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Mr. Chairman, members of the Committee, thank you for this opportunity to present the Federal Reserve Board's views on reforms to the regulation of the government securities market. Since September, when I last testified before this Committee, staff of the Federal Reserve, the Treasury Department, and the Securities and Exchange Commission (SEC) have conducted an exhaustive examination of this market, the results of which were released yesterday. My prepared remarks will touch upon some of the main conclusions of this report from the particular perspective of the Board of Governors of the Federal Reserve System. Our perspective differs somewhat from the other agencies contributing to the report due to differences in legislative mandates.

The Board of Governors has little direct regulatory authority for the U.S. government securities market. While the Board has general oversight responsibility for all Federal Reserve District Banks, the District Banks act as fiscal agents of the Treasury, thus sharing with the Treasury operating responsibility for the market. It is the SEC's charge to enforce the securities laws that seek to foster a high degree of fairness in the marketplace. With neither the direct responsibilities of funding the government nor substantial regulatory oversight, the Board of Governors can view this market from a somewhat different vantage point--a policy perspective that allows us to examine these issues in an economy-wide context.

When we look to the government securities market, we see a market that works as well as any on earth. U.S. government debt is an ideal trading vehicle, since it is all closely substitutable and has none of the default risk or idiosyncratic problems of private issues. As a result, market participants, in the aggregate, willingly commit substantial amounts of risk capital and exchange a large volume of securities each day. Positions are large yet trading skills are so sharply refined that bid/ask spreads are razor thin, a small fraction of the size of spreads in major equity markets.

This market generates widespread macroeconomic benefits. The government securities market efficiently absorbs the large quantity of new issues required to finance the deficit. With real-time quotes on a range of instruments, this market serves as the foundation for private market rates and a haven for ready liquidity. Further, this deep and liquid market gives the Federal Reserve a powerful, reliable mechanism to implement monetary policy.

Nonetheless, the admission of wrongdoing by Salomon Brothers, episodes of price distortions, and other evidence uncovered in our joint study all suggest that this market has faults. It can be improved. The proposals contained in the joint report, along with other reforms announced earlier, constitute the comprehensive modernization of the mechanisms and practices in the government securities market. Implementing these proposals represents a formidable, though feasible, task in our view.

Over the longer term, the most effective force in enhancing market efficiency and reducing the potential for manipulative abuses is the force of competition. And the joint report provides a blueprint to open up the government securities market to broader based participation. Automating Treasury auctions; facilitating direct bidding by customers, including non-primary dealers; implementing a single-price, open auction technique; and reducing the barriers to primary dealer membership all will serve, in time, to broaden participation in the primary market and in the secondary market for newly issued securities. More depth and breadth in this end of the market should increase efficiency, reduce Treasury financing costs, and lessen the potential for manipulative trading abuses. In addition, the competitive force of broader participation will be reinforced by proposals targeted at manipulative abuse: tightening up on the enforcement of auction rules, enhanced market surveillance by the Federal Reserve Bank of New York to identify potential manipulative episodes that could trigger SEC investigations, and Treasury supply management to reopen securities to combat squeezes.

Taken together, these actions should serve to deter manipulative practices and quickly detect abuses should they occur. Moreover, they are relatively low-cost, market-based responses that should achieve these benefits without impairing the efficiency and liquidity of this vital market.

There are, of course, many other alternatives which could be considered to combat the potential for abuses in this market. However, the government securities market is too important a national resource and works too well to be put at risk by regulatory change for the sake of change. From the Board of Governors' perspective, a compelling case must be established that the benefits outweigh the costs.

For example, there is an alternative way to address manipulative trading strategies in the domestic market: pass legislation that constructs a complex and burdensome apparatus of reporting requirements. No doubt, the need to post large trades and end-of-day positions with a regulator well might cause a potential manipulator to think twice. Unfortunately, it also would lead other potential participants to think twice before entering the market. A reporting burden falls on the good and the bad, boosting the cost of every trade. While the direct costs of additional record keeping might be kept manageable, an indirect cost looms larger. Market participants might withdraw rather than risk the divulging of their finances and trading strategies. Indeed, they have ready alternatives, since U.S. government securities trade in an international market. Margins in this industry are thin and it does not take much to lead to sizable shifts in trading behavior. An elaborate web of reporting requirements designed to snare manipulators might well reduce the number of participants, thereby raising the cost of Treasury financing. And, of course, the stakes are high. A tiny increase in Treasury rates translates into a very substantial increase in cost to U.S. taxpayers.

The agencies agreed that the Treasury market differs sufficiently from the stock market to make large-trade reporting unnecessary. On the other hand, there has been less agreement concerning the need for large-position reporting. The Board of Governors believes little incremental benefit would accrue from requiring large holders to report their positions and that the costs might be quite large indeed. In view of the extensive nature of the other changes proposed in this report, one might question the capacity of this market to absorb, at an acceptable cost, this additional change--the imposition of broad-based reporting requirements for large market participants. Even backup authority risks sending the same chilling message about the U.S. market to all participants choosing a trading arena in the global market place.

The taint of manipulation in trading is sufficiently damaging to the market that the Board of Governors would accept large-position reporting--despite the obvious costs--if there were no other effective remedy. However, a surer and less costly way to fight manipulative practices in the market is to modify the way in which the Treasury sells securities and to take a more active role in how those securities trade thereafter. And the interagency report provides such a market-based solution to the problem that targets manipulative behavior without impairing the liquidity of this important market. There are three basic elements to this overall strategy, involving improved auction mechanisms, enhanced market surveillance, and active supply management.

While many aspects of Salomon Brother's admission of wrongdoing and the results of the subsequent investigation cause concern, one is particularly unsettling: because of the falsification of bids at auctions, the Treasury was the direct counterparty in attempts to manipulate the market. Immediate steps were taken to reduce the risk of a reoccurrence, including tightening up on enforcement of auction rules and implementing measures to encourage more direct bidding. Looking forward, automation of the auction process, already under way and expected to be completed by year end, should efficiently snare any infraction of the rules.

More important still, automation will facilitate consideration of alternative auction techniques. At a minimum, switching to single-price awards from the current multiple-price format should foster greater participation and likely reduce gaming behavior at the auction. But more can be done. Linking bidders directly by a computer network and conducting the auction in real time will expose any would-be manipulator to public scrutiny in time to give the competition the opportunity to react. With the element of surprise gone, the potential return to manipulation should disappear. Thus, the auction of the near future may well be played in the open, on a level field, with sharply defined and easily policed foul lines.

The report also finds that the benefits of enhanced monitoring extend to when-issued and secondary-market trading. Manipulative behavior leaves its footprints in market quotes, as a shortage of an issue will be evidenced by a yield trading below that of similar securities and by depressed financing rates. The agencies agreed that the Federal Reserve Bank of New York, with its substantial experience as the operating arm of the Federal Open Market

Committee and (along with the other Reserve Banks) as one of the fiscal agents of the Treasury, should have primary responsibility for market surveillance; the Bank, in turn, will provide information to the the Treasury, the SEC, and the Board of Governors. It is the Board of Governors' view that rigorous monitoring of the behavior of market rates will expose manipulative behavior without the need to gather the positions of large traders routinely.

Indeed, automation and enhanced market monitoring also presents the opportunity to correct a long-standing market misimpression. Although the Federal Reserve Bank of New York has no statutory authority to regulate the primary dealers, many people view the primary dealer system as evidence of some measure of responsibility and oversight by the Federal Reserve Bank of New York of those firms. Ongoing automation and enhanced monitoring capabilities will let the Bank move to a more open set of trading relationships, thus disabusing market participants of the notion that the primary dealers have a special status. To further that end, the Bank will eliminate its dealer surveillance unit, showing unambiguously that responsibility rests with the primary regulator. The Bank will also lower the impediments to primary dealer membership, thereby encouraging a broadening of membership in the primary dealer system.

The careful monitoring of the market will be made more credible by action: persistent and large-scale price anomalies consistent with a manipulative squeeze will call forth two sets of policy responses. First, if other evidence, including discussions with market participants, suggests manipulation, then the SEC will begin an investigation to determine if any security laws have been broken. Second, and more immediately, the Treasury will act in the market to narrow those price anomalies, thereby limiting the extent of the market disruption in general and reducing the potential gain if manipulative behavior was the root cause. The Treasury's actions will be effected by either holding a new auction of the sought-after security--a reopening--or through the sale of those securities into the market by the trading desk of the Federal Reserve Bank of New York on behalf of the Treasury--a tap issuance. The resulting expansion of supply should slash the manipulator's potential gain, making it unlikely that any one would even try to manipulate the market. Circumstance and experience over time will dictate when an increase in supply will be required and which means of augmenting the issue will be taken.

It is the Board of Governors' judgment that the reforms that I have outlined--changes in auction mechanisms, active and rigorous monitoring of market rates, and the clear willingness to use relative supplies to punish manipulative behavior--will prevent a replay of last year's events. These are fundamental changes in market mechanisms that promise to open up this market to broader based participation while, at the same time, enhancing regulatory surveillance and remedial capabilities. Nonetheless, these are cost-effective, market-based responses to irregularities in a market that otherwise functions quite well. These responses are measured, targeted and commensurate to the problem at hand, and, in our view, obviate the need to punish many with reporting burdens because of the actions of a few. This strategy also offers flexibility to deal with future problems as they arise. It is perhaps ironic that the most serious abuses in the history of this market--the Salomon Brothers' episode--have served as the catalyst for changes that promise substantial long-term benefits. Taken together, these proposals and those already implemented constitute a thorough, thoughtful, and feasible renovation of the government securities market and will result in a healthier, more efficient market for our U.S. government securities.