviewed the two bids by Warburg and noted that the legal relationship between the two required that they limit their combined bids to 35% of an auction. The Treasury sent a copy of the letter to Paul Mozer, S.G. Warburg, and S.G. Warburg, plc, the parent of Mercury and S.G. Warburg.

In an effort to stem any further investigation by the Treasury, Paul Mozer contacted Mercury and requested that the firm not respond to the Treasury's letter. Mozer explained the problem as a mistake and asked that Mercury not embarrass Salomon by volunteering information about the mistake to the Treasury. Thomas Murphy also tried unsuccessfully to set up a meeting between Paul Mozer and an acquaintance of his at S.G. Warburg, who happened to be the managing director who had received the Treasury's letter. When Murphy failed to arrange a meeting, Mozer notified Meriwether on April 27, 1991 of the Treasury's letter. In the meeting, Meriwether warned Mozer "that the matter was very serious and represented career-threatening conduct." When Meriwether pressed Mozer on the extent of his unauthorized use of customers' names, Mozer had assured him that there had been only one such incident.

Over Mozer's objections, Meriwether immediately notified Tom Strauss and informed him of Mozer's disclosures. The following morning, April 28, 1991, Meriwether, Strauss, and Donald Feuerstein, Salomon's chief legal counsel, met to discuss Mozer's admissions. All three agreed that John Gutfreund, who was traveling on business at the time, needed to be informed of the violations. When the group informed Gutfreund the next day, April 29, 1991, all four agreed that they had to report Mozer's offense to the regulators supervising the sale of Treasury securities. The group discussed how best to report the matter, but did not reach a decision on how to approach the Government with the disclosures. Mozer remained the head of the Treasury securities trading activities.

The May Squeeze

Mériwether's attention was drawn again to Mozer's Treasury securities trading activities shortly after the May 22, 1991 auction of $12 billion in 2-year notes. In that auction, Paul Mozer submitted a $4.2 billion bid in Salomon's name (34% of the auction), a $2 billion bid for Tiger Investments (17% of the auction), and a $4.3 billion bid for Quantum Fund (35% of the auction).
auction). All three bids were at the aggressive yield of 6.81%, two basis points below most dealers' expectations for the auction. As a result, Salomon's and its customers' bids offered the Government the best rate in the auction and the Treasury awarded Salomon, Tiger, and Quantum the full amount of their bids without proration.

Salomon and its customers now controlled $10.6 billion of the new notes awarded to bidders at the May 22 auction. One week after the auction, Tiger sold its entire position to Salomon, which in turn sold $600 million in notes to Quantum. These two transactions occurred at market prices that were higher than the auction price and generated a profit for Tiger. Salomon and Quantum continued to control the majority of the notes issued in the auction.

After the auction, the 2-year notes rose in price as dealers scrambled to buy notes with which to meet their commitments to provide new notes to their customers and other dealers. Because so few notes were available for sale after the auction, many dealers had to borrow them from Salomon and Quantum under "repurchase agreements," a standard arrangement under which the notes would go back to Salomon after a specific period of time. Because of the short supply, Salomon and Quantum were able to charge a higher than normal interest rate for the temporary use of the new notes.

For example, Michael Irelan, a trader for St. Louis-based Boatmen's Bank, had made pre-auction commitments to deliver $120 million in notes to other dealers after the auction. In making these commitments, Irelan had ignored the advice of his friend, Thomas Murphy at Salomon, who had suggested that demand for the notes would be high after the auction and that they would be hard to find. After the auction, no notes were available and Irelan was forced to borrow them from Salomon, costing Boatmen's Bank a net loss of $8,000 per day.35

Irelan was not alone in getting caught in the May squeeze. Many speculators had expected lackluster demand for the notes and declining prices after the auction. Together with Irelan, they complained bitterly to the Fed about Salomon's position. In response to these complaints, the Fed contacted Salomon and asked that it sell or loan its 2-year notes to alleviate the squeeze. Paul Mozer told the Fed that he would do what he could to make sure that the notes were available to short sellers at a rate that allowed them to meet their commitments.

Tight markets like the May squeeze were not uncommon in Treasury trading. Just one month prior, Salomon itself had been caught short of 2-year notes in a squeeze that developed when two large investors, Caxton Corp and Steinhardt Partners, each bought $8 billion of April 2-year notes. The squeeze developed when the two investors sold the securities to foreign banks that would not lend them to dealers on Wall Street. As late as June, many of the biggest dealers continued to lose money in the squeeze.36

Although the Treasury was upset about Salomon's possible involvement in the May squeeze, the U.S. Government and American taxpayers probably benefitted from Salomon's aggressiveness. Salomon's bid of 6.81% saved the Government almost $5 million in interest. Furthermore, most of the large and small investors in the U.S. Government securities market were not hurt. The state governments, pension funds, and government bond mutual funds that held most of the Government debt did not make pre-auction commitments like the ones

arranged by Michael Irelan. If these investors bought the notes at the May auction, they benefitted from the tight conditions that developed.

Meriwether's Concerns

By early June, 1991, Salomon had still not disclosed Mozer's unauthorized bid in the February auction and the Treasury was now upset about the firm's possible role in the May squeeze. As the vice-chairman with responsibility for U.S. Treasury securities trading activities, Meriwether was ultimately responsible for the actions of Mozer and the other traders in his department.
**Exhibit 1**  Selected Financials, Salomon Inc, 1986 to 1990

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(all figures in millions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest and Dividends</td>
<td>$4,932</td>
<td>$4,161</td>
<td>$3,360</td>
<td>$5,758</td>
<td>$5,920</td>
</tr>
<tr>
<td>Principal Transactions</td>
<td>1,064</td>
<td>1,154</td>
<td>1,711</td>
<td>2,513</td>
<td>2,389</td>
</tr>
<tr>
<td>Investment Banking</td>
<td>577</td>
<td>403</td>
<td>564</td>
<td>470</td>
<td>416</td>
</tr>
<tr>
<td>Commissions</td>
<td>208</td>
<td>266</td>
<td>206</td>
<td>226</td>
<td>207</td>
</tr>
<tr>
<td>Other</td>
<td>8</td>
<td>19</td>
<td>35</td>
<td>32</td>
<td>14</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>6,789</td>
<td>6,003</td>
<td>6,146</td>
<td>8,999</td>
<td>8,946</td>
</tr>
<tr>
<td><strong>Interest Expense</strong></td>
<td>(4,484)</td>
<td>(3,973)</td>
<td>(3,541)</td>
<td>(6,093)</td>
<td>(5,959)</td>
</tr>
<tr>
<td><strong>Non-Interest Expense</strong></td>
<td>(1,512)</td>
<td>(1,805)</td>
<td>(1,852)</td>
<td>(2,166)</td>
<td>(2,481)</td>
</tr>
<tr>
<td><strong>Income Before Taxes</strong></td>
<td>793</td>
<td>225</td>
<td>753</td>
<td>740</td>
<td>506</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>516</td>
<td>142</td>
<td>280</td>
<td>470</td>
<td>303</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>78,164</td>
<td>74,747</td>
<td>85,256</td>
<td>118,250</td>
<td>109,877</td>
</tr>
<tr>
<td><strong>Stockholders' Equity</strong></td>
<td>3,454</td>
<td>3,481</td>
<td>3,459</td>
<td>3,565</td>
<td>3,523</td>
</tr>
</tbody>
</table>

Source: Annual Reports, Salomon Inc.

**Exhibit 2**  Example of Treasury Auction Bids and Awards

<table>
<thead>
<tr>
<th>February 21, 1991 Auction of 5-Year Notes (millions)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes Available</td>
<td>$9,040</td>
</tr>
<tr>
<td>Bids at 7.50% (Lowest Yield)</td>
<td>3,914</td>
</tr>
<tr>
<td>Bids at 7.51% (Stop-out Yield)</td>
<td>9,492</td>
</tr>
<tr>
<td>Bids above 7.51%</td>
<td>15,780</td>
</tr>
<tr>
<td>Notes Available</td>
<td>9,040</td>
</tr>
<tr>
<td>less Notes Awarded at Lowest Yield (7.50%)</td>
<td>-3,914</td>
</tr>
<tr>
<td>Notes Available at Stop-out Yield (7.51%)</td>
<td>5,126</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bid Proration at Stop-out Yield:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes Available at Stop-out Yield</td>
</tr>
<tr>
<td>Bids at Stop-out Yield</td>
</tr>
<tr>
<td>Proration percentage</td>
</tr>
</tbody>
</table>

Source: Casewriter's estimates.
Exhibit 3  Selected Sections of the Exchange Act and S.E.C. Rules

Sec. 10(b) [It shall be unlawful] to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [S.E.C.] may prescribe.

Sec. 17 Every . . . broker or dealer who transacts business in securities . . . shall make and keep for prescribed periods such records . . . as the [S.E.C.] prescribes.

S.E.C. Reg. §240.17a-3. (a) . . . every broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934, as amended, shall make and keep current the following books and records relating to his business:

(1) Blotter (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities, all receipts and disbursements of cash, and all other debits and credits.

(3) Ledger accounts itemizing separately as to each cash and margin account of every customer and of such member, broker or dealer, and partners thereof, all purchases, sales receipts, and deliveries of securities and commodities for such account.

(6) A memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted.

(7) A memorandum of each purchase and sale for the account of such member, broker, or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where such purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt, the terms and conditions of the order, and the account in which it was entered.

(8) Copies of confirmations of all purchases and sales of securities, including all repurchase and reverse repurchase agreements, and copies of notices of all other debits and credits for securities, cash, and other items for the account of customers and partners of such member, broker, or dealer.

Sec. 20(a) Every person who, directly or indirectly, controls any person liable under any provision of this title or any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation.

Source: Commerce Clearing House, Federal Securities Law Reports.