Remarks by
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It's a pleasure to have this opportunity to speak about the government securities market to so knowledgeable an audience. As many of you know, Chairman Greenspan spoke eloquently at an uptown dinner last night about the enduring principles of fiscal policy, first spelled out by Alexander Hamilton, which have made the U.S. government securities market a model of efficiency and the envy of the world. If you did not hear -- or have not had a chance to see -- his remarks, I commend them to you.

Tonight, I'll give something more of a view from the trenches, while still addressing the overriding objective of preserving the efficiency of our government securities market. The focus of my remarks will be on what we at the New York Fed call "market surveillance": that is, what we do to identify and understand day-to-day changes in the dynamics of demand and supply conditions in the government securities market and, in particular, how we try to identify possible manipulative behavior.

I suspect that the question of how to define manipulative behavior in the financing market would have intrigued Marcus Nadler. Thus, in the spirit of the Money Marketeers, I will try to remove some of the mystery from the term "market surveillance" and give you a better understanding of what we are looking for, in the hope that you will then be better able to help promote the efficient functioning of the government securities market.

The announced topic for my talk this evening is "The Desk and the Bond Market: An Operational View". This was intended to give you fair notice that I have no intention of discussing the current stance of monetary policy while, at the same time, not scaring off too many of you by mentioning market surveillance.

I had been tempted to call these remarks "Reflections of a Rookie Manager", but I found this too depressing. Even though I have been in the job for almost two years, I realized that I have not yet finished my rookie season because, in the units of time observed in the bond market, my first season won't be over until I've been through a full interest-rate cycle -- and I don't even know when that will be.

Before turning to the subject of market surveillance, I thought I would first mention a few of the changes that have been made at the Open Market Desk.

One thing we've done is to change the manner in which the Desk conducts outright purchases of coupon securities. Instead of making a single pass for all maturities, we now conduct separate passes for different sectors of the yield curve over several days. So, rather than our taking 45 minutes to sort through the dealers' propositions on more than 200 different securities, we take around 15 minutes to sort through and respond to propositions in just one sector at a time. As a result, we get somewhat better prices because we no longer have to pay the implicit options premium for the extended delay in getting back to the dealers. It also gives us more flexibility in adding reserves as needs grow over a number of days, rather than having to inject large amounts of reserves on a single day.

We recently have sent the primary dealers a new master agreement covering our repo and matched-sale transactions. For some time, the Desk had been relying on a rather terse document to establish the legal underpinnings of our operations. Now, following the good example of the PSA model agreement, we're lining up our documentation, more or less, with industry practice.

We are now in the process of renovating the entire 9th floor of the Bank as a new dealing room, where we will bring together both our domestic open market operations and our foreign exchange operations. We will no longer have the great "chalk board" where, for many years, we have kept updated prices on all outstanding Treasury securities. So, before the end of the year, we will stop calling the dealers for quotes of all Treasurys and, like all of you, we will begin relying on digital feeds rather than chalk.

I am now going to address most of my remarks to the subject of market surveillance because it is one area, in which I have some direct responsibility, where I think we could improve the clarity of your understanding of what we are trying to do and, thereby, generate more of a dialogue on what we all can do to preserve the efficient functioning of this market.

We, in the official sector, have learned a great deal since both the 1991 Salomon Brothers episode and the issuance of the "Joint Report on the Government Securities Market" in January 1992.

Among the first things we learned was to appreciate the ebb and flow of pressures in the repo market that are associated with the distribution process from one Treasury auction cycle to the next; and that there are a number of reasons why a particular security trades on special -- as a consequence of heightened demand or limited supply -- which may have nothing to do with someone manipulating the market.

With careful analysis, we learned -- what most traders already knew -- that there is a cycle with which securities trade on special, with the degree of specialness (or premium demanded) rising and falling from one auction to the next, and then dropping sharply following the announcement of the new issue of the same maturity as dealers shift their attention to the need to position, acquire and distribute the new issue. Understanding this cycle, which is described in an article by Frank Keane just published by the Bank, has been essential to our work on market surveillance, because it gives us more appropriate benchmarks with which to compare repo rates if we have a concern.

One thing I now better understand is the critical role the repo market plays in the price discovery process in the cash market. Transient shifts in the demand and supply for particular maturities are not fully reflected in yields but are priced into overnight repo rates, thereby reducing a small, but not insignificant, source of pressure which might otherwise produce volatility in yields.

This division of labor between the cash and repo markets itself reflects the change in the market-making process which has occurred with the growth of the repo market together with that of both the cash and repo brokers' markets. A long time ago, the market-making function of the dealers was principally exhibited in their willingness to quote two-way prices in the cash market not only to customers but also to other dealers. With the development of both the repo market and the brokers' market, there has been increasing reliance on the repo market as a flexible means of managing short positions in the cash market. As a consequence, the repo market has become an essential component of the market-making process in the cash market.

Given the current structure of the market, we really have to redefine the characteristics of a market maker to include a willingness to make issues held available in the repo market when they are in demand, as indicated by whether they are trading persistently on special. Thus, we think that any firm that wants to hold itself out as an active market maker should make issues in which it holds a net-long position available in

the financing market, either on a term or overnight basis, at reasonable rates and in reasonable quantities, and with best efforts to make timely deliveries, when those issues are particularly in demand.

By reasonable rates, I mean ones that reflect a genuine effort to find the intersection of demand and supply curves as indicated by trends in the behavior of rates on the relevant and comparable issues. By reasonable quantities I mean: consistent with market convention and in relation to the size of the long position held.

Firms that play this role are both supporting the repo market and facilitating the price discovery process. Firms that do not play this role, which in the ordinary course of business do not make available in the repo market issues in which they hold long positions, may be behaving entirely reasonably as "end-users", buying cash positions in order to hold them; but they are not supporting the repo market and should be regarded as consumers rather than providers of market liquidity.

The inter-agency Working Group on Market Surveillance -- composed of the Treasury, the Federal Reserve Board, the SEC, the CFTC, in addition to ourselves -- has the responsibility to monitor the government securities market for incidents of market manipulation, other illegal behavior, and also to monitor any developments which may impair the efficient functioning of the market as a whole. The New York Fed's staff are continuously monitoring conditions in the financing and cash markets, as well as in the primary market, and report their observations to the Working Group, particularly focusing on anomalies in rates and rate movements which may be the result of something other than the natural phenomenon of cyclical movements in supply and demand.

If we, at the New York Fed, have collected evidence suggesting that price anomalies are not just a part of the normal ebb and flow of the market, we provide the information we have on the behavior of the firm or firms involved to the inter-agency Working Group. One of the agencies in the Group may then refer the matter to their own enforcement area or to some other appropriate enforcement agency.

This is really no different from how we, at the New York Fed's market desks, behave whenever we come upon information which suggests that laws or regulations may have been violated: we refer the matter to the appropriate enforcement agency, whether that be our own bank supervisors or someone else.

In this area, however, the New York Fed has taken on the role of advance scout, monitoring the market for possible signs of manipulation. The Working Group acts as a clearinghouse for an inter-agency discussion of the issue. If sufficient grounds exist, the relevant agency -- relevant in terms of the firms involved or the apparent conduct, whether it be a bank supervisor, the SEC, the CFTC, or other law enforcement authority -- will be the one to make a follow-up investigation and any determination of whether to proceed with an enforcement action.

Even with this division of labor, in the first instance we face the challenge of identifying instances where market manipulation may be occurring. Unfortunately for us, there is no simple legal or economic definition of manipulation that is widely accepted.

Over the past several years, however, as a result of the combination of our practical experience observing the market and our review of the economic literature, we have identified three parameters which can be used as early warning signs of when a firm may be abusing its market power in a specific security. Position size, transaction volume, and the specials rate, for a given security, when considered together provide a threshold indication of instances where we need to consider whether a firm may be using its market position to extract a de facto monopoly rent from other market participants.

Position size we define, in terms of an overall long position, as the sum of the firm's cash and net term repurchase agreement positions, as a share of the outstanding amount of the public's share of an issue -- that is, excluding what we hold in the System Open Market Account.

Transaction volume is measured in terms of a firm's turnover in the specific issue as a share of estimates of market turnover in that issue, and we also focus on some qualitative issues such as how, when and with whom transactions are conducted.

The specials rate for a specific issue is the interest rate at which that security trades in the financing market, which we assess relative to the normal pattern or cycle for that issue or issues of similar maturity.

It is critical that these three factors be looked at in their totality. If this is done, one begins to recognize that a range of different sets of values can all indicate the possibility that someone may be trying to manipulate the market. Persistent patterns of *large position size* and an *appreciable share of turnover* in an issue that is *persistently trading deeply on special* will give rise to heightened concern on our part.

For example, an attempt to manipulate the market could be indicated when a single firm: consistently holds a net-long position of more than half of an issue; has activity representing more than one quarter of the turnover in that issue over a number of days; and when the issue is persistently trading within 50 basis points of the fails rate -- that is, trading at a rate between zero and 50 basis points in the financing market. However, concerns could also be raised when a firm holds less than 50 percent of an issue, but has activity of more than half of market turnover. Both such patterns would suggest to us that someone *may* be attempting to abuse their dominant position in a particular issue and, if the specific security is trading persistently and deeply on special, will give rise to heightened concern on our part.

There can also be cases where a firm may have a considerable long position, say of over two-thirds of an issue, and the issue is trading on special, but the firm has no activity in the repo market. This could simply indicate that a firm is holding a large long position and there might be little causal connection between the position and the specials rate, which could reflect other cyclical or transient factors. But such a pattern could also indicate the initial steps in an effort to manipulate the financing rate on the issue, the profits of which would be derived when the firm begins gradually to make the issue available in the financing market.

If a firm really is not a participant in the repo market, and does not lend out issues that are on special, then the fact that it is holding a large long position in a issue, without lending it out, provides no necessary indication of intent--on its part--to manipulate the market.

However, if a firm is usually an active participant in the repo market, but is not providing a particular issue in which it holds a long position, then we would have some cause for concern. In such a case, if the issue were persistently trading on special, we might then look into whether the trader was playing any of the usual games to finance his positions, such as lending the issue at general collateral rates to a customer who typically would not lend the security on.

Measurement of position size in relation to total outstanding amounts can be misleading because the actual supply available for trading may be considerably less. While we initially rely on this more conservative measure of position size, we are aware that effective control of an issue can be achieved with much smaller amounts.

Another problem we face is gathering estimates of a firm's turnover relative to market turnover. Firms themselves know their own turnover and, in on-the-run issues, can contrast these figures with published figures on overall turnover. We can usually encourage firms to share their own figures with us and, going forward, in extremis, we will also be able to rely on the Treasury's new large position reporting rules -- if the Treasury decides that we need them.

The process of collecting and analyzing this information can be quite difficult at times. But it also can be a good bit easier than you might think. You would be amazed at some of the shaggy dog stories we hear, and how easily otherwise sensible people can say things like: "We have this new quant-jock, who discovered that once he controlled more than 75 percent of the available supply in this issue, he could achieve these fabulous rates of return by lending it out in the RP market in small amounts."

While the three factors of position size, turnover, and rate help focus our effort, I want to be clear that there are no simple formulas or position limits that we apply. No one, or even two, of these factors alone necessarily provides any grounds for concern. In the absence of short sellers who wish to borrow the issue in the repo market -- of whom I will speak in a moment -- consistently large, long positions, combined with a significant share of turnover, may not indicate an area of concern.

It is possible that market manipulation may not be occurring even where all three of the factors are at elevated levels. Supply and demand imbalances could be such that a specific issue trades "naturally" at a level that is persistently close to the fails rate. In this setting, a large position holder may not be responsible for the significant scarcity value and it is conceivable that such a firm might be making the issue available at market-determined rates. But such circumstances will certainly draw our attention and we will want to talk to the firms involved in order to understand the rationale for the positions and the special conditions that may be present.

Some firms will be making money and some firms will be losing money on both short and long positions. That's the way markets work and we have a healthy respect and understanding of this. But persistent and systematic efforts by a firm or firms to extract monopoly rents from a dominant position in a particular issue are quite a different matter.

I have gone into such detail about how we track the repo market because I would like to encourage the management of firms actively involved in the government securities market to scrutinize their own traders for behavior which may indicate attempts to manipulate the market.

It should not take much effort to extend most firms' risk management systems to track position size relative to outstanding amounts, as well as turnover, in relation to the financing rates at which specific issues are trading. In this way, a firm's management should be able to monitor the potential for its traders to abuse a market position, or collude with other firms, and then take the necessary steps to prevent traders from extending positions and activity into problematic territory.

I think it would be good market practice for firms to establish their own internal guidelines for each of the three factors I have mentioned. When these internal thresholds are hit, or about to be hit, if I were the head of a dealing room, or in charge of risk management or compliance, I think that I would want to call the New York Fed -- before they called me -- so that I could explain the strategy being pursued with a certain position and the unique circumstances that may be present.

I am not suggesting that you call us because we know exactly where and when certain position sizes and levels of activity will indicate an attempt to manipulate the market. I am suggesting that managers of trading operations should recognize the potential for abuse that exists when an issue is persistently trading with scarcity value and learn to monitor the relevant aspects of their own traders' behavior. I think we would all be better off if management took the time to make sure that these risks are being adequately managed and that they are not being trapped in the trading room. In sum, I am suggesting the benefits of *involvement* by firm management and of *communication* with us.

I'd like briefly to mention the Desk's role in the financing market where, as you know, most of our operations are conducted. When adding reserves to the banking system, we operate in the general collateral market: accepting Treasurys against our provision of funds at general collateral rates bid by the primary dealers.

We expect primary dealers to refrain from repoing in to us securities that are otherwise difficult to acquire in the financing market. We refuse to accept collateral that is trading persistently on special and will instruct dealers to arrange a substitution should an issue, already submitted in a term operation, subsequently go on special. To put it bluntly, the surest way to subject yourself to heightened scrutiny by the New York Fed is to attempt to deliver to us large amounts of collateral that is trading deeply on special.

I have spent a good deal of time speaking about long position-holders, the potential for abuse of market power and the associated responsibilities. I would like to take a moment to talk about the responsibilities of short sellers -- a subject which gets insufficient attention.

As some of you have heard me say, it is **NOT** the purpose of the New York Fed's market surveillance efforts to make the market safe for short sellers. The market will function most efficiently when there is an appropriate balance between the risks of failing to deliver, on the one hand, and the risks of withholding collateral, on the other.

Market participants taking short positions should not look to the New York Fed as a means of limiting their costs. Holders of short positions should make prior arrangements to secure collateral when conditions appear congested, or otherwise ensure that their positions can be covered -- perhaps by entering into term agreements.

I would like especially to emphasize that market participants creating or extending short positions when an issue is trading at levels close to the fails rate should not expect much sympathy from the New York Fed should there be a problem obtaining the security; and they should have every intention of making delivery. Again, trading management and compliance efforts should be able to monitor these conditions and take steps to prevent traders from extending positions and activity into problematic territory, on the short side as well.

I have laid out quite a lot over the past half hour, but I think it really comes down to what I said just a moment ago: the government securities market will be functioning most efficiently when there is a healthy, competitive dynamic between the risks of holding long positions and the risks of holding short positions.

The New York Fed took on the responsibility for monitoring the government securities market in the hope that we could encourage market participants to undertake the necessary self-policing to maintain this dynamic balance and, thereby, avoid the need for more heavy-handed forms of regulation. Tonight I have spelled out some concrete steps I think all market participants should take to help secure and encourage the efficient functioning of this extraordinary market.

I hope that you have found it worth your while and I look forward to your questions.