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Statement by

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before the

Subcommittee on
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Summary

In the view of the Board of Governors, the smooth functioning of the overall government securities market indicates that broad-based regulatory redesign is not needed. Given the scale of federal borrowing, the Treasury is in no position to impose costs or discourage participation without the strong presumption of offsetting benefits. In our estimation, many components of H.R. 618 do not pass this test. Instead of considering a risky overhaul of a market that works well, Congress can chart a safer course: restore the Treasury's rulemaking authority, perhaps allow NASD to set sales practice standards for its members in this market, and support the agencies' substantial ongoing efforts to improve surveillance and enforcement.

I welcome this opportunity to discuss legislative initiatives concerning the government securities market. By my count, this marks the ninth time since Salomon Brothers' admission of wrongdoing that I have delivered testimony on this subject before a Congressional panel. In my view, there is enough at stake, particularly in terms of financing the federal deficit, to warrant this close scrutiny. The interest cost of the federal debt depends on the rates when securities are first auctioned, while this Committee's mandate concerns secondary market trading in government securities. But that is not a realistic distinction in practice, since the Treasury's ability to tap funding sources in the primary market depends critically on the assurance of smooth trading in the secondary market.

Developments since August 1991

Over the past 1-1/2 years, the Board of Governors, the Federal Reserve Bank of New York (FRBNY), the Treasury, and the Securities and Exchange Commission (SEC), among others, have devoted considerable attention to the government securities market. An important initial product of that work was the Joint Report on the Government Securities Market, which contained a comprehensive survey of the market and a detailed plan for correcting the problems that had been identified. Much of the plan delineated in the report has been put in place. After consulting with the other agencies, Treasury implemented redesigned auction

procedures and rules to eliminate the possibility of a recurrence of the abuses committed in the Salomon Brothers episode. With the help of staff at the New York Fed and the Commodity Futures Trading Commission (CFTC), the Board, Treasury, and SEC formed an Interagency Working Group on Market Surveillance. As a result, enforcement responsibilities and procedures have been clarified and intensified. After careful study, the Treasury commenced a yearlong experiment with auction technique, and the FRBNY has made considerable progress in automating the auction process. In addition, the New York Fed has adopted changes in the administration of its relationship with primary dealers and is in the process of revising the information that it collects from them.

Meanwhile, staff at the various agencies, as well as academic researchers, have studied the relationship between prices in the cash and financing markets. This research has produced techniques to identify rate anomalies that could be associated with squeezes. And the Treasury has shown a willingness to act through supply management when market prices suggest a serious shortage. Last year, one issue, a ten-year note, was reopened under the policy articulated in the Joint Report for addressing an "acute, protracted" shortage. Under the threat of Treasury reopenings, no market participant can be confident of profiting by cornering the market in a Treasury issue.

Thus, the government securities market has already been subject to substantial change and to intensified scrutiny on an ongoing basis.

This extensive, in-depth analysis has increased my respect and appreciation for this financial marketplace. In this regard, the U.S. government securities market has no rival. This market is the deepest and broadest of all securities markets, offering widespread economic benefits by permitting transactions of enormous size to be conducted at razor-thin bid-ask spreads. In general, the governmental initiatives undertaken to date with respect to this market have not been intrusive or especially costly, and thus have been consistent with its continued efficiency.

What is Needed

In weighing the need for additional legislation, the Board of Governors believes that the best, most efficient, and equitable laws and regulations are drawn up to address specific problems. This is why, in the Board's view, the timely enactment of the legislative agenda outlined in the Joint Report would serve the nation's interest. This agenda--reestablishing the Treasury's rulemaking authority for the government securities market and perhaps eliminating the prohibition on the National Association of Securities Dealers (NASD) to specify sales practice rules for members participating in this market--would complement the administrative actions that have

already been put into motion. Unfortunately, H.R. 618 goes far beyond this recommendation by introducing potentially confusing and possibly overlapping lines of authority amongst the agencies, by erecting a regulatory apparatus that is more appropriate for equity markets, and by creating the potential for bureaucratic judgment to substitute for the market determination of the flow of pricing information. These actions would raise the cost of participating in the government securities market precisely when our federal finances are critically reliant on worldwide market acceptance for the Treasury's massive debt issuance.

The Board of Governors does not believe that the evidence supports the case for the sweeping changes in regulatory practices envisioned in this proposed legislation. In our view, the record over the last 1-1/2 years and a careful weighing of the costs versus benefits would not warrant such steps. The incidents that have come to light are apparently related to individual ethical lapses that are unfortunately all too common when money changes hands. From what is known thus far, it appears that the existing body of laws and regulations has proved sufficient to mete out punishment to the guilty. While there are reports that criminal investigations may have been made more difficult by shoddy bookkeeping practices at some government securities brokers and dealers, recordkeeping at most of those entities is already covered under the existing

regulatory umbrella. The measures already implemented, including stricter enforcement and more uniformity in interpretation of the existing rules by self-regulatory organizations and regulatory authorities that administer the rules, should smooth the way in investigating potential abuses. Of course, such improvements within the current regulatory framework would be made easier if Congress acted to restore the Treasury's rulemaking authority for government securities brokers and dealers, which lapsed in 1991.

The Board of Governors believes that a decisive case has not yet been presented for adding statutory requirements on sales practice rules. If Congress deems that a provision for sales practice rules is necessary, this could be obtained by simply removing the prohibition on the NASD from applying its sale practice rules to government securities transactions. This would bring NASD firms into line with procedures at New York Stock Exchange member firms, extending sales practice rules to all nonbank brokers and dealers.

What Is Not Needed

Compared with H.R. 618, the legislative agenda outlined above is narrower and, in our view, better targeted. It appropriately recognizes the substantial administrative changes already set in motion as well as the unique nature of the government securities market. In the

view of the Board of Governors, more sweeping and intrusive action does not stand the scrutiny of rigorous cost-benefit analysis. This was our judgment at the time of the writing of the Joint Report, and events since have only strengthened this conclusion.

There is no evidence of market failure that would warrant the significant overhaul envisioned in H.R. 618. In a market where so much money changes hands so quickly, even the whiff of illicit activity would inspire a chorus of complaints and withdrawals from trading. In fact, bid-ask spreads remain narrow, volume remains heavy, and there have been no notable changes in the ranks of participation. Even without evidence of spotty trading, thin markets, or trading failures, if there was a convincing logical chain to suggest that the government securities market was now susceptible to wrongdoing, then prophylactic action could well be justified. On this score, though, the structure of the government securities market would appear to offer little scope for large-scale mischief.

First, prices in the government securities market appear mostly driven by macroeconomic fundamentals. Government securities are homogeneous, with few of the idiosyncratic factors that push and pull the prices of private debt or equity instruments relative to market averages.

Second, in a homogeneous, highly visible market such as this one, the force of competition remains the best protection from manipulation. With narrow bid-ask spreads and the quick dissemination of information, there is little room to hide collusive activity. Such a market is inherently transparent.

Third, a trader who attempted to gain from market manipulation now faces the prospect of aggressive Treasury debt management that would reopen an issue to shave any illicit gain. Against this backdrop, many of the potentially costly provisions of H.R. 618 guard against an enemy that will never take the field.

In the Board's view, there is no compelling need to grant new recordkeeping authority to the SEC, especially when existing authority can be used more effectively. Nor is there a need for large-position reporting, given the substantial improvement in the agencies' market surveillance efforts. The FRBNY's discussions with market participants provide a wealth of detail to inform the Treasury reopening decision and to alert enforcement agencies of potential problems. These sources are augmented by dealer report forms that soon will routinely extract information on specific securities. But at a more fundamental level, currently available data on market prices provide a continuing stream of data to mine for evidence of manipulative intent.

In our view, there is no demonstrated need to put the SEC into the business of mandating what trading screens look like and who gets the information feeds, and such initiatives could impose significant costs on the market. Transparency, or the ability to get timely and reliable price quotes in the government securities market, has improved markedly of late. GOVPX, for example, has enhanced the information that it provides to the market. If private sector initiatives are allowed to run their course, this access should be further widened. The threat of governmental interference may only prove counterproductive, as private firms delay additional improvements for fear that another format might be thrust upon them.

The Board accepts that the broad-based apparatus of reporting requirements in this market that could be implemented under H.R. 618 might reduce the cost of investigating abuses and facilitate enforcement. On the other side of the ledger, such changes would boost the cost of every trade and potentially reduce the ranks of market participants. The Treasury's appetite for financing is too large to make purchasing its securities more expensive or to discourage willing buyers with administrative burdens motivated by the vague fear that someone, somewhere out there, may be inclined to cheat.

It is true that H.R. 618 does not mandate these increased reporting requirements but rather gives various

agencies the authority to enact these changes should they deem them fit. However, even backup authority may send a chilling message about the U.S. market to all participants choosing where to trade in the global marketplace. Rather than risk slipping into a fundamental change through backup authority, the Board of Governors feels it would be a wiser course of action to return to Congress for enabling legislation in the future should such authority appear necessary.