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Statement of  
David W. Mullins, Jr.  
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, I am pleased to be here today to testify in connection with the regulation of the government securities market. President Corrigan's statement has detailed both the role of the Federal Reserve Bank of New York in this market, including its relationship with the primary dealers, and the circumstances surrounding the disclosures by Salomon Brothers. As he noted, the Board of Governors of the Federal Reserve System was actively involved in the consultations among regulators during this episode. In my prepared remarks, I shall first delineate the role of the Board of Governors in this market and then turn to the other issues we were asked to address-- specifically, the potential implications of this episode for regulatory and legislative initiatives.

The Board of Governors considers the U.S. government securities market 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, this market 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 importantly, the U.S. government securities market is the market through which the Federal Reserve implements monetary policy, and thus this market must be an

efficient and reliable transmitter of our monetary policy actions.

Though an important market, the Board of Governors has little direct regulatory authority for the U.S. government securities market. In this market, the Reserve Banks operate as fiscal agents of the U.S. Treasury and the New York Reserve Bank also serves as the operating arm of the Federal Open Market Committee. The Board, though, retains general oversight responsibility for all Federal Reserve District Bank activities. Moreover, the Board of Governors bears the responsibility for determining overall policy for the Federal Reserve System with respect to this market and all other matters. For example, the Board consults with the Treasury and the Securities and Exchange Commission on issues related to administration of the Government Securities Act. Because of these responsibilities and the importance of this market, the Board is committed to participate actively in the process of ensuring and enhancing the efficiency and integrity of this market.

The market under consideration here is at the center of the nation's financial system. Its depth and breadth are unparalleled. And it is because of the importance of the market for U.S. government securities that the events of recent months are of such concern. The price distortions in certain securities, the admissions of

wrongdoing by Salomon Brothers, and the allegations of further misconduct have raised troubling questions about the government securities market. While it has been extraordinarily resilient and has continued to function well over this period, this episode underscores the importance of ensuring the integrity of this market.

Of course, we must not overlook the fact that existing enforcement mechanisms appear to have been instrumental in this unfolding episode. These mechanisms included surveillance activities, inquiries, and other enforcement activities by the Federal Reserve Bank of New York, the Treasury, the SEC, and the Justice Department. Although senior Salomon Brothers officials were aware of rule violations months before, the firm finally admitted wrongdoing only under the pressure of these advancing enforcement processes. And of course, these enforcement processes continue to move forward as we meet here today. It is already apparent to all observers that the consequences of willful violations in this area are quite severe indeed.

While this has been a troubling episode, it is not apparent that sweeping changes in regulation are warranted. It is clear that tightening up on enforcement would be efficacious in detecting and deterring future offenses. For example, the Federal Reserve regularly receives information on dealer positions in when-issued securities. These

reports were not actively monitored. Though not designed for enforcement purposes, closer attention to them may be helpful in raising questions about situations with possible enforcement implications. Going forward, the Federal Reserve is committed to ensuring active monitoring of all incoming data and prompt referral of anomalous findings to appropriate regulatory authorities. Indeed, surveillance and enforcement activities have already been intensified.

And yet this episode has raised concerns that go beyond the straightforward process of detecting and punishing wrongdoing. With the revelations by Salomon Brothers, the price distortions in certain recent issues, and allegations of other misconduct, some have felt that the fairness of the market has been called into question. Others have raised concerns about the efficiency of market mechanisms. The smooth functioning of this market in recent months demonstrates that there appears to have been no economically meaningful loss of confidence in this market as yet. Nonetheless, these concerns need to be addressed; reduced confidence in the fairness and efficiency of the government securities market could potentially impair liquidity and raise the cost of Treasury financing.

In response to these concerns, a wide variety of proposals have been advanced for changes in regulation or market structure. I believe this broad-based reassessment is appropriate and healthy. This episode has presented us

with an opportunity to undertake a thorough analysis of the structure of this market and its regulations.

I also believe that the assessment of these important issues should not be done in haste. Nor should changes be considered in a piecemeal manner. The issues are too complex and the consequences of mistakes too severe for us to rush to judgment on fundamental issues of market structure and regulation.

What is needed is a rigorous, comprehensive, and coordinated review of the government securities market--its structure, practices, and regulation. The objective should be to find ways to ensure and enhance the efficiency and integrity of this market.

A key question to be addressed in the course of such a review is whether current laws, regulations, procedures, and enforcement efforts foster the efficiency and liquidity of this market, as well as provide adequate protection against the potential for manipulative practices. A wide range of issues should be on the table, pertaining to both the primary and secondary markets for Treasury securities. It may well be that, upon review, additional rules or reporting requirements or significant changes in the auction process or in the oversight structure of the market will be found to be in order. At this point, however, conclusions would be premature. The issues are complex and interrelated, investigations are not yet

completed, and the data needed to make informed judgments are still being gathered.

In thinking about such issues, the Board begins from the premise that it is absolutely essential that the extraordinary liquidity and efficiency of the government securities market not be impaired. This liquidity is important to the smooth functioning of the financial system, it facilitates the implementation of monetary policy through open market operations, and it allows the Treasury to issue federal debt at the lowest possible cost to the taxpayers.

With well over \$2 trillion in Treasury debt held by the public, the stakes are high and the consequences of mistakes are severe. Should either concerns about market integrity or inappropriate regulation raise the interest rate on Treasury debt even one one-hundredth of a percentage point, this would aggregate into more than \$200 million in increased interest cost every year which would have to be borne by U.S. taxpayers. Time is needed for a careful, analytical approach to the issues of market structure and regulation.

The Department of the Treasury, the Federal Reserve, and the SEC have agreed to undertake an intensive examination of market practices, structure, and regulation, culminating in recommendations for changes needed to ensure and enhance the efficiency and integrity of this market. We would expect this review to take place over the span of the

next ninety days. I appreciate, Mr. Chairman, that this timetable does not mesh with the sunset date on the Treasury's rulemaking authority under the Government Securities Act, but I believe the added time is necessary to bring adequate resources to bear on this very important matter. In any case, our timetable need not serve as an impediment to action on the Government Securities Act. The legislative process can usefully go forward on extending the Treasury's rulemaking authority and addressing other concerns that already had been under consideration; if it wishes, the Congress can always take up other related issues later, perhaps after the agencies have completed their review.

Disclosures to date about wrongdoing in the market have not fundamentally altered the Board's views--conveyed in letters and congressional testimony earlier this year--on the amendments that had been proposed with respect to the Government Securities Act. Specifically, we continue to support the recommendation that the Treasury's rulemaking authority be extended past its current sunset date. Beyond that, however, we do not feel that the need for the additional legislation, calling for sales practice rules or mandating the dissemination of information, has been decisively demonstrated, nor has the Salomon episode produced evidence of such a need.

Should Congress nevertheless conclude that additional rules are desirable to help curb existing or potential abuses, we would urge that, in the case of securities trading information, the market be given adequate opportunity to satisfy Congressional concerns before backstop authority mandating dissemination may be exercised. And, with regard to sales practice rules, 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, thereby 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.

In sum, Mr. Chairman, recent events have raised troubling questions about the U.S. government securities market. These concerns must be addressed. A thorough and thoughtful investigation is the first step in this process. Ultimately, a careful and wide-ranging examination of the government securities market, with the goal of enhancing its efficiency and its fairness, will be an important input to

our consideration of the appropriate changes in this market. Though I am deeply concerned about recent revelations and await the results of ongoing investigations, I do not believe that the government securities market is broken in any fundamental sense. I do, however, believe it can be improved, and the Board of Governors is committed to this end.

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