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Statement of

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Vice Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Telecommunications and Finance

of the

Committee on Energy and Commerce

U.S. House of Representatives

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Mr. Chairman, Congressman Rinaldo, members of the Committee, thank you for this opportunity to present the Federal Reserve Board's views on legislative proposals pertaining to the regulation of the government securities market.

As I noted in testimony before you last month, we view the U.S. government securities market as the most important securities market in the world. It is important for at least three reasons. First, market conditions there determine the cost to the taxpayer of financing U.S. government operations. Second, it serves as the foundation for other money and capital markets here and abroad, and as a prime source of liquidity for financial institutions. Finally, and for us perhaps most key, it is the market in which the Federal Reserve implements monetary policy; in this role, it must serve as an efficient and reliable transmitter of policy actions.

This market is a valuable national resource and has performed very well throughout the years. Nevertheless, it is not immutable, and it is certainly not perfect--as Salomon Brothers' admissions of wrongdoing have quite clearly pointed out. But, changes--especially government-mandated changes--in market practices, structure, and regulation must be rigorously derived from thoughtful study of this marketplace, so that the chance of inadvertent damage to the market is minimized. These hearings, Mr.

Chairman, contribute to that process of careful consideration. Without such a process, regulatory changes-- however well-intentioned--risk producing costly mistakes.

It is essential to preserve the unparalleled depth and liquidity of the market in any reforms that are instituted. There likely will be useful changes that can be made, but the bulk of those recommendations should await the results of a thorough, full-scale investigation of the market, and such a study is under way by the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission. This interagency study encompasses both the primary and secondary markets in government securities and the proposals emerging from it will likely interact in complex ways. A piecemeal approach cannot capture these interactions; a coordinated approach is needed.

While the interagency study is in process, some actions already have been taken in response to the abuses that Salomon Brothers committed. In particular, surveillance and enforcement activities have been intensified. A permanent, interagency surveillance group has been created to formalize and expand information sharing among the Treasury, the Federal Reserve, and the SEC. And plans for automating the auction process have been accelerated. The objective is to build a fully computerized bidding procedure. This initiative should not only broaden

access to the primary market and enhance enforcement efforts, it also should facilitate other potential improvements in the auction process. Broader-based participation in auctions should reduce the vulnerability to abuses and result in a deeper, more efficient market.

More sweeping changes are, I believe, premature at this time; for the reasons I noted earlier, I feel it is too early to move forward with specific legislative initiatives prompted by the Salomon Brothers' episode. A comprehensive review of the market and the abuses is not yet completed, and rigorous study is required to determine the need for change, to weigh the costs and benefits of alternatives, and to craft any requisite legislation that accomplishes the goal of improving the market and does so without significant adverse consequences.

Of course, I do welcome the opportunity to discuss the proposals before us today. These proposals fall into two broad categories--those designed to address the Salomon Brothers' abuses and those associated more generally with the debate on the reauthorization of the Government Securities Act. With respect to the latter, several of these involve issues that were analyzed last year both by the General Accounting Office in its report on the Government Securities Act and by the Treasury, Board, and SEC in their joint report. It certainly is not premature to make progress on these proposals. In particular, as was

articulated in the October 1990 joint report and in earlier Board testimony, we support extending--or more correctly, now reinstating--the rulemaking authority of the Treasury Department that expired at the beginning of this month. And we would like to see this authority made permanent.

With regard to mandated dissemination of trading information and sales practice rules, the Board still believes that a decisive case has not yet been presented for adding statutory requirements. Nevertheless, we would not oppose a modest broadening of current law, with adequate safeguards.

Specifically, in the case of securities trading information, we would urge that the current private-sector initiative in this area be given adequate opportunity to satisfy Congressional concerns, with backstop authority for mandating dissemination if necessary. We have some reservations, however, about whether the current proposal on information dissemination includes enough leeway to allow a more efficient, more flexible, market-based solution to the problem before the government steps in with regulation. Adding language that, for example, requires the government to make specific findings before invoking its backstop authority to mandate information disclosure would help provide some additional safeguards against unnecessary regulation.

If Congress feels that a provision for sales practice rules, too, is a necessity, perhaps the least costly and most responsive added measure would be a simple removal of the prohibition on NASD applying its sales practice rules to government securities transactions. That change would bring NASD firms into line with what is already the case for NYSE member firms, extending sales practice rules 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 general, we favor consultation and cooperation and oppose the granting of veto powers over other agencies' regulations in this market. We are pleased to see that the Committee's legislative proposals include extensive consultation provisions.

The other four proposals on which you requested our views appear to represent responses to the Salomon Brothers' episode, and thus fall into the category of proposals that, in our view, are better considered as part of a comprehensive review of the market. While we are not prepared to express a definitive view, I would like to share some preliminary reactions to these proposals.

Perhaps the strongest potential concerns are associated with the proposed system of large trader reporting for the government securities market. Additional

recordkeeping and reporting by brokers and dealers may well be worthwhile. But imposing this burden with respect to all large traders may not be necessary and could well involve significant costs.

While a large trader reporting system may be appropriate for the stock market, the government securities market is a very different market. It is important that the need for large trader reporting be rigorously determined based upon the findings of our study of this episode, because of the possibly considerable costs associated with this reporting burden. These include the direct cost incurred by market participants in producing and maintaining reports. More importantly, such a reporting system could cause some investors to withdraw from a Treasury market in which their finances and trading strategies may be revealed. Reduced investor demand could translate into higher interest rates required to finance Treasury debt, and this potential for an increase in taxpayer cost must be carefully assessed. Indeed, compared with a large trader reporting system, there may be equally efficacious, much less costly alternatives. The stakes are high, the consequences of mistakes severe, and we believe that careful study is called for before proceeding with proposals in this area.

With regard to the proposals on requiring internal controls and extending SEC authority to prevent fraudulent and manipulative acts and practices, I expect our review of

the market and its regulation to shed light on the need for such legislation. Certainly, it is essential for securities firms to have adequate internal procedures to prevent wrongdoing by their employees, and it is necessary that there be adequate provisions to prevent fraud in this market. However, a determination on whether these two provisions would represent significant, cost-effective, appropriate additions in this regard should, in our view, await the results of further study.

While the Salomon Brothers' episode highlighted some vulnerabilities in the government securities market, it also presented us with an opportunity, not only to fix the specific problems, but also to initiate a comprehensive study with the objective of designing and implementing fundamental improvements in market practices, structure, and regulation. I fully expect that we will be able to use this opportunity to enhance the integrity and efficiency of this important market.