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Testimony by

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Thank you for this opportunity to give our views regarding possible amendments to the Government Securities Act of 1986. At the outset, let me note that the Federal Reserve Board continues to support the recommendations of the joint Treasury-SEC-Board study--most importantly, that Congress extend Treasury's rulemaking authority over the market beyond the current sunset date. The experience of the past several years can, in our view, be read as ratifying the importance and usefulness of the Government Securities Act and of the rules Treasury has promulgated under the authority that Act granted it. In its capacity as rulemaker, the Treasury has effectively addressed the concerns about the maintenance of a fair, honest, and liquid market that motivated the original legislation. Thus, in light of both its experience and its special expertise in this market, the Department of the Treasury should retain its current authority to write the rules in the market for government securities.

Before getting into the specifics of other suggested amendments, I would like to lay out the Board's frame of reference in approaching this issue. Specifically, we begin from the premise that it is absolutely essential to preserve the extraordinary liquidity and efficiency of the government securities market. This liquidity both facilitates the implementation of monetary policy through open market operations and allows the Treasury to issue federal debt at the lowest possible cost to the taxpayers. Investors accept a lower rate of return on government securities, in part because they know this market is deep and broad and liquid--large transactions can be made quickly with relatively little effect on prices and can, if need be, reversed just as

quickly with relatively low transactions costs. While we view market liquidity as essential, this is not to say that investor protection is not also a legitimate concern. It is an important concern in its own right, and, if not adequately addressed, a loss of investor confidence in the fairness and functioning of the government securities market could itself impair liquidity.

But any securities regulation involves costs--directly to the issuer, customer, or dealer, as well as indirectly by potentially diminishing the general liquidity of the market. Consequently, in weighing the advisability of new legislation to add regulation, the Congress will, of course, want to assure itself that the expected benefits of any new regulation exceed the associated expected costs. Several years ago, when drafting the Government Securities Act, the Congress explicitly considered the case for broader regulation of sales practices and some other areas, but chose not to make it part of the Act. In the Board's view, a convincing case for calling this decision into question has not yet been made.

In the area of sales practice rules, the General Accounting Office's report in September 1990 recommended that the Congress amend the Securities Exchange Act to authorize a federal agency to adopt rules of fair practice applicable to all government securities brokers and dealers, addressing, at a minimum, dealer markups and investor suitability requirements. The Treasury's proposed legislation would do just that, and would designate the Treasury itself as the federal agency in charge, with quite broad powers in this area.

In taking a closer look at these proposals, our experience in applying markup rules elsewhere suggests that there are significant difficulties and ambiguities in administering such rules fairly. Even if judgments about the reasonableness of markups in this fast-paced market could be made on an ex-post basis, it could be difficult to formulate meaningful criteria for use in making ex-ante judgments and providing guidance to dealers. The government securities market spans a wide range of securities, from the extremely liquid, so-called "on-the-run" Treasury securities, where bid-asked spreads are razor-thin, to the more exotic and sometimes tailor-made hybrids and derivatives, where a fair markup could be sizable.

In the same vein, the Board is concerned that suitability rules could impose a burden on the government securities market by adding to costs, delaying the execution of transactions, and potentially limiting the range of legitimate investments available to a dealer's customers. Moreover, many of the losses in the government securities market cited by the GAO and others in support of sales practice rules have involved large investors, whom one would expect to have the sophistication to judge the appropriateness of various investments themselves. It is doubtful that any suitability rules should apply to those best described as institutional investors.

There are, nevertheless, concerns that smaller and perhaps less sophisticated investors may, at times, have been subjected to high-pressure sales tactics and sold inappropriate investments. As the regulator of state-chartered member banks, some of whom have been the targets of such practices, the Board is aware of this possibility, and

in 1988 the Board, along with the other bank regulatory agencies, adopted a policy statement regarding the selection of securities dealers and unsuitable investment practices. The policy statement lists standards an institution should apply when selecting a dealer and describes the interest-rate risk characteristics of several extremely volatile instruments, such as stripped mortgage-backed securities, noting that such instruments "cannot be considered as suitable investments for the vast majority of depository institutions." The adoption of the policy statement, together with an effort to educate banks to the risks involved, has virtually eliminated the problem for the banks we regulate.

There are other investors for whom this would not be a practical or a complete solution, however, and the Board recognizes that Congress may conclude that additional sales practice rules are desirable to help curb existing or potential abuses. In that case, perhaps the least costly measure would be a simple removal of the prohibition on NASD applying its sales practice rules to government securities transactions. Allowing NASD to apply its existing rules to government securities sales by its members would parallel what is already the case for NYSE member firms, and it would extend coverage to all nonbank brokers and dealers. In this process, which would in essence take place with oversight by the SEC, we would favor substantive consultation and cooperation with the Department of the Treasury as the primary regulator of this market.

In our view, going further than this--to cover bank dealers--is unnecessary, given the lack of allegations of sales practice abuses

involving these dealers. Bank examiners routinely go through customer complaint files, and this is an area in which they simply have not been seeing complaints. We believe that the bank supervisory agencies, through the use of frequent and detailed examinations and other tools at their disposal, have the ability to identify any abuses quickly, should they develop.

The issue of whether legislation is needed to expand access to information about securities trading through interdealer brokers appears at present to be very nearly moot. An independent corporation sponsored by the Public Securities Association and owned by the brokers and dealers is moving toward implementation of its plan to disseminate price and volume information on a fee basis in just a few days. We recognize that this initiative may have been motivated strongly by the possibility of legislative action. But we believe that so long as it is going forward, actual legislation and associated regulatory oversight are unnecessary and could actually constrain rapidly changing market practices. Should this latest private-sector initiative falter, however, or should the information prove inadequate, our view of the desirability of a legislative response likely would change.

With respect to the GAO recommendation that Securities Investor Protection Corporation insurance be extended to customer accounts at registered government securities brokers and dealers, there could be some marginal benefits in terms of customer protection, but other regulatory changes might be necessary in connection with the adoption of this proposal. For example, SIPC has pointed out that the proposal raises major questions about regulatory oversight, because all current

members of SIPC are subject to the full rulemaking authority of the SEC. A range of related questions warrants further study before a definitive conclusion can emerge about the desirability of expanding SIPC coverage.

On a minor note, we question the Treasury's recommendation that the Act be amended to provide for information to be furnished to the Treasury directly by the Federal Reserve Banks, rather than through the Board of Governors, as it is now. Any information that the Treasury might need from the Federal Reserve to carry out its responsibilities under the Government Securities Act likely would be obtained through our supervisory authority, and the Board has detailed, well established procedures concerning the release of such information. The proposed rule change would be inconsistent with those procedures. Accordingly, in the absence of a clear need for such a change, we would oppose it.

Finally, committee staff has requested that we also address a recent episode in the Treasury coupon market, in which strong demands by a few participants apparently "squeezed" others in the market who had committed to deliver last month's two-year Treasury note. As a result, prices were distorted for a time in the market for the security and for its financing. In the wake of that incident, questions have arisen about whether current regulations provide adequate protection against the potential for manipulative practices in this market. As is the case for the other concerns being addressed here today, equitable and nondistorting regulations are not easy to design, and we would counsel caution in expanding regulation lest the cost to the taxpayer be excessive. Certainly, we do not want to interfere with strong bidding for securities that lowers the cost to the taxpayer of servicing the

public debt. But if that strong bidding results in the perception that Treasury securities prices are arbitrary and subject to manipulation, marketmakers and investors could turn away from these instruments, impairing liquidity and ultimately lowering demand in the market with adverse effect on the cost to the government. Both the facts and the outlook in this area are worth studying further, and it may be that additional rules or reporting requirements will be found to be in order. At this point, however, no new legislation appears to be needed, and a range of possible responses could be implemented under the Treasury's existing authority.

In sum, by instituting an effective and comprehensive regulatory structure, the Government Securities Act of 1986 appears to have largely accomplished its goals. It is the Board's position that the need for additional legislation, beyond that already proposed in the joint Treasury-SEC-Board study, has not been decisively demonstrated. Nevertheless, we would not stand in opposition to a modest broadening of the scope of regulation over this market through the removal of the prohibition on the NASD applying its existing sales practice rules to the government securities activities of its members. However, we would view substantial additional regulation as not only unnecessary, but detrimental. The creation of a whole new panoply of rules and regulations likely would prove an inefficient and potentially very costly way of dealing with the relatively few abuses that have occurred in this area.