

# **GOVERNMENT SECURITIES REFORM**

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**HEARINGS**  
BEFORE THE  
SUBCOMMITTEE ON  
TELECOMMUNICATIONS AND FINANCE  
OF THE  
COMMITTEE ON  
ENERGY AND COMMERCE  
HOUSE OF REPRESENTATIVES  
ONE HUNDRED THIRD CONGRESS  
FIRST SESSION  
ON

**H.R. 616 and H.R. 618**

BILLS TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 AND TO  
EXTEND AND REVISE RULEMAKING AUTHORITY WITH RESPECT TO  
GOVERNMENT SECURITIES UNDER THE FEDERAL SECURITIES LAWS

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MARCH 17 AND 30, 1993

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# GOVERNMENT SECURITIES REFORM

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WEDNESDAY, MARCH 17, 1993

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON ENERGY AND COMMERCE,  
SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE,  
*Washington, PC.*

The subcommittee met, pursuant to notice, at 9:40 a.m., in room 2322, Rayburn House Office Building, Jon. Edward J. Marked (chairman) presiding.

Mr. MARKEY. Good morning.

Today the subcommittee is holding its fifth hearing on the state of the Government securities marketplace and the need for reforms in the regulation of this market. Today's hearing will be focusing on H.R. 618, the Government Securities Reform Act of 1993, which I introduced earlier this year along with Representatives Fields, Wyden, Sonar, and Cooper, and the chairman of the full committee, Mr. Dingell.

All investors and taxpayers have a stake in the regulation of the most important financial market we have, the \$4 trillion market for the U.S. Government debt. This market provides the fuel for the Nation's fiscal engine, establishes a benchmark for interest rates throughout the global economy, and is used by the Federal Reserve to carry out monetary policy and represents the primary investment held by many State and local governments.

Ironically, this most important financial market has traditionally been largely exempt from the type of regulations we have relied on to police the stock market or corporate bond market. Originally, such exemptions may have been justified on the basis of the risk-free nature of Treasury securities.

During the 1980's, however, the Government securities market was transformed from a sleepy arena for funding the public debt to a fast-paced playground for Wall Street traders and speculators. In addition to traditional Treasury notes, bills, and bonds, Wall Street firms are now peddling a wide array of more risky financial products such as interest-only or principal-only STRIPS of Treasury securities and a bewildering alphabet soup of ABA's, CMO's, and REMIC's.

The Salomon Brothers auction bidding scandal dramatically underscored the consequences of relying continually on a chubby system of informal regulation based on the New York Fed's private business relationship with a select group of privileged primary dealers and periodic closed-door sessions between Treasury and an industry trade association.

The apparent disregard of the Treasury auction rules by key Salomon Brothers traders and the failure of Salomon's senior management to report evidence of wrongdoing to regulators provided compelling evidence of the need to reform the system and to ensure that informal regulation was a thing of the past.

Moreover, the Salomon regulations and revelations were followed by subsequent disclosures that 98 firms engaged in improper activity in connection with the sales of Fannie Mae, Freddie Mac, and other Government agency securities, reports of abuses of Treasury's noncompetitive bidding rules, and pre-arranged trades aimed at generating fictitious tax losses.

Let's face it. This is not your father's Government securities market any longer. Competitive pressures have built to a critical point, and new checks on improper or manipulative activity are needed.

During the last Congress, this subcommittee struggled long and hard to craft a bipartisan compromise that would assure that the SEC can carry out its mission to police this market for fraud and manipulation, correct other regulatory deficiencies, and not undermine the fundamental liquidity and efficiency of this market. Towards this end, the subcommittee worked closely with regulators and industry to pare back early proposals for large trader reporting, audit trails, and broad price transparency authority in favor of more tightly focused provisions authorizing large provision reporting, enhanced transaction record-keeping, and price transparency back-stop authority.

I believe that the resulting product struck the proper balance in assigning rule-making or consultative roles to each of the respective agencies with interest and responsibilities related to the functioning of this market.

In my view, H.R. 618 represents the irreducible minimum of what Congress must enact if it wants to be at all serious about reforming the market in the aftermath of the Salomon Brothers and other scandals.

The time for boosterism has passed, yet some refuse to admit it. To the boosters I can only say, boosterism leads to complacency and complacency leads to disaster. We do not intend to ignore the lessons of the recent scandals, and we intend to move forward to schedule a markup on this bill at an early date.

This morning, we will be examining some of the steps regulators have taken to respond to the lessons of the Salomon Brothers scandal. We will also be considering what additional measures Congress should adopt to supplement these actions with legislative reforms.

We will be asking regulators just what they are doing to prevent fraud and manipulation in this market and what tools they need to detect and prosecute any future effort to con, squeeze, or otherwise manipulate any sector of this market. We will also be hearing from two distinguished witnesses with extensive regulatory and trading experience in the Government securities market who can testify as to the continued need for vigilance in combatting manipulative and fraudulent activities in this market.

I look forward to the testimony of all of our witnesses which will be helpful to us as we move forward in passing this important legislation.

That concludes the opening statement of the Chair.

[Testimony resumes on p. 40.]

[The text of H.R. 618 follows:]

103<sup>D</sup> CONGRESS  
1<sup>ST</sup> SESSION

# H. R. 618

To extend and revise rulemaking authority with respect to government securities under the Federal securities laws, and for other purposes.

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## IN THE HOUSE OF REPRESENTATIVES

JANUARY 26, 1993

Mr. MARKEY (for himself, Mr. FIELDS of Texas, Mr. DINGELL, Mr. WYDEN, Mr. SYNAR, and Mr. COOPER) introduced the following bill; which was referred to the Committee on Energy and Commerce

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## A BILL

To extend and revise rulemaking authority with respect to government securities under the Federal securities laws, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*  
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the "Government Securities  
5 Reform Act of 1993".

1 **SEC. 2. EXTENSION OF GOVERNMENT SECURITIES RULE-**  
2 **MAKING AUTHORITY.**

3 Section 15C(g)(1) of the Securities Exchange Act of  
4 1934 (15 U.S.C. 78o-5(g)(1)) is amended by striking  
5 "October 1, 1991" and inserting "October 1, 1997".

6 **SEC. 3. RECORDKEEPING.**

7 Section 17 of the Securities Exchange Act of 1934  
8 (15 U.S.C. 78q) is amended by adding at the end thereof  
9 the following new subsection:

10 "(i) **GOVERNMENT SECURITIES RECORDKEEPING.—**

11 "(1) **MAINTENANCE OF RECORDS.—**The Com-  
12 mission may prescribe rules to require any govern-  
13 ment securities broker or government securities deal-  
14 er to make, keep, and maintain for prescribed peri-  
15 ods, in a form and containing such information as  
16 may be specified by the Commission, records of gov-  
17 ernment securities transactions, including (but not  
18 limited to) records of the date and time of execution  
19 of trades.

20 "(2) **EXAMINATION OF RECORDS.—**Every gov-  
21 ernment securities broker and government securities  
22 dealer shall make such records available for exam-  
23 ination to representatives of the appropriate regu-  
24 latory agency for such government securities broker  
25 or government securities dealer and furnish copies  
26 thereof to such representatives on request.

1           “(3) **FURNISHING RECORDS TO RECONSTRUCT**  
2 **TRADING.**—Every government securities broker and  
3 government securities dealer shall furnish to the  
4 Commission on request such of the information re-  
5 quired to be made, kept, or maintained under this  
6 subsection as the Commission may require to recon-  
7 struct trading in furtherance of the purposes of this  
8 title. In requiring information pursuant to this para-  
9 graph, the Commission shall specify the information  
10 required, the period for which it is required, the time  
11 and date on which the information must be fur-  
12 nished, and whether the information is to be fur-  
13 nished directly to the Commission, to the Federal  
14 Reserve Bank of New York, or to an appropriate  
15 regulatory agency or self-regulatory organization  
16 with responsibility for examining the government se-  
17 curities broker or government securities dealer. The  
18 Commission may require that such information be  
19 furnished in machine readable form.

20           “(4) **LIMITATION; CONSTRUCTION.**—The Com-  
21 mission shall not utilize its authority under this sub-  
22 section to develop regular reporting requirements for  
23 information concerning a substantial segment of all  
24 daily transactions in government securities; however,  
25 the Commission may require information to be fur-

1 nished under this subsection as frequently as nec-  
2 essary for particular inquiries or investigations. The  
3 Commission shall, where feasible, avoid requiring  
4 any information to be furnished under this sub-  
5 section that the Commission may obtain from the  
6 Federal Reserve Bank of New York.

7 “(5) CONSULTATION REQUIREMENT.—In mak-  
8 ing rules under this subsection applicable to govern-  
9 ment securities brokers and government securities  
10 dealers for which a Federal banking agency is the  
11 appropriate regulatory agency, the Commission shall  
12 consult with and consider the views of each such ap-  
13 propriate regulatory agency. If a Federal banking  
14 agency comments in writing on a proposed rule  
15 under this subsection that has been published for  
16 comment, the Commission shall respond in writing  
17 to such written comment before adopting the pro-  
18 posed rule. The Commission shall, at the request of  
19 the Federal banking agency, publish such comment  
20 and response in the Federal Register at the time of  
21 publishing the adopted rule. For purposes of this  
22 paragraph, the term ‘Federal banking agency’ has  
23 the meaning provided in subsection (h)(3)(G).

24 “(6) AUTHORITY OF THE COMMISSION TO LIMIT  
25 DISCLOSURE OF INFORMATION.—Notwithstanding

1 any other provision of law, the Commission and the  
2 appropriate regulatory agencies shall not be com-  
3 pelled to disclose any information required under  
4 this subsection. Nothing in this subsection shall au-  
5 thorize the Commission or any appropriate regu-  
6 latory agency to withhold information from Con-  
7 gress, or prevent the Commission or any appropriate  
8 regulatory agency from complying with a request for  
9 information from any other Federal department or  
10 agency requesting information for purposes within  
11 the scope of its jurisdiction, or complying with an  
12 order of a court of the United States in an action  
13 brought by the United States, the Commission, or  
14 the appropriate regulatory agency. For purposes of  
15 section 552 of title 5, United States Code, this sub-  
16 section shall be considered a statute described in  
17 subsection (b)(3)(B) of such section 552.”

18 **SEC. 4. LARGE POSITION REPORTING.**

19 (a) **AMENDMENT.**—Section 15C of the Securities Ex-  
20 change Act of 1934 (15 U.S.C. 78o-5) is amended—

21 (1) by redesignating subsections (f) and (g) as  
22 subsections (g) and (h); and

23 (2) by inserting after subsection (e) the follow-  
24 ing new subsection:

25 “(f) **LARGE POSITION REPORTING.**—

1           “(1) REPORTING REQUIREMENTS.—The Sec-  
2           retary may adopt rules to require specified persons  
3           holding, maintaining, or controlling large positions  
4           in to-be-issued or recently issued Treasury securities  
5           to file such reports regarding such positions as the  
6           Secretary determines to be necessary or appropriate  
7           for the purpose of monitoring the impact in the  
8           Treasury securities market of concentrations of posi-  
9           tions in Treasury securities and for the purpose of  
10          otherwise assisting the Commission in the enforce-  
11          ment of this title. Reports required under this sub-  
12          section shall be filed with the Federal Reserve Bank  
13          of New York, acting as agent for the Secretary, and  
14          shall be provided by that Federal Reserve Bank to  
15          the Commission on a timely basis.

16          “(2) LIMITATION ON REQUIRING CERTAIN RE-  
17          PORTS.—The Secretary may not require under this  
18          subsection—

19                 “(A) reports from persons that are not  
20                 government securities brokers or government  
21                 securities dealers, or

22                 “(B) reports from government securities  
23                 brokers and government securities dealers that  
24                 identify particular customers and customer po-  
25                 sitions,

1       except when the Secretary determines, after con-  
2       sultation with the Commission and the Board of  
3       Governors of the Federal Reserve System, that mar-  
4       ket conditions exist that require such information be  
5       obtained to carry out the purposes of this sub-  
6       section.

7           “(3) **ADDITIONAL CONSIDERATIONS.**—In mak-  
8       ing determinations under paragraphs (1) and (2),  
9       the Secretary shall take into account any impact on  
10      the efficiency and liquidity of the Treasury securities  
11      market and on the cost to the taxpayers of funding  
12      the Federal debt.

13          “(4) **RECORDKEEPING REQUIREMENTS.**—Rules  
14      under this subsection may require persons holding,  
15      maintaining, or controlling large positions in Treas-  
16      ury securities to make and keep for prescribed peri-  
17      ods such records as the Secretary determines are  
18      necessary or appropriate to ensure that such persons  
19      can comply with reporting requirements under this  
20      subsection.

21          “(5) **AGGREGATION RULES.**—Rules under this  
22      subsection—

23           “(A) may prescribe the manner in which  
24           positions and accounts shall be aggregated for  
25           the purpose of this subsection, including aggre-

1 gation on the basis of common ownership or  
2 control; and

3 “(B) may define which persons (individ-  
4 ually or as a group) hold, maintain, or control  
5 large positions.

6 “(6) DEFINITIONAL AUTHORITY; DETERMINA-  
7 TION OF REPORTING THRESHOLD.—

8 “(A) In prescribing rules under this sub-  
9 section, the Secretary may, consistent with the  
10 purpose of this subsection, define terms used in  
11 this subsection that are not otherwise defined in  
12 section 3 of this title.

13 “(B) Rules under this subsection shall  
14 specify—

15 “(i) the minimum size of positions  
16 subject to reporting under this subsection,  
17 taking into account the purposes of this  
18 subsection and the potential for price dis-  
19 tortions or other anomalies resulting from  
20 large positions;

21 “(ii) the types of positions (which may  
22 include financing arrangements) to be re-  
23 ported;

24 “(iii) the securities to be covered; and

1           “(iv) the form and manner in which  
2           reports shall be transmitted, which may in-  
3           clude transmission in machine readable  
4           form.

5           “(7) **LIMITATION ON DISCLOSURE OF INFORMA-**  
6           **TION.**—Notwithstanding any other provision of law,  
7           the Secretary and the Commission shall not be com-  
8           pelled to disclose any information required to be  
9           kept or reported under this subsection. Nothing in  
10          this subsection shall authorize the Secretary or the  
11          Commission to withhold information from Congress,  
12          or prevent the Secretary or the Commission comply-  
13          ing with a request for information from any other  
14          Federal department or agency requesting informa-  
15          tion for purposes within the scope of its jurisdiction,  
16          or complying with an order of a court of the United  
17          States in an action brought by the United States,  
18          the Secretary, or the Commission. For purposes of  
19          section 552 of title 5, United States Code, this sub-  
20          section shall be considered a statute described in  
21          subsection (b)(3)(B) of such section 552.”.

22          (b) **CONFORMING AMENDMENT.**—Section 15C(d)(2)  
23 of such Act is amended to read as follows:

24          “(2) Information received by an appropriate regu-  
25 latory agency, the Secretary, or the Commission from or

1 with respect to any government securities broker, govern-  
 2 ment securities dealer, any person associated with a gov-  
 3 ernment securities broker or government securities dealer,  
 4 or any other person subject to this section or rules promul-  
 5 gated thereunder, may be made available by the Secretary  
 6 or the recipient agency to the Commission, the Secretary,  
 7 the Department of Justice, the Commodity Futures Trad-  
 8 ing Commission, any appropriate regulatory agency, any  
 9 self-regulatory organization, or any Federal Reserve  
 10 Bank.”.

11 **SEC. 5. AUTHORITY OF THE COMMISSION TO REGULATE**  
 12 **TRANSACTIONS IN EXEMPTED SECURITIES.**

13 (a) **PREVENTION OF FRAUDULENT AND MANIPULA-**  
 14 **TIVE ACTS AND PRACTICES.**—Section 15(c)(2) of the Se-  
 15 curities Exchange Act of 1934 (15 U.S.C. 78o(c)(2)) is  
 16 amended—

17 (1) by inserting “(A)” after “(2)”;

18 (2) by striking “fictitious quotation, and no  
 19 municipal securities dealer” and inserting the follow-  
 20 ing:

21 “fictitious quotation.

22 “(B) No municipal securities dealer”;

23 (3) by striking “fictitious quotation. The Com-  
 24 mission shall” and inserting the following:

25 “fictitious quotation.

1       “(C) No government securities broker or government  
2 securities dealer shall make use of the mails or any means  
3 or instrumentality of interstate commerce to effect any  
4 transaction in, or induce or attempt to induce the pur-  
5 chase or sale of, any government security in connection  
6 with which such government securities broker or govern-  
7 ment securities dealer engages in any fraudulent, decep-  
8 tive, or manipulative act or practice, or makes any ficti-  
9 tious quotation.

10       “(D) The Commission shall”; and

11           (4) by inserting at the end thereof the follow-  
12 ing:

13       “(E) The Commission shall, prior to adopting rules  
14 or regulations under subparagraph (C), consult with and  
15 consider the views of the Secretary of the Treasury and  
16 the Board of Governors of the Federal Reserve System.  
17 If the Secretary of the Treasury or the Board of Gov-  
18 ernors of the Federal Reserve System comments in writing  
19 on a proposed rule or regulation of the Commission under  
20 such subparagraph (C) that has been published for com-  
21 ment, the Commission shall respond in writing to such  
22 written comment before adopting the proposed rule.”.

23       (b) FRAUDULENT AND MANIPULATIVE DEVICES AND  
24 CONTRIVANCES.—Section 15(c)(1) of the Securities Ex-  
25 change Act of 1934 (15 U.S.C. 78o(c)(1)) is amended—

- 1 (1) by inserting “(A)” after “(c)(1)”;
- 2 (2) by striking “contrivance, and no municipal  
3 securities dealer” and inserting the following:  
4 “contrivance.  
5 “(B) No municipal securities dealer”;
- 6 (3) by striking “contrivance. The Commission  
7 shall” and inserting the following:  
8 “contrivance.  
9 “(C) No government securities broker or government  
10 securities dealer shall make use of the mails or any means  
11 or instrumentality of interstate commerce to effect any  
12 transaction in, or to induce or attempt to induce the pur-  
13 chase or sale of, any government security by means of any  
14 manipulative, deceptive, or other fraudulent device or con-  
15 trivance.
- 16 “(D) The Commission shall”; and
- 17 (4) by inserting at the end thereof the follow-  
18 ing:
- 19 “(E) The Commission shall, prior to adopting rules  
20 or regulations under subparagraph (C), consult with and  
21 consider the views of the Secretary of the Treasury and  
22 the Board of Governors of the Federal Reserve System.  
23 If the Secretary of the Treasury or the Board of Gov-  
24 ernors of the Federal Reserve System comments in writing  
25 on a proposed rule or regulation of the Commission under

1 such subparagraph (C) that has been published for com-  
2 ment, the Commission shall respond in writing to such  
3 written comment before adopting the proposed rule.”.

4 **SEC. 6. BROKER/DEALER SUPERVISION RESPONSIBILITIES.**

5 Section 15 of the Securities Exchange Act of 1934  
6 (15 U.S.C. 78o) is amended by adding at the end thereof  
7 the following new subsection:

8 “(h) **POLICIES AND PROCEDURES TO PREVENT AND**  
9 **DETECT VIOLATIONS.**—Every government securities  
10 broker and government securities dealer shall establish,  
11 maintain, and enforce written policies and procedures rea-  
12 sonably designed, taking into consideration the nature of  
13 such person’s business, to prevent and detect in connection  
14 with the purchase or sale of government securities, insofar  
15 as practicable, fraud and manipulation in violation of this  
16 title and the rules and regulations thereunder and viola-  
17 tions of such other provisions of this title and the rules  
18 and regulations thereunder as the Commission shall des-  
19 ignate by rule. The Commission, as it deems necessary or  
20 appropriate in the public interest or for the protection of  
21 investors, shall prescribe rules or regulations to require  
22 specific policies or procedures reasonably designed to pre-  
23 vent such violations.”.

1 **SEC. 7. SALES PRACTICE RULEMAKING AUTHORITY.**

2 (a) **RULES FOR FINANCIAL INSTITUTIONS.**—Section  
3 15C(b) of the Securities Exchange Act of 1934 (15 U.S.C.  
4 78o-5(b)) is amended—

5 (1) by redesignating paragraphs (3), (4), (5),  
6 and (6) as paragraphs (4), (5), (6), and (7), respec-  
7 tively; and

8 (2) by inserting after paragraph (2) the follow-  
9 ing new paragraph:

10 “(3) **SALES PRACTICE RULES.**—(A) With respect to  
11 any financial institution that has filed notice as a govern-  
12 ment securities broker or government securities dealer or  
13 that is required to file notice under subsection (a)(1)(B)  
14 of this section, the appropriate regulatory agency for such  
15 government securities broker or government securities  
16 dealer may issue such rules with respect to transactions  
17 in government securities as may be necessary to prevent  
18 fraudulent and manipulative acts and practices and to pro-  
19 mote just and equitable principles of trade.

20 “(B) Each appropriate regulatory agency shall con-  
21 sult with the other appropriate regulatory agencies for the  
22 purpose of ensuring the consistency of the rules prescribed  
23 by such agencies under this paragraph. The appropriate  
24 regulatory agencies shall consult with and consider the  
25 views of the Secretary and the Commission with respect  
26 to the impact of such rules on the operations of the market

1 for government securities, consistency with analogous  
 2 rules of self-regulatory organizations, and the enforcement  
 3 and administration of such rules. The consultation re-  
 4 quired by this paragraph shall be conducted prior to the  
 5 appropriate regulatory agency adopting a rule under this  
 6 paragraph, unless the appropriate regulatory agency de-  
 7 termines that an emergency exists requiring expeditious  
 8 and summary action and publishes its reasons therefor.  
 9 If the Secretary or the Commission comments in writing  
 10 to the appropriate regulatory agency on a proposed rule  
 11 that has been published for comment, the appropriate reg-  
 12 ulatory agency shall respond in writing to such written  
 13 comment before adopting the rule.”.

14 (b) RULES BY REGISTERED SECURITIES ASSOCIA-  
 15 TIONS.—

16 (1) REMOVAL OF LIMITATIONS ON AUTHOR-  
 17 ITY.—(A) Section 15A of the Securities Exchange  
 18 Act of 1934 (15 U.S.C. 78o-3) is amended—

19 (i) by striking subsections (f)(1) and  
 20 (f)(2); and

21 (ii) by redesignating subsection (f)(3) as  
 22 subsection (f).

23 (B) Section 15A(g) of such Act is amended—

1 (i) by striking “exempted securities” in  
 2 paragraph (3)(D) and inserting “municipal se-  
 3 curities”;

4 (ii) by striking paragraph (4); and

5 (iii) by redesignating paragraph (5) as  
 6 paragraph (4).

7 (2) OVERSIGHT OF REGISTERED SECURITIES

8 ASSOCIATIONS.—Section 19 of the Securities Ex-  
 9 change Act of 1934 (15 U.S.C. 78s) is amended—

10 (A) in subsection (b), by adding at the end  
 11 thereof the following new paragraph:

12 “(5) The Commission shall consult with and consider  
 13 the views of the Secretary of the Treasury prior to approv-  
 14 ing a proposed rule change filed by a registered securities  
 15 association that primarily concerns conduct related to  
 16 transactions in government securities, except where the  
 17 Commission determines that an emergency exists requir-  
 18 ing expeditious or summary action and publishes its rea-  
 19 sons therefor. If the Secretary comments in writing to the  
 20 Commission on such proposed rule change that has been  
 21 published for comment, the Commission shall respond in  
 22 writing to such written comment before approving the pro-  
 23 posed rule change.”;

24 (B) in subsection (c), by adding at the end  
 25 thereof the following new paragraph:

1       “(5) Before adopting a rule to amend a rule of a reg-  
2  istered securities association that primarily concerns con-  
3  duct related to transactions in government securities, the  
4  Commission shall consult with and consider the views of  
5  the Secretary, except where the Commission determines  
6  that an emergency exists requiring expeditious or sum-  
7  mary action and publishes its reasons therefor. If the Sec-  
8  retary comments in writing to the Commission on such  
9  proposed rule change that has been published for com-  
10 ment, the Commission shall respond in writing to such  
11 written comment before approving the proposed rule  
12 change.”.

13           (3) CONFORMING AMENDMENT.—

14           (A) Section 3(a)(12)(B)(ii) of such Act (15  
15       U.S.C. 78b(a)(12)(B)(ii)) is amended by strik-  
16       ing “15, 15A (other than subsection (g)(3)),  
17       and 17A” and inserting “15 and 17A”.

18           (B) Section 15(b)(7) of such Act (15  
19       U.S.C. 78o(b)(7)) is amended by inserting “or  
20       government securities broker or government se-  
21       curities dealer registered (or required to reg-  
22       ister) under section 15C(a)(1)(A)” after “No  
23       registered broker or dealer”.

1 **SEC. 8. MARKET INFORMATION.**

2 (a) **TRANSPARENCY.**—The Securities Exchange Act  
3 of 1934 is amended by adding at the end of section 11A  
4 (15 U.S.C. 78k-1) the following:

5 “**MARKET INFORMATION WITH RESPECT TO GOVERNMENT**  
6 **SECURITIES**

7 “**SEC. 11B. (a) FINDINGS.**—The Congress finds  
8 that—

9 “(1) it is necessary and appropriate for the pro-  
10 tection of investors to assure public dissemination of  
11 information concerning government securities trans-  
12 actions and quotations;

13 “(2) government securities brokers, government  
14 securities dealers, and government securities infor-  
15 mation systems have created substantial trans-  
16 parency through the dissemination of information  
17 concerning government securities transactions and  
18 quotations and are expected to maintain and im-  
19 prove such transparency through voluntary actions;  
20 and

21 “(3) if such voluntary actions do not attain the  
22 objectives stated in subsections (b) and (c), the  
23 Commission should have the authority, in accord-  
24 ance with the requirements of this section, to assure  
25 the attainment of those objectives.

1       “(b) GOVERNMENT SECURITIES INFORMATION SYS-  
2       TEMS.—

3               “(1) CONDITIONAL AUTHORITY.—Upon a find-  
4       ing by the Commission that information available to  
5       investors generally through government securities in-  
6       formation systems taken as a whole does not meet  
7       the objectives set forth in paragraph (2) with respect  
8       to a class or category of regularly traded govern-  
9       ment securities, the Commission, having due regard  
10      for the public interest, the protection of investors,  
11      the maintenance of fair and orderly markets, the in-  
12      tegrity, liquidity, and efficiency of the government  
13      securities market, and the fostering of competition,  
14      may prescribe rules applicable to government securi-  
15      ties information systems to the extent necessary to  
16      assure that government securities information sys-  
17      tems meet the objectives set forth in paragraph (2)  
18      with respect to such class or category of securities.  
19      The Commission (A) shall not utilize its authority  
20      under this paragraph to regulate the amount of fees  
21      charged for information, and (B) shall not require  
22      dissemination through government securities infor-  
23      mation systems of information not transmitted by or  
24      through government securities interdealer brokers  
25      (or their functional equivalents).

1           “(2) OBJECTIVES.—The Commission may not  
2 take action under paragraph (1) of this subsection  
3 unless the Commission makes the finding required  
4 by paragraph (1) and determines that such action is  
5 necessary or appropriate—

6           “(A) to assure that information on trans-  
7 actions in and quotations for a class or category  
8 of regularly traded government securities being  
9 reported through government securities infor-  
10 mation systems taken as a whole is available to  
11 investors generally and includes—

12           “(i) information concerning price and  
13 volume with respect to a reasonably suffi-  
14 cient number or proportion of transactions  
15 in any security in such class or category to  
16 permit the determination of the prevailing  
17 market price for such security; and

18           “(ii) reports of the highest bids and  
19 lowest offers for any security in such class  
20 or category being reported through such  
21 systems (including the size at which gov-  
22 ernment securities brokers and dealers are  
23 willing to trade with respect to such bids  
24 and offers);

1           “(B) to assure that such information is  
2 timely reported;

3           “(C) to assure that such information is  
4 made available to investors generally on a fair,  
5 reasonable, and nondiscriminatory basis; and

6           “(D) to assure the ability of investors to  
7 obtain and retain such information for analyt-  
8 ical purposes.

9           “(e) STANDBY AUTHORITY WITH RESPECT TO MAR-  
10 KET INFORMATION.—

11           “(1) AUTHORITY.—Subject to paragraph (2),  
12 the Commission by rule—

13           “(A) may require any government securi-  
14 ties broker or government securities dealer that  
15 regularly trades a security as to which the Sec-  
16 retary of the Treasury has made a determina-  
17 tion under paragraph (2) to report any pur-  
18 chase or sale of such a security to any securities  
19 information processor that has the capability  
20 and agrees to disseminate such reports or, if  
21 there is no such processor, to a self-regulatory  
22 organization designated by the Commission to  
23 receive such reports, and may require such se-  
24 curities information processor or self-regulatory  
25 organization to make information with respect

1 to such purchase or sale publicly available on  
2 fair, reasonable, and nondiscriminatory terms  
3 and conditions; and

4 “(B) may require any self-regulatory orga-  
5 nization, and any government securities broker  
6 or government securities dealer that regularly  
7 trades such securities, to act jointly in plan-  
8 ning, developing, or operating facilities for the  
9 dissemination of information with respect to  
10 purchases or sales of government securities.

11 “(2) INADEQUATE PRICE INFORMATION FIND-  
12 ING REQUIRED.—The Commission may not take an  
13 action authorized by paragraph (1) of this sub-  
14 section with respect to any class or category of regu-  
15 larly traded government securities unless the Sec-  
16 retary of the Treasury, after consultation with the  
17 Commission, determines that information that is  
18 available to investors generally with respect to such  
19 class or category either—

20 “(A) does not permit investors in general  
21 to determine readily the prevailing market price  
22 of securities in such class or category of regu-  
23 larly traded government securities; or

1           “(B) is no longer representative of the  
2           market for such class or category of govern-  
3           ment securities.

4           “(3) RULE OF CONSTRUCTION.—This sub-  
5           section is not intended to authorize the Commission  
6           to require the establishment or use of a consolidated  
7           trading system for government securities.

8           “(d) RULEMAKING.—

9           “(1) CONSULTATION.—In making rules under  
10          this section, the Commission shall consult with and  
11          consider the views of the Secretary of the Treasury  
12          and the Board of Governors of the Federal Reserve  
13          System. If the Secretary of the Treasury or the  
14          Board of Governors of the Federal Reserve System  
15          comments in writing on a proposed rule that has  
16          been published for comment, the Commission shall  
17          respond in writing to such written comment before  
18          adopting the proposed rule. Prior to prescribing a  
19          rule pursuant to subsection (c), the Commission  
20          shall consult with representatives of the persons de-  
21          scribed in subsection (a)(2).

22          “(2) STANDARDS.—In making rules under this  
23          subsection, the Commission may designate classes or  
24          categories of government securities, establish stand-  
25          ards for determining whether they are regularly

1 traded, and establish standards for determining  
 2 whether a person regularly trades such government  
 3 securities or a class or category of such government  
 4 securities.

5 “(e) EXAMINATION ACCESS.—

6 “(1) AUTHORITY TO EXAMINE.—Systems and  
 7 operations of government securities information sys-  
 8 tems (and records relating thereto) are subject to  
 9 reasonable examination by representatives of the  
 10 Commission—

11 “(A) to assess whether the objectives set  
 12 forth in subsection (b)(2) of this section are  
 13 being met; and

14 “(B) to assess compliance with any rules  
 15 or regulations under this section.

16 “(2) LIMITATIONS.—The Commission shall  
 17 have no authority under this section—

18 “(A) to examine the financial, personnel,  
 19 marketing, sales, product, and service develop-  
 20 ment, or similar business records of such per-  
 21 son; or

22 “(B) to examine systems and operations  
 23 unrelated to dissemination of government secu-  
 24 rities information.

1 The Commission may not examine contracts except  
2 to the extent necessary to assess whether the objec-  
3 tives set forth in subsections (b)(2)(C) and (b)(2)(D)  
4 of this section are being met, and to determine com-  
5 pliance with rules prescribed for purposes of such  
6 subsections.

7 “(3) PROTECTION OF INFORMATION.—Notwith-  
8 standing any other provision of law, the Commission  
9 (and any Federal agency or department to which  
10 such information is disclosed) shall not be compelled  
11 to disclose any information obtained by the Commis-  
12 sion in an examination under this subsection. Fur-  
13 thermore, the Commission (and any Federal agency  
14 or department to which such information is dis-  
15 closed) shall not publicly disclose information ob-  
16 tained by the Commission in such an examination,  
17 except that this sentence shall not prohibit the dis-  
18 closure of such information in a proceeding brought  
19 by the Commission. Nothing in this section shall au-  
20 thorize the Commission to withhold information  
21 from Congress, or prevent the Commission or any  
22 appropriate regulatory agency from complying with  
23 a request for information from any other Federal de-  
24 partment or agency requesting information for pur-  
25 poses within the scope of its jurisdiction, or comply-

1       ing with an order of a court of the United States in  
2       an action brought by the United States, the Com-  
3       mission, or the appropriate regulatory agency. For  
4       purposes of section 552 of title 5, United States  
5       Code, this subsection shall be considered a statute  
6       described in subsection (b)(3)(B) of such section  
7       552.

8       “(f) VIOLATIONS OF RULES PROHIBITED.—No gov-  
9       ernment securities broker, government securities dealer,  
10      securities information processor, or government securities  
11      information system shall make use of the mails or any  
12      means or instrumentality of interstate commerce to effect  
13      any transaction in, to induce the purchase or sale of, or  
14      to distribute or disseminate any quotation or transaction  
15      report for, any government security in contravention of  
16      any rule adopted pursuant to this section.

17      “(g) EFFECTIVE DATE OF RULEMAKING AUTHOR-  
18      ITY.—The authority of the Commission to prescribe rules  
19      under subsections (b) and (c) is effective on October 1,  
20      1993.

21      “(h) DEFINITION.—For purposes of this section, the  
22      term ‘government securities’ does not include a security  
23      secured by an interest in pools of mortgages representing  
24      liens on residential real estate.”.

1 (b) CONFORMING AMENDMENTS.—The Securities  
2 Exchange Act of 1934 is amended—

3 (1) by striking “(other than an exempted secu-  
4 rity)” in section 3(a)(22)(A);

5 (2) by adding at the end of section 3(a) the fol-  
6 lowing:

7 “(53) The term ‘government securities informa-  
8 tion system’ means any person engaged in the busi-  
9 ness of operating a system for the timely, automated  
10 dissemination to more than 10 persons of (A) quota-  
11 tions for government securities of or through govern-  
12 ment securities interdealer brokers (or their func-  
13 tional equivalents), or (B) reports of purchases or  
14 sales of government securities by or through govern-  
15 ment securities interdealer brokers (or their func-  
16 tional equivalents).”; and

17 (3) by inserting at the end of section 11A(b)(1)  
18 the following: “The Commission shall not require  
19 any securities information processor to register  
20 under this section in connection with its activities  
21 with respect to quotations for or transactions in ex-  
22 empted securities.”.

23 (c) STUDIES WITH RESPECT TO MORTGAGE-BACKED  
24 GOVERNMENT SECURITIES.—

1           (1) **STUDIES REQUIRED.**—With respect to gov-  
2 ernment securities (as defined in section 3(a)(42) of  
3 the Securities Exchange Act of 1934) that are se-  
4 cured by an interest in pools of mortgages represent-  
5 ing liens on residential real estate (hereafter in this  
6 subsection referred to as ‘mortgage-backed govern-  
7 ment securities’), the Secretary of the Treasury, the  
8 Securities and Exchange Commission, and the  
9 Board of Governors of the Federal Reserve System  
10 shall monitor and evaluate the effectiveness of pri-  
11 vate sector efforts to disseminate mortgage-backed  
12 government securities price and volume information,  
13 and determine whether such efforts—

14                   (A) assure the prompt, accurate, reliable,  
15 and fair reporting, collection, processing, dis-  
16 tribution, and publication of information with  
17 respect to quotations for and transactions in  
18 mortgage-backed government securities and the  
19 fairness and usefulness of the form and content  
20 of such information;

21                   (B) assure that all mortgage-backed gov-  
22 ernment securities information processors may,  
23 for the purpose of distribution and publication,  
24 obtain on fair and reasonable terms such infor-  
25 mation with respect to quotations for and

1 transactions in mortgage-backed government se-  
2 curities, as reported, collected, processed, or  
3 prepared for distribution or publication by any  
4 processor of such information (including self-  
5 regulatory organizations) acting in an exclusive  
6 capacity; and

7 (C) assure that all mortgage-backed gov-  
8 ernment securities brokers, mortgage-backed  
9 government securities dealers, mortgage-backed  
10 government securities information processors,  
11 and other appropriate persons may obtain on  
12 nondiscriminatory terms such information with  
13 respect to quotations for and transactions in  
14 mortgage-backed government securities as is  
15 distributed or published.

16 (2) REPORTS.—The Secretary of the Treasury,  
17 the Securities and Exchange Commission, and the  
18 Board of Governors of the Federal Reserve System  
19 shall each submit a report to the Congress describ-  
20 ing its findings under this subsection and any rec-  
21 ommendations for legislation not later than 18  
22 months after the date of enactment of this Act.

1 **SEC. 9. STUDY OF REGULATORY SYSTEM FOR GOVERN-**  
2 **MENT SECURITIES.**

3 (a) **JOINT STUDY.**—The Secretary of the Treasury,  
4 the Securities and Exchange Commission, and the Board  
5 of Governors of the Federal Reserve System shall—

6 (1) evaluate the effectiveness of any rules pro-  
7 mulgated or amended after October 1, 1991, pursu-  
8 ant to section 15C of the Securities Exchange Act  
9 of 1934 or any amendment made by this title, and  
10 any national securities association rule changes ap-  
11 plicable principally to government securities trans-  
12 actions approved after October 1, 1991, in carrying  
13 out the purposes of such Act;

14 (2) evaluate the effectiveness of surveillance  
15 and enforcement with respect to government securi-  
16 ties, and the impact on such surveillance and en-  
17 forcement of defects in any available audit trails  
18 with respect to transactions in such securities; and

19 (3) submit to the Congress, not later than  
20 March 31, 1997, any recommendations they may  
21 consider appropriate concerning—

22 (A) the regulation of government securities  
23 brokers and government securities dealers,

24 (B) the dissemination of information con-  
25 cerning quotations for and transactions in gov-  
26 ernment securities,

1 (C) the prevention of sales practice abuses  
 2 in connection with transactions in government  
 3 securities, and

4 (D) such other matters as they consider  
 5 appropriate.

6 (b) GAO STUDY.—The Comptroller General shall—

7 (1) conduct a study of the effectiveness of regu-  
 8 lation of government securities brokers and govern-  
 9 ment securities dealers pursuant to section 15C of  
 10 the Securities Exchange Act of 1934 and the effec-  
 11 tiveness of the amendments made by this title; and

12 (2) submit to the Congress, not later than  
 13 March 31, 1996, the Comptroller General's rec-  
 14 ommendations for change, if any, or such other rec-  
 15 ommendations as the Comptroller General considers  
 16 appropriate.

17 **SEC. 10. TECHNICAL AMENDMENTS.**

18 (a) AMENDMENTS TO DEFINITIONS.—Section 3(a) of  
 19 the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))  
 20 is amended—

21 (1) in paragraph (34)(G) (relating to the defini-  
 22 tion of appropriate regulatory agency), by amending  
 23 clauses (ii), (iii), and (iv) to read as follows:

24 “(ii) the Board of Governors of the  
 25 Federal Reserve System, in the case of a

1 State member bank of the Federal Reserve  
2 System, a foreign bank, an uninsured  
3 State branch or State agency of a foreign  
4 bank, a commercial lending company  
5 owned or controlled by a foreign bank (as  
6 such terms are used in the International  
7 Banking Act of 1978), or a corporation or-  
8 ganized or having an agreement with the  
9 Board of Governors of the Federal Reserve  
10 System pursuant to section 25 or section  
11 25A of the Federal Reserve Act;

12 “(iii) the Federal Deposit Insurance  
13 Corporation, in the case of a bank insured  
14 by the Federal Deposit Insurance Corpora-  
15 tion (other than a member of the Federal  
16 Reserve System or a Federal savings bank)  
17 or an insured State branch of a foreign  
18 bank (as such terms are used in the Inter-  
19 national Banking Act of 1978);

20 “(iv) the Director of the Office of  
21 Thrift Supervision, in the case of a savings  
22 association (as defined in section 3(b) of  
23 the Federal Deposit Insurance Act) the de-  
24 posits of which are insured by the Federal  
25 Deposit Insurance Corporation;”;

1           (2) by amending paragraph (46) (relating to  
2 the definition of financial institution) to read as fol-  
3 lows:

4           “(46) The term ‘financial institution’ means—

5                 “(A) a bank (as defined in paragraph (6)  
6 of this subsection);

7                 “(B) a foreign bank (as such term is used  
8 in the International Banking Act of 1978); and

9                 “(C) a savings association (as defined in  
10 section 3(b) of the Federal Deposit Insurance  
11 Act) the deposits of which are insured by the  
12 Federal Deposit Insurance Corporation.”; and

13           (3) by redesignating paragraph (51) (as added  
14 by section 204 of the International Securities En-  
15 forcement Cooperation Act) as paragraph (52).

16           (b) EFFECTIVE DATE OF BROKER/DEALER REG-  
17 ISTRATION.—

18           (1) GOVERNMENT SECURITIES BROKERS AND  
19 DEALERS.—Section 15C(a)(2)(ii) of the Securities  
20 Exchange Act of 1934 (15 U.S.C. 78o-5(a)(2)(ii)) is  
21 amended by inserting before “At the conclusion” the  
22 following: “The order granting registration shall not  
23 be effective until such government securities broker  
24 or government securities dealer has become a mem-  
25 ber of a national securities exchange registered

1 under section 6 of this title, or a securities associa-  
 2 tion registered under section 15A of this title, unless  
 3 the Commission has exempted such government se-  
 4 curities broker or government securities dealer, by  
 5 rule or order, from such membership.”.

6 (2) OTHER BROKERS AND DEALERS.—Section  
 7 15(b)(1)(B) of such Act (15 U.S.C. 78o(b)(1)(B)) is  
 8 amended by inserting before “At the conclusion” the  
 9 following: “The order granting registration shall not  
 10 be effective until such broker or dealer has become  
 11 a member of a registered securities association, or  
 12 until such broker or dealer has become a member of  
 13 a national securities exchange if such broker or deal-  
 14 er effects transactions solely on that exchange, un-  
 15 less the Commission has exempted such broker or  
 16 dealer, by rule or order, from such membership.”.

17 **SEC. 11. OFFERINGS OF CERTAIN GOVERNMENT SECURI-**  
 18 **TIES.**

19 Section 15 of the Securities Exchange Act of 1934  
 20 (15 U.S.C. 78o) is amended by inserting after paragraph  
 21 (6) of subsection (c) the following new paragraph:

22 “(7) In connection with any bid for or purchase  
 23 of a government security related to an offering of  
 24 government securities by or on behalf of an issuer,  
 25 no government securities broker, government securi-

1 ties dealer, or bidder for or purchaser of securities  
 2 in such offering shall knowingly or willfully make  
 3 any false or misleading written statement or omit  
 4 any fact necessary to make any written statement  
 5 made not misleading. For purposes of the preceding  
 6 sentence, the term 'government security' shall not  
 7 include any obligation subject to the public debt  
 8 limit established in section 3101 of title 31, United  
 9 States Code."

10 **SEC. 12. RULE OF CONSTRUCTION.**

11 (a) IN GENERAL.—No provision of, or amendment  
 12 made by, this title may be construed—

13 (1) to apply to the initial issuance of any public  
 14 debt obligation, or

15 (2) to grant any authority to (or extend any au-  
 16 thority of) the Securities and Exchange  
 17 Commission—

18 (A) to prescribe any procedure, term, or  
 19 condition governing such initial issuance,

20 (B) to require any recordkeeping, or the  
 21 furnishing of any information, with respect to  
 22 such initial issuance, or

23 (C) to otherwise regulate in any manner  
 24 such initial issuance.

39

36

1 (b) PUBLIC DEBT OBLIGATION.—For purposes of  
2 this section, the term “public debt obligation” means an  
3 obligation subject to the public debt limit established in  
4 section 3101 of title 31, United States Code.

○

•HR 618 IH

Mr. MARKEY. The Chair turns to recognize the gentleman from Louisiana, Mr. Tauzin, if he has an opening statement.

Mr. TAUZIN. Mr. Chairman, in recognition of the Chair's earlier motion to monopolize opening statements—I'm teasing you—so the witnesses could have more time to tell us their story, I do not have an opening statement.

Mr. MARKEY. The Chair respects the gentleman's deference to the Chair, and he notes that most other members are now still in traffic most likely, and we will, as a result, turn to our opening set of witnesses, which I think will help to lay out the basic problems in this area.

We will begin with the Honorable Richard Breeden, who is the Chairman of the Securities and Exchange Commission. No. Let's start with Mr. Mullins. I think it might make sense to start with Mr. Mullins instead, who is from the Board of Governors of the Federal Reserve System.

Other members have arrived.

Do any of the arriving members have an opening statement they would like to make?

Ms. SCHENK. Just that the metro was late.

Mr. MARKEY. Without objection, all of the opening statements in written form of all of the members will be included in the record.

[The prepared statement of Hon. Michael G. Oxley follows.]

#### STATEMENT OF HON. MICHAEL G. OXLEY

Thank you, Mr. Chairman. I want to commend you for holding these hearings on H.R. 618, The Government Securities Reform Act of 1993.

The purpose of the Government securities market is to finance the national debt at the lowest possible cost. Public confidence in the integrity of the market is essential. It was to help preserve that confidence that Congress enacted the Government Securities Act of 1986.

The GSA established a Federal system for regulating the Government securities market, including previously unregulated brokers and dealers, in order to protect investors and to ensure the maintenance of a fair, honest and liquid markets.

At that time, the Department of the Treasury was instructed to adopt rules to prevent fraudulent and manipulative acts and practices. Their efforts have been successful. The rules they adopted have improved and strengthened investor safety in the market. Treasury's rulemaking authority, however, sunset on October 1, 1991.

I believe it is incumbent upon Congress to remedy the situation in which the Treasury Department is without authority to regulate its own marketplace as quickly as possible. Our legislation does this by reauthorizing the Treasury Department to adopt rules as necessary.

In 1987 Treasury, the Federal Reserve and the GAO agreed that Government securities brokers should make more quotation information available. Increasing the amount of information available to the public makes financial markets more efficient without any risk to their safety.

In testimony at our hearings in the 102nd Congress, many witnesses agreed that additional disclosure would help but they urged caution. Specifically, they asked us to allow private industry to lead the development of market information systems. I agreed with them then and I agree now. I do not see the Government replacing private companies as the manager of the evolution of vendor services. Private sector initiatives have significantly enhanced transparency in the Government securities market.

I do believe that the Government has a role to play in insuring that this critically important marketplace is not disrupted by fraud and scandal. It is appropriate for the Government "safety valve" to guard against market information streams misleading investors. To the extent that disclosure of quotation information could result in misinformed investors, it is appropriate for the Government to continue to monitor developments in this area, and to retain "back-up" authority to step in to prevent fraud or manipulation.

If industry systems deteriorate to the point where the information they publish no longer represents the true market, then the SEC must be authorized to take action. The legislation before us today, however, recognizes the Treasury Department's special interest in the operation of this market. Consequently, it is up to the Treasury to make the determination that the information systems have become dysfunctional. This is a good solution to a potential problem.

Personally, I believe industry initiatives show that this legislative authority will most likely never be used, and in time will be viewed as an overabundance of caution on the part of Congress.

The 1986 Act did not give Treasury authority to enact sales practice rules, and it restricted the NASD from applying its already existing sales practice rules to its member Government securities dealers. The securities exchanges and bank regulators do regulate the sales practices of their Government securities dealers. Critics maintain that the NASD's inability to enforce sales practice rules on over 1,300 dealers creates a major gap in investor protection. I agree, and support the sales practice provisions of this legislation.

In H.R. 618, I believe we have fashioned responsible legislation. During the hearings held before this subcommittee during the 102nd Congress, many witnesses urged caution and we have responded appropriately.

I reject the suggestion offered by another committee of the House that wholesale restructuring of the Government securities markets is necessary or desirable. The Energy and Commerce Committee should push forward with this carefully crafted legislation and bring it to the house floor as soon as is possible.

I look forward to the testimony of our witnesses on these and the other issues before us today and yield back the balance of my time.

Mr. MARKEY. So we will turn then and recognize you, Mr. Mullins. Whenever you feel comfortable, please begin.

**STATEMENTS OF DAVID W. MULLINS, JR., VICE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM; WILLIAM J. McDONOUGH, EXECUTIVE VICE PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK; AND HON. RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY CATHERINE McGUIRE, SPECIAL ASSISTANT**

Mr. MULLINS. Thank you, Mr. Chairman. We are happy to go first.

Mr. Chairman, members of the committee, I appreciate the opportunity to present the views of the Board of Governors of the Federal Reserve System on H.R. 618, the Government Securities Reform Act of 1993.

This committee is to be commended for working long, hard, and conscientiously on issues pertaining to the Government securities market, matters that are of crucial importance to our Federal finances. The Board has reviewed H.R. 618 carefully. However, I must report that we remain unconvinced of the wisdom and necessity of adopting many of the measures called for under this legislation.

Let me summarize briefly our views. As my colleague, Mr. McDonough, has outlined in his written testimony, the Government securities market has already undergone a substantial amount of change, including redesigned auction procedures and techniques, substantially intensified surveillance and enforcement mechanisms, changes to the primary dealer system to open it up, and supply management through Treasury reopenings. All of this should help eliminate the possibility of a recurrence of the abuses committed in the Salomon Brothers episode and should serve to deter and detect any future episodes of abuse.

In weighing the need for additional legislation, we should recognize that the U.S. Government securities market shows few signs of a need for sweeping regulatory redesign. It is the broadest, deepest, and most liquid of all securities markets, offering widespread economic benefits by permitting transactions of enormous size at razor-thin bid-ask spreads and allowing the Federal debt to be financed at minimum cost to the taxpayer.

Under the current regulatory structure, the smooth functioning of the overall market betrays no indication of any loss of confidence or fear of fraud on the part of market participants. Nonetheless, in the Board's view, the Nation's interest would be served by the timely enactment of the legislative agenda outlined in last year's joint report and included in H.R. 618. This agenda, reestablishing Treasury's rule-making authority for the Government securities market and perhaps eliminating the prohibition on NASD to specify sales practice rules, would complement the administrative actions that are already well advanced.

Unfortunately, H.R. 618 goes far beyond this legislative agenda. It would introduce confusing and overlapping lines of authority among agencies, it would erect a regulatory apparatus that is more appropriate for the equity markets, and it would create the potential for bureaucratic edict to substitute for 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 world-wide market acceptance for Treasury's massive debt issuance.

The Board of Governors supports Congress's wisdom in 1986 in designating the Treasury Department as the primary regulator and rule-writer in the Government securities market. Treasury is in the best position to weigh the impact of regulation on taxpayers and market participants, and Treasury has every incentive to protect the integrity of the market.

In the Board's view, there is no compelling need to grant new record-keeping authority to the SEC, especially when existing Treasury authority can be used more effectively if necessary, nor is there any need for large position reporting given the substantial improvement of the Agency's market surveillance efforts. In our view, there is no demonstrated need to thrust the SEC into the business of mandating what trading screens should look like, especially in view of the risk of impeding rapidly advancing industry initiatives.

The Board acknowledges that the broad-based apparatus of reporting requirements that could be erected under H.R. 618 might facilitate and reduce the cost of investigating relatively infrequent episodes of abuse. On the other side of the ledger, such changes would boost the cost of every trade, all \$200 billion a day in trades, and potentially reduce the ranks of market participants, thereby raising the cost of financing the Federal debt.

In considering broad-based regulatory change for a market this important, the burden should rest with the proponents for establishing a convincing case that benefits outweigh associated costs. In view of the scale of Federal borrowing, we should be wary of imposing costs or discouraging participation without the strong presump-

tion of offsetting benefits. In our estimation, many of the proposals in H.R. 618 do not pass this test.

In conclusion, Mr. Chairman, the current effort of the administration and Congress to reduce the Federal budget deficit is a most encouraging development. However, with interest expense fast becoming the single largest item on the expenditure side of the Federal accounts, it would take a sustained rise of less than a quarter of a percentage point in the average Treasury issuing rate over the next 4 years to offset \$30 billion of spending cuts proposed by the President. The stakes are indeed high in considering regulatory redesign of a market that reaches directly into the taxpayer's pocket-book.

Instead of considering a risky overhaul of a market that works so well, Congress can chart a safer and sounder course: Restore the Treasury's rulemaking authority, perhaps allow NASD to set sales practice standards, and support the Agency's substantial ongoing efforts to improve surveillance and enforcement. The Board of Governors feels that such a course would be certain to reinforce and enhance the efficiency and integrity of this very important market. We look forward to continuing to work with the committee on these issues.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Mullins follows:]

STATEMENT OF DAVID W. MULLINS, JR.

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.

Over the past 1½ 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 year-long 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 10-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.

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 1½ 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 sales 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.

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 id-

iosyncratic 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.

Mr. MARKEY. Thank you very much, Mr. Mullins.

Our next witness, Mr. William McDonough, is the executive vice president of the Financial Market Group from the Federal Reserve Bank in New York, and is continuing our Hibernian trend here in the witnesses. He represents the New York Fed which conducts the auctions, carries out the open market operations to conduct monetary policies, and runs the market surveillance program that collects data on market activity.

We welcome you, Mr. McDonough. Whenever you feel comfortable, please begin.

#### STATEMENT OF WILLIAM J. McDONOUGH

Mr. McDONOUGH. Thank you, Mr. Chairman and members of the subcommittee.

I will concentrate this morning on the progress that has been made during the last year regarding official oversight and regulation of the Government securities market. This review should help the subcommittee address the question of how the legislative proc-

ess can best support efforts to ensure that the Government securities market retain its status as the most efficient market in the world.

Following the Salomon Brothers events, the Treasury, the SEC, and the Federal Reserve moved quickly to address the various concerns. The Agency set up a working group on market surveillance with the New York Fed accepting primary responsibility for collecting and disseminating information. The Treasury clarified and restated auction rules and, with the Fed, strengthened procedures for enforcement of those rules.

What we seek is balance between the efficiency of the market and adequate regulatory oversight. It is simply not possible to design a system at any price which would provide absolutely fail-safe protection against all problems or potential problems. Overloading the regulatory system increases cost and discourages innovation without materially improving the likelihood of detecting and remedying any wrongdoing or possible wrongdoing.

Remember that in the face of apparent irregularities in the marketplace, securities and bank regulators already have access to individual dealer firms' books, records, and trading systems.

There has been great progress made in improving communications among the agencies involved in the surveillance effort, the New York Fed, the Federal Reserve Board, the Treasury, the SEC, and the CFTC. The entire working group holds biweekly conference calls, and senior officials of the working group meet quarterly. There has been no facet of the work of the Interagency Group to date that has witnessed material differences of opinion or judgment among the various agencies.

The New York Fed surveillance group looks at both the overall market and specific cases that look unusual and might be a cause of official concern. We look at price movements, yield spreads, and trading volume in the cash market as well as market quotes and trades for overnight contracts and term maturities in the financing markets. We collect aggregate data from individual primary dealers on positions, transactions, financing, trade settlement, and when-issued activity. We also receive information on individual securities when we undertake a formal survey of primary dealers activity as part of our analysis of unusual situations.

Based on our ongoing surveillance of the overall Treasury market and related markets, we can evaluate the current behavior of specific securities of interest against a comprehensive market view. Then we share our conclusions with the Interagency Working Group.

In the situations we have analyzed, we found that the apparent shortages of specific Treasury issues represented the natural consequences of legitimate uses of the Treasury market, especially in connection with risk management strategies to facilitate underwriting, issuance, and distribution of the full range of fixed-income securities, those sold by corporations, State and local governments, and others.

We are mindful that we must pursue each incident of unusual market activity rigorously, and we are increasing our capabilities and resources to do just that. Congress can support these efforts by reauthorizing the Treasury's rule-making authority under the

GSA of 1986 and explicitly incorporate the making of misleading statements to an issuer of Government securities as a violation of the Securities Exchange Act of 1934.

The New York Federal Reserve Bank is sympathetic to legislation giving the Treasury back-up authority to require holders of large positions in Treasury securities to report that information. With those steps and our continued and improving surveillance efforts, I believe we best strike that balance between providing effective oversight by the agencies and avoiding the cost of excessive regulation. That cost will, without the slightest doubt, be borne by the American taxpayer.

The progress we have made so far and the outlook for ongoing improvement make any additional measures clearly premature. The agencies already have the ability to review, analyze, and act appropriately and promptly when market developments raise issues of public concern.

Thank you, Mr. Chairman.

[The prepared statement of Mr. McDonough follows:]

STATEMENT OF WILLIAM J. McDONOUGH

Mr. Chairman and members of the subcommittee, I am pleased to have the opportunity to appear before you in my capacity as Executive Vice President of the Federal Reserve Bank of New York responsible for the Financial Markets Group. As such I have responsibility for Domestic and Foreign Operations of the System Open Market Account and for the recently formed Market Surveillance Function. My statement this morning will discuss the market surveillance activities of the Federal Reserve Bank of New York, and the overall subject of the official oversight and regulation of the Government securities market.

We all share a common goal regarding the Government securities market. That is, we all want to ensure that the integrity, health and efficiency of the world's largest and most liquid securities market is preserved. Quite clearly, the American public and the world at large share an enormous interest in the continued vitality of the market for U.S. Treasury securities and its ability to meet both public and private needs.

Against this background, the immediate question before the subcommittee centers on how the legislative process can best support efforts to ensure that this vital market retains its status as the most efficient market in the world. As the subcommittee deliberates this important topic, I think it necessary to consider the strides taken over the last year to improve the monitoring of this market.

Salomon Brothers' admissions of deliberate and repeated violations of Treasury auction rules could well have damaged the public's confidence in the overall soundness of the Government securities market. Fortunately, this did not happen, as evidenced by the efficiency with which the market has continued to perform. Nonetheless, some important questions were raised about the workings of that market and the official oversight of the market.

Following the events of August, 1991, the Treasury, the SEC and the Federal Reserve moved quickly to address the various concerns that arose from the Salomon revelations. The agencies have set up a working group on market surveillance with the Federal Reserve Bank of New York accepting primary responsibility for collecting and disseminating information. The Treasury facilitated broader auction participation, clarified and restated auction rules and, with the Federal Reserve, strengthened the procedures for enforcement of those rules. Changes were made to the administration of the primary dealer system to provide greater access to participants who wished to service the central bank.

Ongoing automation initiatives will lend further support to ensuring that the primary and secondary markets are, open and accessible. Our new system for automated Treasury auctions is in the final stages of testing and its implementation is scheduled for next month. This effort will speed and further systematize the auction review process and further allow for broader bidder access. In addition, we have finalized many of the business requirements for the automation of our open market operations and have taken some initial steps in development, with a view toward implementing a number of capabilities next year. This effort will provide an efficient

way of accommodating an expansion in the number of our trading counterparties—should such occur.

Market participants themselves have reviewed and improved internal compliance procedures and audits following the revelations of wrongdoing in 1991. Finally, it is important to restate that, in the face of apparent irregularities in the marketplace, securities and bank regulators already have access to individual dealer firms' books, records and trading systems. Having said that, it should also be stressed that it is neither possible nor desirable to have absolutely failsafe management and control systems or regulatory schemes that can prevent or detect every problem or potential problem. Nor is it desirable to discourage innovation with overly restrictive and duplicative rules. What is needed is an approach which strikes an appropriate balance between the efficiency of the market and adequate regulatory oversight.

Of the efforts taken to date, I should comment on the significant progress made in improving communications among the agencies involved in the surveillance effort—the Bank, the Treasury, the SEC, the Federal Reserve Board, and the CFTC. The entire working group holds a bi-weekly conference call and senior officials of the working group meet quarterly. I can assure you that the progress made in cooperation and information sharing will certainly continue. And, I can also assure you that there has been no facet of the work of the Interagency Group to date that has witnessed material differences of opinion or judgment among the various agencies.

In its effort to satisfy the needs of the working group, the New York Fed's surveillance work has focused on activity surrounding a number of specific Treasury securities, as well as a variety of overall market conditions. Additional attention was devoted to those incidents that, based on comparisons to either historical experience or then-existing market conditions, were a potential source of concern. Needless to say, our methods are being refined as we gain more experience and receive input from the other agencies.

In the interest of time, I will not cover the full scope of our efforts. However, allow me to mention briefly a few of the specifics of market surveillance. We look at price movements, yield spreads and trading volume in the cash market. In the financing market, we review market quotes and trades for overnight contracts and term maturities. From individual primary dealers, we collect aggregate data on positions, transactions, financing, trade settlement and when-issued activity in specific securities. We also receive information on individual securities when we undertake a formal survey of primary dealers' activity.

More broadly, we have access to market opinion, analytics, general economic data, and specific information on other, related markets. Finally, our daily conversations with the market participants themselves provide invaluable information on market developments and their own trading activity. This wealth of information allows us to evaluate the current behavior of specific securities of interest from the vantage point of a comprehensive view of the market. We share with the members of the Interagency Working Group all significant market information that we collect.

Our surveillance efforts over this past year focused on apparent shortages of specific Treasury securities. Time and again, we found that individual episodes of "specials" trading represented the natural consequence of legitimate uses of the Treasury market, especially in connection with risk-management strategies to facilitate the orderly underwriting, issuance and distribution of the full range of fixed-income securities sold by corporations, State and local governments and others. At times, these activities can generate large amounts of short positions in Treasury securities as underwriters hedge their exposures. As a consequence, temporary shortages of certain issues can and will develop even though there is a large amount of securities outstanding.

Despite the general thrust of our findings to date, we recognize that we must continue to pursue each incident of unusual market activity rigorously. To meet this responsibility, we intend to build upon the strong start we have made in tightening surveillance. We will continue to improve our knowledge of market developments, our methods of review and analysis, and the technical resources we need to operate efficiently and effectively with a view to servicing the needs of the other members of the Interagency Working Group.

At the same time, I believe Congress can provide some further support for our efforts by reauthorizing the Treasury's rulemaking authority under the Government Securities Act of 1986, and explicitly incorporating the making of misleading statements to an issuer of Government securities as a violation of the Securities Exchange Act of 1934. In addition, the Federal Reserve Bank of New York is sympathetic to legislation that would give the Treasury backup authority to require holders of large positions in Treasury securities to report this information. This measure will further our efforts to develop a comprehensive view of the market.

With these steps—and our continued surveillance efforts—I think we come much closer to striking that appropriate balance I spoke of earlier between providing effective oversight by the agencies and avoiding the burdens of excessive regulation that can easily stifle the efficiency and liquidity of the market, a potentially significant cost which ultimately will be borne by the American taxpayer. The progress we have made so far and the outlook for our near-term initiatives make any additional measures seem clearly premature. The agencies have the ability to review, analyze and act appropriately—and in a timely fashion—when market developments raise issues of public concern.

Thank you, Mr. Chairman.

Mr. MARKEY. Thank you, Mr. McDonough, very much.

Now for the next in a series of Richard Breeden's final victory tour around this subcommittee. This is his final appearance on Government securities before the committee.

We welcome you back, Mr. Chairman, once again, and we appreciate your willingness to continue to aid the subcommittee in the drafting of legislation. Whenever you feel comfortable, please begin.

#### STATEMENT OF HON. RICHARD C. BREEDEN

Mr. BREEDEN. Thank you, Mr. Chairman.

I am reminded of the Broadway show, "Promises, Promises."

I am also, on St. Patrick's Day, reminded of the fact that sometimes we are treated to a display of blarney, and some of the arguments on this overall issue, I think, display the finest of that tradition.

Mr. Chairman, you have often referred to the SEC as the cop on the beat. You have never said so, but I have often assumed that you had in mind an Irish cop. Thus, it is a pleasure on St. Patrick's Day to discuss the need for some new law enforcement tools for the cops on the Government securities beat.

Mr. MARKEY. Are you Irish, sir?

Mr. BREEDEN. Only partially.

Mr. MARKEY. Only partially. Well, we really hit the jackpot here today, didn't we? We see all sides of the species sitting right here. We have gathered them all together. We can see why we have never resolved the problem in Northern Ireland right here. We like to argue just for the sake of arguing. Transubstantiation has nothing on the Government securities marketplace. We can't resolve either one of them.

Yes, please go ahead.

Mr. BREEDEN. As the Government's deficit spending has increased in recent years, the market for Government securities has grown ever larger and more important. For a long period, there was complacency about how this market operated and how it was regulated. The New York Times captioned a long article about regulation in this area with the title, "When the regulators stood still." Many people assumed that most market participants were sophisticated institutions that could fend for themselves; some people still do assume that.

This complacency should have been shattered, in my opinion, by the revelation that Salomon Brothers and others submitted false bids involving billions of dollars in at least 10 separate Treasury auctions. In some cases, Salomon Brothers and certain customers acquired nearly 90 percent of the securities in specific Treasury auctions. These securities subsequently traded at levels that were not reflective of prices in the Treasury market generally. The

Salomon Brothers scandal underlined not only the extent to which a few primary dealers have dominated some aspects of this market but, to a degree, also dominated the oversight system of this market.

Among other things, the SEC's review in conjunction with the Federal Reserve, the Treasury, the Federal Reserve Bank of New York of these markets has revealed a number of serious problems, many of which have been chronicled before this committee. The auction technology used for auctions of Treasury securities still depends on slips of paper being dropped into wooden boxes. I think the top hats and tails used by the people to collect them are gone, but the system still does create delays of up to an hour or more between the time an auction actually occurs and the time that results are announced. Thus, for an hour or so market participants don't know whether they now own billions of dollars worth of Treasury securities, forcing them to hedge in the marketplace what they may not actually own.

This cost to hedge phantom positions is not necessary. The cost, which over the years, has probably run into the hundreds of millions of dollars or more is, of course, ultimately passed on to the Treasury in the form of higher borrowing costs; 1960's, or at least 1970's, technology could have eliminated this problem. The absence of automated auction systems also makes it impossible to verify the identity of bidders electronically, verification that would have made the Salomon Brothers' false bids much, much harder to submit.

Fortunately, the Treasury and Federal Reserve are said to be about to implement a fully automated auction system to resolve those problems. However, other problems shown by the Salomon scandal still remain. For example, even though the transparency of the Government securities market has improved substantially in recent years due to private and voluntary actions, this system, the entire system of transparency for the market, is today still completely voluntary.

No matter how the market changes or transparency diminishes, there is no agency—not the Treasury, not the Federal Reserve, not the SEC—that has statutory authority to require the public reporting of prices and transactions. That is a worrisome fact, given that the interests of primary dealers and the interests of the public, both as taxpayers and as investors, are not congruent.

Even with the much-ballyhooed improvement in transparency to date, the fact remains that any trade that big dealers or their customers want to hide from sight can be simply conducted in a manner that never shows up on today's screens. The total amount of Government securities trading is said to be very, very high. But if, in fact, you look at the number of transactions—they are a quite small number compared to the vastly higher volume of trading in corporate debt and equities. Yet the Government securities transparency systems still do not capture trades by certain dealers or of certain securities. It would be easy to do this.

We hear a lot of rhetoric about cost and bureaucratic mandates and how burdensome this would be. The fact of the matter is that reporting these trades would be very easy to do with off-the-shelf technology that exists today and is used in markets all over the world. The fact of the matter is, it wouldn't be hard to do it. People

just don't want to do it because then the public would be able to look into the clubhouse.

The sales practices used by brokers in Government securities are, by statute, exempt from the sales practice rules that govern their conduct in every other securities market. This means that if the Treasury or GSE securities are involved, abuses such as churning accounts or making unsuitable recommendations must reach the level of deliberate fraud before they become illegal. Sales practice rules relate to the conduct of brokers. They have nothing to do with, and should not depend on, the identity of the issuer of the securities.

Another very serious problem that exists today and has not been solved to date is the issue of books and records concerning trades in Government securities, particularly books and records by bank dealers and certain other dealers that are not subject to current SEC rule-making authority on the retention of books and records.

In other areas of securities law, a firm that has committed a fraud has a Hobson's choice; they have to either keep incriminating evidence which we can find when we go in to investigate a case, or they have to alter or destroy books and records that are required to be kept, in which case we can prosecute the failure to keep the books and records as an independent offense.

Thus, books and record requirements are not simply a paperwork requirement of some kind, but they are a key element of the law, making it hard for people who have committed a crime in the marketplace to avoid detection for that conduct.

Now we have come a long way from the time when Irish monks carefully and beautifully copied out religious records, but in some senses nothing has changed, for some firms do still use scrolls. I thought, since this is a debate the committee has been having for a long time, that you might be interested, Mr. Chairman, in seeing how some of the records in this market are kept (indicating scroll).

This is a scroll that one securities firm used to keep its trading records. It is printed out like this. This is only 3 hours of trading by one dealer in one day. As you can see, some of these transactions are typed, others are scratched out, others are handwritten, and if you want to find out what happened in this market for these 3 hours from this trader, you can't get the information, put it in the computer, and analyze it. You get the scroll—and this is literally how the firm keeps it—and you go through this scroll by hand looking for evidence.

If the public would like to hire an extra 25,000 civil servants to go through scrolls hunting for evidence, I suppose we could charge them to do so, but with today's computer technology it would be very easy to keep these records in a form that could be put on one 3.5-inch disc that could go in a computer and could rather easily be analyzed.

That is what this debate about record-keeping is all about, the simple fact that we would like the authority to say, "You can't keep the records in a scroll; we would like it in a capacity that it can be delivered to us so that we can analyze it." That is the law in every other securities market, and it absolutely escapes me where it is that all these enormous costs that are supposedly going to be incurred are going to come from—from saying that you have to

keep your records in a format that a computer rather than a monk can digest?

Now what H.R. 618 would provide is, in fact, the legal authority to issue uniform rules for the Government securities market for making, keeping, and providing records of trading. I might add that those records are, in most cases, unless we get a witness who wants to sing—those records are the only evidence of crime, and we can't bring people to court because we have a suspicion. We have to bring them to court only when we have evidence that will stand up in front of a judge and a jury.

So if you don't let us keep the evidence, you are making a decision that you don't want any prosecutions, and, believe me, people in the marketplace understand that very simple distinction.

In the current form in which some of the records are kept, it is, I should hope, obvious that it is quite difficult for us to reconstruct trading. If it is difficult or impossible to reconstruct trading, traders will be tempted to violate trading rules, and, as Oscar Fingal O'Flaherty Wills Wilde said, "I can resist everything except temptation."

In these and other areas, there are serious weaknesses in the current system. Even though almost 2 years have passed since the May 1991 auction, after which the first reports of wrongdoing emerged, the legal loopholes in this market have still not been plugged.

One argument against this legislation is that it would increase costs and that these costs would be passed along to the taxpayers. I agree with the paramount importance of avoiding unnecessary regulatory costs. I think that is important all across the economy and certainly is a factor that we must bear in mind in securities markets.

Unfortunately, the argument in this area is rather overdone. Neither transparency nor full audit trails, which this bill does not require, are unusual or abnormally burdensome. They are, in fact, requirements that are complied with by every bank or securities firm that conducts business in securities markets anywhere in the world every day. They are normal things; they are traditional.

Indeed, a high official of the Bank of England once told me that they would find it inconceivable to operate the U.K. gilt market without maintaining full audit trails so that they could later investigate if wrongdoing was to occur in that market. So even in Government securities markets in other parts of the world the concept of record-keeping and audit trails is neither unknown nor thought to be unduly burdensome. Most firms that are active in the U.S. market because of other areas of their securities trading have those requirements that they live with every day.

Now another argument, other than cost, is that we ought to trust to evolution in the marketplace to solve this problem. Here I would suggest that the appropriate answer would be gleaned from Mr. Dooley, the legendary Irish barman and sage who once said, "Trust everybody, but cut the cards."

Some who oppose these requirements simply do not want to see a larger role for the SEC in these markets. However, I would point out that the SEC, and only the SEC, has the authority to enforce the anti-fraud provisions of the Federal securities laws against se-

curities firms, banks, insurance companies, industrial companies, or anybody else who commits a fraud in the purchase or sale of securities. The Federal Reserve doesn't have the authority to bring an action for violations of rule 10b-5, for example. They can conduct examinations, but they cannot enforce the anti-fraud rules. That is something that only the SEC can do. So if you deny us the access to the evidence to bring cases because no other agency can, in fact, bring those cases, you are, in essence, mandating that no cases will be brought.

Now events in many countries, as well as our own sometimes painful history, show that when public confidence in a financial market is lost it can take many years to restore. While I accept the Vice Chairman's argument that there have been relatively infrequent problems, it only takes once, as events in the Indian securities market demonstrated, where the market collapsed and was closed essentially for months. It can only take one problem, if it is the wrong kind of problem, to shatter public confidence, and it could take years to restore that public confidence. In the meantime, the public could lose billions of dollars through lost participation in the market.

In sum, the SEC strongly supports H.R. 618. What happened at Salomon Brothers in its dealings with the Treasury and at many other firms in their dealings with the GSE's was almost predictable given the legal and practical structure of the market. The legal loopholes should be plugged, and doing so will not result in any serious issue of cost or market efficiency.

The concepts and requirements at issue are perfectly standard in U.S. and foreign securities markets. Hopefully, Congress will eliminate these unnecessary risks to public confidence in this vital market. If you don't choose to act, it cannot be said that it can't happen here. It already did, and it is time that we learned from what happened.

Thank you.

[Testimony resumes on p. 80.]

[The prepared statement of Mr. Breeden follows:]

TESTIMONY OF  
RICHARD C. BREEDEN, CHAIRMAN  
U.S. SECURITIES AND EXCHANGE COMMISSION  
CONCERNING H.R. 618,  
THE GOVERNMENT SECURITIES REFORM ACT OF 1993  
BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE  
OF THE COMMITTEE ON ENERGY AND COMMERCE  
U.S. HOUSE OF REPRESENTATIVES  
MARCH 17, 1993

Chairman Markey and Members of the Subcommittee:

I am pleased to appear before the Subcommittee, on behalf of the Securities and Exchange Commission, to testify in support of H.R. 618, the Government Securities Reform Act of 1993.

Throughout the past few decades, as the volume of deficit spending by the government has risen dramatically, the market for government securities in the United States has grown steadily larger and more important in providing financing to operate the government. For a long period, there seemed to be a general complacency concerning the overall operation and regulation of this marketplace.<sup>1</sup> Known instances of serious wrongdoing seemed to be minimal, though most traditional systems of

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<sup>1</sup> See, e.g., Louis Uchitelle & Stephen Labaton, When the Regulators Stood Still, N.Y. Times, Sept. 22, 1991, § 3, at 1; Jonathan Fuerbringer, A Year Later, Bond Traders Are a Humbler Lot, N.Y. Times, Aug. 7, 1992, at D1.

oversight of securities markets were limited or nonexistent in these markets. In addition, market participants were traditionally thought to be large and sophisticated institutions that did not need all the protections of federal securities laws.

Previous assumptions about the government bond market were shattered with the revelation that false bids involving billions of dollars had been submitted in at least ten separate auctions of Treasury securities by officials of Salomon Brothers and others. In some cases, Salomon Brothers and certain of its customers acquired as much as 86% of the securities of a specific Treasury auction. Prices of those securities subsequently traded at levels that were not reflective of prices in the Treasury market generally. Widespread publicity of the existence of a possible "squeeze" in the Treasury market raised the specter that public confidence in the Treasury market as a whole might be seriously damaged.

The SEC has participated in several reviews of the market for "government securities." That term includes not only securities issued by the Treasury, but also securities issued by the various government-sponsored enterprises ("GSEs"), which are in fact securities issued by private corporations. That long review has pointed up numerous problems. These include:

Auction technology: While there are numerous electronic systems in use around the world that permit the instantaneous transmission of orders into a central computer, prior to the Salomon revelations the Treasury auction was run using slips of paper dropped into wooden boxes. Among other defects, this system created a one-hour delay

following the time of an auction before participants were advised whether or not they had been successful in the auction. Thus, participants would have to hedge billions of dollars in purchases that might or might not have occurred, resulting in considerable unnecessary costs that ultimately would be passed on to the Treasury. The absence of automated auction systems also prevented the ability to verify the identity of bidders electronically, which would have made it much more difficult to submit false bids.

Transparency: Traditionally the government market has operated in an environment in which large "primary dealers" doing business with the Federal Reserve had the most up-to-date information concerning prices in the market. Public customers, and smaller firms that did not have "primary dealer" status, did not have access to the most current prices and volume of transactions. By contrast, all market participants -- large and small -- have access to virtually real time public reports of prices and volume of trades in the U.S. equity securities market through the "consolidated tape." This lack of transparency in trading government securities means that, relatively speaking, the largest dealers had an enormous information advantage that virtually guaranteed the ability to profit at the expense of their customers.

Over the past few years, Congress has been considering the lack of transparency in the government securities market. As this debate has continued, the industry has made considerable improvements in the information that is now disclosed through various private reporting systems. This growth in transparency is extremely important because it increases public confidence in the quality of executions, improves market efficiency and makes it easier to detect suspicious transactions.

Despite the paramount importance of transparency in protecting public interests in an honest trading market, transparency today remains completely voluntary. In addition, existing systems capture only certain transactions, such as interdealer transactions. Other transactions, such as transactions between a dealer and a hedge fund, for example, do not appear on today's screens.

Sales practices: What are supposed to be the safest securities today may be sold using sales practices that would result in a dealer in other types of securities being severely sanctioned. In order to prosecute traditional customer abuses such as churning of accounts or the sale of unsuitable securities to customers, they would have to rise to the level of fraud if such abuses involve Treasury or government-sponsored enterprise securities rather than traditional corporate debt or equity securities. This anomaly results from a statutory prohibition against the NASD applying its normal rules to its members concerning sales practices in government securities.

Law Enforcement: Today books and records concerning trades in government securities by bank dealers and certain other dealers are not subject to any SEC rulemaking authority. In other areas of securities law, a firm that has committed a fraud must either keep incriminating evidence, which the SEC can then discover, or alter or destroy required books and records, which the SEC can prosecute as an independent offense. Books and records requirements are thus not a mere "paperwork" requirement, but a key element of the law that enables the SEC to build prosecutions in numerous fraud cases. Books and records requirements also make it easier for outside auditors

and internal compliance staffs to monitor a firm's trading practices. Unfortunately, brokers and dealers in government securities are today not required to keep records in a prescribed fashion, thereby making it difficult to obtain useful information to track suspected market manipulations, for example, or to bring a separate case for books and records violations.

In these and other areas, serious weaknesses in the current system were discovered, and have been chronicled in numerous reports and Congressional hearings. Despite the seriousness of the past problems, the holes in our normal dike against wrongdoing in securities markets have not been plugged nearly two years after the problems with the May 1991 auction came to light.

Of course it is true that any additional regulatory costs in this market could be passed along to taxpayers, and the SEC does not support creating unnecessary new regulatory controls. However, the argument about regulatory costs in this area is often blown out of proportion. In fact, neither transparency requirements nor full audit trails (both well beyond the provisions of H.R. 618) are unusual or abnormally burdensome requirements for securities markets. Indeed, audit trails are required by most significant capital markets around the world, including other markets for sovereign debt such as the U.K. "gilt" market. Most firms that are active in this market live with such requirements in other markets every day.

Of course some who oppose such requirements simply do not wish to see a larger role for the SEC in these markets. However, the SEC and only the SEC has the

authority to enforce the antifraud provisions of the federal securities laws against securities firms, banks, insurance companies, industrial companies or anyone else, individual or corporate, who commits a fraud in the purchase or sale of securities. Thus, it is not H.R. 618 that would create a larger role for the SEC, but rather the temptation of market participants to engage in fraud in the belief that enforcement in this area is not likely to be effective.

Events in many countries, as well as our own sometimes painful history, show that when public confidence in a financial market is lost, it can take many years to restore. Fraud or customer abuse can dramatically reduce public participation in a securities market. Thus, the costs of modest oversight of potentially manipulative or abusive practices must be compared against the incalculable costs for taxpayers that would result if public confidence in the honesty and integrity of this market were to be seriously eroded.

For these and other reasons, we believe that reforms to governing law in this area are warranted. Fortunately, the Federal Reserve and the Treasury are working hard to implement automated systems for auction bidding that will make a significant improvement over the past. However, the well-known gaps in the law made it easier for abuses to be attempted. Closing these gaps would strengthen the market without resulting in any serious cost or market efficiency. Hopefully, Congress will move to reduce the unnecessary risks to public confidence in this market that we cannot do without.

H.R. 618 represents a continuation of efforts by the Subcommittee over the last two years to address, in narrowly prescribed ways, the regulatory gaps that have left the government securities market without basic safeguards that apply to every other securities market in this country. The bill carries over the provisions of H.R. 3927, as reported last session by the full Energy and Commerce Committee.<sup>2</sup> However, H.R. 618 has been significantly narrowed from earlier proposals, especially in the areas of transparency and recordkeeping. I testified on behalf of the Commission in April of 1992 in support of an earlier and somewhat broader version of that bill,<sup>3</sup> and before this Subcommittee in October 1991 concerning related reform proposals.<sup>4</sup>

H.R. 618 adopts certain legislative proposals recommended in the January 1992 Joint Report on the Government Securities Market ("Joint Report") of the Department of the Treasury, the SEC and the Board of Governors of the Federal Reserve System and contains some additional provisions designed to deter fraud and manipulation. Although the SEC has supported broader authority in certain respects than is contained in H.R. 618, we support H.R. 618 as a means to address identified deficiencies in the current regulatory structure for the government securities market in a responsible, balanced manner. Most important, we believe that, in the absence of the recordkeeping

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<sup>2</sup> House Comm. on Energy and Commerce, Report to Accompany H.R. 3927, H.R. Rep. No. 722, 102d Cong. 2d Sess. (July 24, 1992) ("House Report").

<sup>3</sup> Testimony of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs (April 28, 1992) ("April 1992 Testimony").

<sup>4</sup> Testimony of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce (October 25, 1991) ("October 1991 Testimony").

and reporting, sales practice, and transparency reforms contained in the legislation, the Commission's ability to fulfill its mission to maintain public confidence and combat fraud in the market will be seriously compromised.

I. Recordkeeping

The SEC's ability to discover wrongdoing is affected by its ability to obtain clear and comprehensible transaction records. Section 3 of H.R. 618 authorizes the SEC to prescribe consistent and uniform recordkeeping rules for completed transactions and to require records to be provided for investigations in a useable format. Although the authority is carefully limited, it would substantially increase the SEC's ability to effectively investigate cases of suspected wrongdoing. It would also create a more effective tool for sanctioning firms where records that would show improper activity are altered or are not maintained for any reason.

A. Identified Deficiencies in Recordkeeping Practice

As has been noted in previous testimony by the SEC,<sup>5</sup> the investigations into wrongdoing by Salomon Brothers and GSEs revealed serious recordkeeping problems at certain government securities brokers and dealers. Specifically, inadequate recordkeeping practices among market participants impeded the staff's ability to investigate instances of fraud and abuse through reconstruction of trading activity.

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<sup>5</sup> April 1992 Testimony at 12-13.

Our manual reconstruction of trading activity was complicated by the absence of any standardization in transaction records. The Commission's staff learned in the course of its investigations that recordkeeping practices among government securities brokers and dealers range from handwritten ledgers to sophisticated computerized systems. For example, one firm maintained trading records on a continuous scroll of computer paper containing handwritten notes, cross-outs, and markings over the computer text. These scrolls stretched for literally hundreds of feet for each day's trading activity, requiring extraordinary effort (and patience) by the staff to organize the information in a coherent format. In other cases, records reflecting customer orders were maintained in handwriting on scattered scraps of paper, or in spiral notebooks.

In the bidding context, the handwritten records used in connection with Treasury or GSE auctions were not maintained after the auction, even though such records could have evidentiary value. Moreover, the staff discovered a lack of records adequately explaining the allocation of Treasury securities obtained in auctions between certain firms' proprietary and customer accounts, making it difficult to monitor whether a firm submitted unauthorized bids.

The investigations further uncovered recordkeeping inadequacies relating to the timing of orders and transactions. Where the required records were kept, they often lacked consistent methods to record execution times or used unreliable timestamping practices. Where computerized transaction records were kept, the accuracy of the records varied, depending upon when the transactions were entered into the computer system. For example, some government securities brokers or dealers time-stamped

required records at a single time in large batches, making it impossible to discern when a transaction was executed, or when a customer order was placed. Of course, knowing the sequence of transactions could be vital to our ability to prove a case of manipulation or other violations in court.

The absence of a single set of rules applicable to all dealers that specifically prescribes the information required and the form in which it is required to be kept also may increase the likelihood that records will be altered after the fact. This concern is underscored by the widespread existence of false books and records revealed by the enforcement action involving the bidding practices of 98 broker-dealers and financial institutions in the GSE securities market. Without any requirements as to the form of records and other retention matters, internal and external auditors and compliance personnel do not have a mandatory records baseline where missing records could serve as a warning of possible wrongdoing.

B. Recordkeeping Authority

In order to address these identified deficiencies, Section 3 of the bill supplements the SEC's existing recordkeeping authority applicable to dealers other than financial institutions, with authority to adopt rules applicable to all dealers in government securities. Section 3 clarifies that this authority includes the ability to prescribe specifically the form and content of transaction records. This provision would not impose any significant additional costs on dealers by requiring them to compile or record information that is not already readily accessible. Indeed, the basic terms of any trade -- what was traded, at what price, and by whom -- is in practice needed in order to

settle the trade.<sup>6</sup> Instead, the bill would help to ensure that minimum standards of professional practice are observed in maintaining records for reference in conducting investigations.

The bill would extend this authority to all government securities firms, including bank dealers, in a manner that is extremely narrow and generally consistent with the existing regulatory structure. Though the SEC could require a bank dealer or any other market participant to keep trading records for a specified time and in a specific format, the SEC would not have the authority to conduct routine examinations of bank dealers to determine if records were being maintained. Here, the existing examination and enforcement authority of bank regulators is undisturbed. In addition, the consultation provisions of Section 3 will ensure that the experience and expertise of bank regulators will be utilized to avoid duplication and expense. Indeed, a standardized trading records format and better capacity of firms' internal auditing and compliance staff to detect potential problems should reduce, not increase, the time the SEC might need to spend in a bank in connection with a fraud investigation.

Because the SEC is the only agency with responsibility for enforcing the general antifraud provisions of the federal securities laws, and because of the critical role that recordkeeping plays in allowing the SEC to fulfill that responsibility, the very limited authority over the recordkeeping practices of bank dealers granted to the SEC by Section 3 is fully justified. The SEC already has similar recordkeeping authority with

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<sup>6</sup> See House Report at 45.

respect to the municipal securities activities of bank dealers,<sup>7</sup> which generally has been delegated to the Municipal Securities Rulemaking Board. This authority in the municipal securities market has not impeded bank regulation or unduly burdened bank dealers.<sup>8</sup>

C. Furnishing Records to the Commission

Section 3 also would grant to the SEC authority to require that prescribed records be furnished to the SEC or other regulatory agencies as needed in order to reconstruct trading activity. In order to avoid burdensome costs on dealers, this authority is significantly limited. In making a request for information under this subsection, the SEC must specify the information required, the period of time for which information is sought, the time and date on which it must be furnished, and whether the information is to be furnished to the SEC or to another appropriate regulatory agency.

The SEC may require that the information be furnished in machine readable form. This provision responds directly to the difficulties discussed above in obtaining transaction records in a format that is useful for investigatory purposes. However (as described further below), the provision does not require the establishment of an audit trail mechanism, and the means of transmission could be tailored to the technological capabilities of different firms. Particularly in the case of smaller dealers, the SEC would

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<sup>7</sup> Section 17(a) of the Exchange Act provides recordkeeping authority over registered municipal securities dealers, including bank dealers registered under Section 15B.

<sup>8</sup> Further, the adoption of rules that are consistent across the spectrum of government securities firms will also help avoid competitive inequalities.

work to establish cost-efficient means of furnishing the information, which could include providing software that could be used to "down-load" stored records onto standard diskettes.<sup>9</sup> The ability to require that records be furnished in this way would have substantially assisted the staff in recent investigations of government securities dealers.

Section 3 is substantially narrower than earlier proposals, which would have provided authority to the SEC to require audit trails, or daily time-sequenced trade reports. Audit trail mechanisms are an everyday protection in the equity markets in the United States, where information is furnished to SROs, and in some foreign markets for sovereign debt. The SEC supported audit trail authority in the government securities market in the Joint Report,<sup>10</sup> and we have supported the incorporation of such authority in earlier versions of this legislation.<sup>11</sup> The SEC continues to believe that audit trails would provide a substantial deterrent to fraudulent or manipulative conduct, and that requiring audit trails would eliminate a major gap in the oversight of these markets -- or any market. To would-be fraud artists, the absence of audit trails of any kind in a trading market is a clear sign that law enforcement authorities would find it much more difficult to turn suspicions into prosecutions. That is the wrong signal to send for a market as important as this one.

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<sup>9</sup> See House Report at 45.

<sup>10</sup> Joint Report at 24-25.

<sup>11</sup> April 1992 Testimony at 11-14.

Although the bill does not authorize the SEC to mandate audit trails, the SEC supports the trade reporting authority contained in Section 3 as a significant improvement over the status quo. In addition, a partial and voluntary audit trail could be constructed by combining trade information reported on interdealer broker screens, such as that made publicly available by GOVPX, with clearing data received by the Government Securities Clearing Corporation ("GSCC"). The SEC agrees with the view of the Committee that this step could be accomplished without additional authority, although of course it would require the cooperation of, and investment of resources by, GOVPX and GSCC.<sup>12</sup> However, it should be clearly understood that reliance on existing systems would not serve as a complete substitute for full audit trail authority because, among other reasons, GOVPX does not provide information on all interdealer trades and does not provide any information on trades with customers.<sup>13</sup> Finally, it should be emphasized that without the assurance of adequate transparency provided by Section 8 of the bill, the need for audit trail authority would be much greater.<sup>14</sup>

## II. Transparency

The term "transparency" refers to the degree to which real-time reports of trades and quotes are publicly available. Section 8 of H.R. 618 provides limited authority to assure that industry efforts to improve transparency in the government securities market continue. Although the current provision is more limited than prior proposals, the

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<sup>12</sup> House Report at 25.

<sup>13</sup> See October 1991 Testimony at 18.

<sup>14</sup> See Joint Report at 24-25.

Commission believes that it would provide an important safeguard against any future efforts by primary dealers to limit the accessibility of other dealers and ordinary investors to key categories of market information.

As a general matter, transparency promotes efficiency and fairness in every securities market. Transparency limits the systematic disadvantage of public investors compared to market "insiders," reduces price discrepancies, allows investors to determine whether they are receiving a fair price, and increases the ability of regulators to detect and deter manipulative trading.<sup>15</sup> Public access to price and volume information also increases the pricing efficiency of derivative instruments, such as the many futures and options instruments that relate to government securities.

The SEC has long had authority to assure adequate transparency in equity markets. Pursuant to Section 11A of the Exchange Act, the SEC oversees a wide variety of SRO trade reporting systems, including the Consolidated Tape and Consolidated Quotation Systems, NASDAQ, and the Options Price Reporting Authority. The Consolidated Tape provides real-time trade and quote reports for listed stocks regardless of whether trading occurs on the New York and American Stock Exchanges, on regional exchanges, or on NASDAQ. The NASDAQ National Market System provides immediate trade reports for about 2,700 securities, and real-time reporting recently has been extended to about 4,700 other NASDAQ securities.<sup>16</sup> The Options Price Reporting

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<sup>15</sup> See October 1991 Testimony at 8-13; April 1992 Testimony at 3-8.

<sup>16</sup> Securities Exchange Act Release No. 30569 (April 10, 1992).

Authority provides for the consolidated reporting of last sale reports and quotation information in eligible option contracts listed and traded on national securities exchanges. The number of trades in the government securities market is actually much lower than the number of trades in these equity markets. Presently, the trade reporting systems overseen by the SEC process many times more trades each day than the trades reported through GOVPX.

In addition, the SEC oversees trade reports processed through a range of proprietary systems. Finally, the SEC has had transparency authority in the corporate and municipal debt markets, although it has not found it necessary to exercise that authority. Recently, the NASD has proposed creating a new Fixed Income Pricing System providing for real-time trade reporting for certain high-yield debt securities.

The existing transparency in the government securities market results from the public dissemination of quotation and last sale information by certain interdealer screen brokers. Information is disseminated by GOVPX, which is a joint effort of four interdealer brokers and the 38 primary dealers, and Telerate, which has an exclusive arrangement to disseminate information from Cantor Fitzgerald, another interdealer broker. GOVPX screens represent approximately 75% of the brokered interdealer trades in Treasury securities. Recently, GOVPX began providing information on the size associated with quotes and we understand it will soon permit data to be used in conjunction with analytical systems. GOVPX also recently announced that it would begin to provide price information for additional categories of securities; GOVPX does not now cover GSE or zero-coupon Treasuries.

While these recent steps and announcement are welcome, it should be recognized that the transparency improvements of the last several years have occurred against the backdrop of continuing Congressional consideration of proposals to mandate greater transparency and only following substantial earlier resistance on the part of primary dealers to increased information dissemination. In contrast to concerns previously voiced by some of those dealers, there is no indication that the liquidity of the market has been impaired by increased dissemination of information. It has been the Commission's consistent experience in other markets that expanded public disclosure of trading data actually increases liquidity, sometimes dramatically. This occurs because as customers are better able to determine for themselves if they are being gouged by dealers, spreads tend to narrow and customer participation rises.

The bill would address transparency concerns through the most limited possible means. Section 8 clearly states that Congress prefers to see the continuation of private sector efforts to improve transparency without federal intervention. However, it also provides two tiers of backstop authority to assure that adequate transparency in the market for government securities, other than mortgage-backed securities, could be maintained or achieved if private sector efforts fail.

The first tier concerns the dissemination of information from broker screens. Under this authority, the SEC could act if it determined that trade reports and price quotations (including size) for regularly traded government securities that are available through brokers' screens were not made available to the public in a timely manner and

on a fair, reasonable, and nondiscriminatory basis. The provision would not require any action even if such a determination were made, and it would require the SEC to consider the effects of any proposed regulation on the liquidity, efficiency, and competitiveness of the market.

The second tier of authority would apply only if the Secretary of the Treasury found that investors were unable, through existing government securities information systems, readily to determine the prevailing market price of a class of securities or to analyze the comparative value of securities within a group of similar securities. If Treasury made such a finding, the SEC would be authorized to require government securities brokers and dealers that regularly trade the identified securities to report the information to a securities information processor or SRO (if no securities information processor could carry out this function). The SEC could require these firms and SROs to act jointly in developing facilities for information dissemination, but the SEC could not require anything unless the Secretary of the Treasury acted first to make the necessary findings.

This authority would be much more limited than the transparency authority the SEC has with respect to equity markets under Section 11A. The bill does not authorize the establishment of a consolidated quotation or transaction reporting system for government securities.<sup>17</sup> Moreover, the bill's prohibition on the regulation of fees of government securities information systems ensures that this authority, if used, would not

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<sup>17</sup> See House Report at 52.

reduce the financial incentive to invest in reporting systems. The limitations built into the bill are all appropriate. Further, the SEC believes that this authority should never be used unless all other reasonable avenues are exhausted. Indeed, the SEC has possessed authority to mandate transparency in some other bond markets that has not ever been exercised, demonstrating that our preference for privately-designed systems has a long history and commitment.

Although limited, the transparency authority in H.R. 618 would be important. The financial interest of primary dealers and other dealers may not in all circumstances coincide with the maintenance of an open and transparent market. For example, dealers who are inclined to collude in attempting to create an artificial "squeeze" for a particular security in the secondary market may be inclined not to trade through an interdealer broker. In other circumstances not involving manipulative intent, if one or more major dealers in a given class of securities ceased to trade through interdealer brokers, the ability of investors to determine the true market price of the security necessarily would be impaired. The government securities market is simply too important to the Nation's economy, and the investor protection implications are too great, to leave the preservation of the gains in transparency of the last several years to chance.

Ensuring adequate trade and quote reporting in the government securities market would not in fact cause any significant cost, and it can be done with existing standard technology. The only real issue is whether Congress wishes to promote a dealer's club or a truly efficient market. If the latter, transparency is a fundamental requirement.

### III. Antifraud Measures

H.R. 618 contains several provisions prohibiting fraudulent and manipulative conduct or providing additional authority to the SEC and the NASD to adopt or apply rules designed to deter fraud and manipulation and promote just and equitable principles of trade.

#### A. False or Misleading Statements

Section 11 amends Section 15(c) of the Exchange Act to make it an explicit violation of the Exchange Act for a broker, dealer, or bidder to make false or misleading written statements in connection with the primary offering of government securities other than Treasury securities. Such a provision was recommended by all three agencies in the Joint Report. If applied to Treasury securities it would respond directly to the false bids made by Salomon Brothers and as applied in H.R. 618 it directly addresses the false representations made by selling dealers in bidding for GSE securities. The SEC continues to endorse this measure.<sup>18</sup>

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<sup>18</sup> See April 1992 Testimony at 17-19. The definition of government security does not include public debt obligations for purposes of this provision, and Section 12 states that the bill does not grant authority to the SEC to regulate in any manner the initial issuance of any public debt obligation. The general antifraud authority of Section 10(b) applies to all transactions in all securities. While a distinction between Treasury auction transactions and secondary market (including when-issued) transactions may be appropriate in the context of other provisions of the bill, the Commission believes that the antifraud provisions of the bill, including the express authority of Section 11, should apply equally to both types of transactions.

B. Sales Practice Rules

Section 7 of H.R. 618 eliminates the current prohibition on the application of NASD sales practice rules to government securities transactions. NASD sales practice rules supplement the antifraud provisions of the federal securities laws by applying just and equitable principles of trade, the violation of which, unlike the antifraud provisions, generally does not require a showing of specific intent. Section 15A(f) of the Exchange Act effectively prevents the application of NASD sales practice rules to the government securities market by providing that, with limited exceptions, "nothing in this section shall be construed to apply with respect to any transaction by a registered broker or dealer in any government security."

This regulatory gap is anomalous. The NASD's sales practice rules governing mark-ups, churning, suitability, and unauthorized trading apply to transactions in all equity and corporate debt transactions. In addition, the sales practice rules of the New York Stock Exchange and the other exchanges apply to the government securities activities of their members.

In addition to the application of the sales practice rules themselves, the removal of the limitation in Section 15A(f) would allow the NASD to adopt rules such as fidelity bonding requirements and qualification and testing requirements in order to assure that sales personnel have the requisite knowledge to comply with sales practice and other rules. A sensible and functional approach to regulation requires that government securities transactions not be exempt from the basic customer protection rules that apply

in every other market. Sales practice rules inherently relate to conduct, not to the identity of the issuer or security.

To the extent that this unequal treatment reflects a traditional attitude that government securities are risk-free and therefore that transactions in those securities are not readily susceptible to abuse, that rationale clearly no longer applies in the modern marketplace. First, new derivative government securities that have proliferated in recent years, including STRIPS, mortgage-backed securities and real estate mortgage investment conduits issued or guaranteed by GSEs (which do not themselves carry a government guarantee), zero-coupon securities, and other instruments carry a substantial risk of diminution in value resulting from fluctuation in interest rates. In addition, complicated trading strategies and increased leverage that often accompany these new instruments increase the potential for loss.

The increase in range of available instruments has been accompanied by increased secondary market activity by individuals and smaller corporations and institutions who are attracted by the desire for safe investments. Municipalities, including small towns and villages, have become major holders by investing free cash balances in government securities. Indeed, the presumed safety of government securities may itself increase the potential for sales fraud by lulling more unsophisticated investors into a false sense of comfort.<sup>19</sup>

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<sup>19</sup> In the last five years, the NASD has brought 26 disciplinary actions against 29 firms or individuals associated with those firms for sales practice abuses involving government securities or options on government securities that are exempted under Exchange Act Rule 3a12-7. The abuses included churning, adjusted trading,

The expansion of the NASD's authority in this area is consistent with the traditional Congressional preference for self-regulation of the securities markets. In addition, this approach will not involve significant additional costs because the NASD is already familiar with the application of rules in other contexts and these rules are known and understood by the sales forces of integrated firms.

C. Additional Antimanipulation Authority

Section 15(c)(2) of the Exchange Act presently authorizes the SEC to adopt rules reasonably designed to prevent fraudulent and manipulative conduct by broker-dealers. Transactions in government securities are explicitly exempted from this provision. Accordingly, the SEC's ability to adopt antifraud rules relating to government securities transactions depends on its general authority under Section 10(b) of the Exchange Act. Because Section 15(c)(2) permits the SEC to adopt rules "reasonably designed to prevent" fraud, it provides more flexible authority to prevent fraudulent or manipulative activity.

Unquestionably, the government securities market, like other markets, is subject to manipulation by broker-dealers who have a substantial financial stake in daily price movements. Removing the exemption of government securities from rules designed to

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excessive markups and markdowns and unsuitable recommendations. Although the NASD does not have legal jurisdiction to take action against sales practice abuses that cannot be proven fraudulent, four cases, three of which were related, were settled solely on the basis of violations of NASD rules which are legally inapplicable to exempted securities.

prevent fraudulent conduct would not impair the interests of honest dealers, but it could help make it tougher to attempt a manipulation. The goal here is to deter unlawful conduct, making both market disruptions and enforcement actions less likely. This current exemption is unwarranted for the same reasons that an exemption from NASD rules is unjustified.

D. Internal Procedures

Section 6 would require government securities broker-dealers to adopt and maintain written policies and procedures reasonably designed to prevent the violation of antifraud provisions and such other rules as may be designated by the SEC in connection with government securities transactions. The SEC also is granted authority to prescribe such written policies and procedures by rule.

These provisions mirror existing requirements of the SROs. In addition, Section 15(b)(4)(E) of the Exchange Act provides an affirmative defense to an action by the SEC based on a failure to supervise others who violate the securities laws. Accordingly, the securities industry has long been familiar with the substance of the obligation to supervise. The provision would not create any private right of action.<sup>20</sup> While the SEC did not suggest this provision, we do not believe that it would create significant new costs or burdens.

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<sup>20</sup> House Report at 48.

IV. Treasury Rulemaking Authority

A. Extension of Treasury Rulemaking Authority

H.R. 618 would reinstate and extend until October 1, 1997 the Treasury's authority to issue rules regarding financial responsibility, recordkeeping, and reporting. This authority was an important component of the GSA; the Treasury used it effectively, and the SEC supports its reinstatement.

B. Large Position Reporting

H.R. 618 grants to the Treasury the authority to adopt rules to require holders of large positions in Treasury securities to file reports and keep records concerning such positions. This provision adopts a recommendation by all three agencies in the Joint Report, and the SEC continues to support this provision.<sup>21</sup> It should be noted that this authority does not duplicate or serve as a substitute for the recordkeeping and reporting authority of Section 3 because it is designed for a different purpose and is intended to be invoked on a less frequent basis. It should also be noted that the recordkeeping and transparency provisions of H.R. 618 would probably cost far less in practice than large position reporting. If a choice must be made between them on the basis of cost, large position reporting should be deleted.

V. Conclusion

H.R. 618 builds on the foundation established by the GSA to fill gaps in the regulatory structure of the government securities market in highly specific ways. The

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<sup>21</sup> See April 1992 Testimony at 15.

additional regulatory authority that would be granted to the SEC is modest, but we believe it would be beneficial in helping to maintain the honesty and integrity of these massive trading markets. The recordkeeping and transparency provisions of the bill are especially important in creating more effective deterrence against repeated instances of the violations of law that occurred in these markets. Where significant gaps in the normal protections of law routinely applicable to other trading markets become avenues for illegal activity that could, at its worst, prove seriously destabilizing, prudence dictates closing these gaps in the law. That job should be done carefully, with as little effect and cost as possible on honest market participants. However, given the events we have witnessed, no one can say "it can't happen here."

Mr. MARKEY. Thank you, Mr. Chairman, very much.

We will now turn to questions from subcommittee members, and clearly there is a huge gap that exists between the world which, in my opinion, the SEC observes and the world which Mr. McDonough and Mr. Mullins presume to exist in this Government securities marketplace.

What we have here is, in my opinion, damning evidence of the lack of attention which has been paid by the Fed and the Treasury to the change which has occurred in the marketplace, and it is their right, I suppose, if it is going to be their watch, for President Bush and Treasury Secretary Brady to want to keep this market functioning the same way it was when their dads were investment bankers in the 1930's; that is their privilege.

But, in the same way that President Bush, when he was putting a loaf of bread across a bar scanner in a supermarket and lifted it up in surprise with the same reaction that an ape had discovering fire for the first time, we, in fact, have moved far beyond this point in time in terms of our ability to use modern technology in order to solve problems.

Now, Mr. Mullins and Mr. McDonough are, in fact, raising issues that appear to me to be nothing more than hyperbolic responses to the very real world problems that have been identified, and, to be honest with you—and we will go through this in the course of the morning—we want to hear from Mr. Mullins as to how we are jeopardizing this huge marketplace by ensuring that there is integrity, that there is proper record-keeping, and the issues, by the way, basically boil down to two of the seven provisions which were built into the legislation, which the Chairman of the SEC properly focused his initial testimony on, and that is improved transaction records for enforcement purposes and price transparency to require public access to market price and quotation information, just those two provisions alone.

Although the others are important, they are not clearly as contentious as these two provisions are because they strike at the secrecy, they strike at, if you want, the right of the bishops of the Government securities marketplace to engage in indulgence selling, and the reformation which we are talking about right here is allowing each and every participant in the Government securities marketplace to have their own direct relationship with the Lord without having to rely on the secret sessions of the College of Cardinals meeting and passing on, in good faith although with their interests completely protected, information on to the other souls which are out there operating completely at the will and whim of those bishops and cardinals.

So, Vice Chairman Mullins, I personally find your statements—and I quote—that “there is no evidence of market failure that would warrant the significant overhaul envisioned in H.R. 618” and that “the structure of the Government securities market would appear to offer little scope for large-scale mischief” to be an absolutely astounding statement, absolutely astounding.

That you continue to maintain that in the wake of the Salomon Brothers scandal, of the 98 firms involved in the GSE scandal, the noncompetitive bidding abuses, the fictitious tax trades, Steven Wymer's multiple frauds—if that is not enough to convince you

that there is, in fact, massive fraud in this market that has transpired and continues to go on as we sit here right now, and that there is need for change, I don't know what you are going to need, Mr. Mullins, in order to finally deal with this not from the perspective of an economist but of those people who are out there wondering whether or not, in fact, this real world, with real corruption in it, with people who have real incentives to corrupt this marketplace for their own personal gain, needs changes that will build in more integrity. What else do you need, Mr. Mullins?

Mr. MULLINS. Mr. Chairman, the Board of Governors has deliberated over these issues for more than a year, and when the bill came up again this year, I made a special effort to visit with every member of the Board of Governors on these issues, and I must report that the Board is unanimous in the view and, I think, more concerned than last year in the view that this sort of legislation is unwarranted and could cause problems.

In terms of why we feel that the market overall does not display signs of loss of confidence or widespread fear of fraud, everyone pretty well acknowledges this is the most efficient market observable on Earth with the lowest transaction costs observable on Earth.

Mr. MARKEY. May I ask you something? Can something be efficient and still corrupt at the same time? Are they mutually inconsistent concepts to be operating simultaneously in the same market?

Mr. MULLINS. It is inconsistent to see bid-ask spreads at this level if people are concerned about corruption in the overall market.

Mr. MARKEY. In the overall market, fine. But does that mean that 5,000 or 10,000 people can't be ripped off in a market that is otherwise efficient? And does that mean, as far as you are concerned, that it is not worth the cost to go in and to ensure that those people are not, in fact, stripped of millions, tens of millions, of dollars by those who just want their golden little crumbs that they are going to be able to take on the side in an otherwise efficient market?

Mr. MULLINS. Let me respond to that. Again, our point on the overall market is that we wouldn't see this evident. There are certainly evidences, as Chairman Breeden said, infrequent episodes of abuse, and we think those should be pursued as aggressively as possible. We also believe, though, that if we are going to impose restrictions which will save the cost—

Mr. MARKEY. Do you consider that a restriction, to have that modernized and turned into effective transaction record-keeping, the system that is useful to law enforcement? Is that an unacceptable additional cost?

Mr. MULLINS. The way I would view that, Mr. Chairman, is, record-keeping authority already exists in the Treasury, and if the SEC and the New York Fed need better records, I think they ought to go to the Treasury. That is who Congress gave the authority to.

Mr. MARKEY. Mr. Mullins, don't you understand? It is 2 years later. Denial is massive over at the agencies. You are an economist.

Mr. McDonough, I don't know what your background is; you are a banker.

But this is not your life's calling. You are not—as you wake up as Irishmen, you are not saying, "I want to be a cop." This is what Mr. Breeden always thought was going to be one of the highest callings he could have. We give each of you your due. You know, we need economists.

Mr. McDONOUGH. He is only partially Irish.

Mr. BREEDEN. Today we are all Irish.

Mr. MARKEY. Or wish today we were Irish.

Anyone can demur from that if they want after they hear all the testimony.

Mr. MULLINS. Again, we would trust the Treasury Department and Secretary Bentsen and his staff if changes need to be made.

Mr. MARKEY. Are you going to recommend changes, Mr. Mullins? Didn't you just say that the Board of Governors has said that everything was copasetic?

Mr. MULLINS. Well, no. Let me describe—

Mr. MARKEY. Are you going to recommend changes, Mr. Mullins?

Mr. MULLINS. Well, the enforcement people—and this can be the New York Fed or the SEC—

Mr. MARKEY. How many enforcement people work for you, Mr. Mullins? Do you have any enforcement people who work for you?

Mr. MULLINS. We have no regulatory jurisdiction.

Mr. MARKEY. You don't have any enforcement people.

Mr. McDONOUGH, do you have any enforcement people working for you?

Mr. McDONOUGH. Mr. Chairman, we are not in the enforcement business either.

Mr. MARKEY. You are not in the enforcement business, and you are not in the enforcement business, so tell me again, Mr. Mullins, how it works when there is enhanced enforcement with neither of the agencies who are responsible for it ostensibly are in the enforcement business? How does this work?

Mr. MULLINS. Well, let me tell you what our perspective is here. We are the Nation's central bank. This market is extraordinarily important to us. We implement monetary policy through it. The entire credit structure of the economy is priced off this market—mortgage rates, corporate rates—and any disruptions in this market or increases in overall rates are transmitted through the entire economy. This is why the Board of Governors thinks that we ought to be very careful in instituting wholesale changes.

One of the reasons I think we are more sensitive this year is that President Clinton at the White House last week proposed initiatives to roll back record-keeping and documentation requirements in banking which had been put in statute in response to the S&L crisis and which many people blame as affecting behavior, especially loan availability.

We are concerned that in response to Salomon Brothers—

Mr. MARKEY. Do you agree with the assessment that Mr. Clinton made?

Mr. MULLINS. Well, we worked with the administration—

Mr. MARKEY. Did you agree with his assessment?

Mr. MULLINS. We worked with the administration and do agree that the specific record-keeping and documentation charges adversely affected loan availability. We are concerned that in re-

sponse to Salomon Brothers in which the specific abuses have already been dealt with we might overreact and put in too heavy restrictions, and we simply think the stakes are high.

If it involves increasing the cost of Treasury finance one basis point, that is \$250 million a year every year, and you can transcribe a lot of scrolls for \$250 million a year.

Mr. MARKEY. Mr. Mullins, there was a \$1 billion profit made by the 33 primary dealers last year. That is a lot of profit. Why can't the dealers, out of profit, afford to keep a few more records, report large positions, establish better internal controls? Is that too much of a burden to place upon an industry which clearly is able to make money just by waking up in the morning? This is not a high-risk business.

Mr. MULLINS. I think we should go to Treasury and make those recommendations. The notion of bringing another agency with duplicative responsibility will create—

Mr. MARKEY. But it is not duplicative. As you have both testified today, you are not in the enforcement business.

Mr. MULLINS. But the rule-writing and record-keeping authority is currently at Treasury. Do we need another area of financial regulation with overlapping and balkanized responsibility?

Mr. MARKEY. Well, let me say this to you. We had Steven Wymer here. Are you familiar Steven Wymer? Steven Wymer was before our committee 2 weeks ago, and I asked Mr. Wymer how he felt about the Government securities marketplace, and he told us, this subcommittee, that the Government securities marketplace, in terms of his ability, and every other person he knows who has like minded's ability to corrupt a financial marketplace in America, that this marketplace is like shooting fish in a barrel; and, in fact, he told this committee that of all the marketplaces in America this was the easiest and the most, on a daily basis, corrupted marketplace in the country.

Now this man is an expert, and he is doing it, and he gives us his own opinion regarding to those who are like minded, who wish to corrupt the market system in America; he gives his expert testimony to us with regard to the Government securities marketplace. Now you can sit here and tell us that you place this incredibly high value on efficiency, Mr. Mullins, but you have yet to tell us what value you place on integrity.

Mr. MULLINS. We strongly support the integrity of this marketplace.

Mr. MARKEY. Then why, in the face of the testimony that we have, the scandals which we have observed, are you not willing then to give over to an agency whose task is to police the securities marketplace the ability to get the information and to provide the transparency to customers so that they can be protected and protect themselves?

Mr. MULLINS. If the SEC, for its enforcement objectives, needs better records, I think they should talk to the Treasury. The Congress in 1986 gave Treasury authority here. We think they have the right perspective. It is their market. We have full confidence in the Secretary of the Treasury, and perhaps we need to go to the Treasury and say we need better records. It is my understanding

that the Treasury pretty much copied the SEC recordkeeping requirements.

In Mr. Wymer's case, it is not clear how that relates to the legislation in terms of record keeping. Again, if we need better records, let's get the Treasury to write the rules to do that.

Mr. MARKEY. Since you have such great respect for the 1986 Act and we passed that out of this subcommittee, we may just utter the four most difficult words to utter, and clearly it is not in your power or capability to do this, but we can say the words, "We made a mistake," in 1986, and now we might want to review whether or not, in fact, we should give all of this exclusive power into hands that clearly do not want to do anything with it.

Let me just ask Mr. Breeden: How do you respond to the argument that giving the SEC enhanced record-keeping authority is duplicative, as Mr. Mullins says?

Mr. BREEDEN. Mr. Chairman, I think the issue of new bureaucracies and duplicative regulation is very much overblown, although I accept the importance of the principles that Mr. Mullins is talking about. I agree, for example, that there has been a serious problem in banking with too many rules and requirements, that documentation for a loan rather than for banks buying Government securities—which is what they have been doing instead of making loans for the last 4 years—became overextensive. But I don't see what in the world that has to do with the question of keeping a simple record about whom you bought from, at what price, at what time, or whom you sold to for a securities deal.

Now if you don't know whom you bought from, how are you going to collect the money? How are you going to know if you didn't get at settlement time what it was you were supposed to get? Every firm already has to keep the information we are talking about. We are not talking about something exotic, we are not talking about appraisals, we are not talking about going out and hiring outside evaluators the way they have to do in some of these lending documents. We are talking about keeping information on who the buyer was, who the seller was, what the time of the transaction was, and what the price of the transaction was, but to do so in a format that isn't filled with white-outs and criss-crosses, and done in a manual way, and dispersed in a way that you have to march up Fifth Avenue with a brass band issuing subpoenas in order to look at whether certain transactions were honest or manipulative.

So we are talking about a simple question of standardizing records that already exist by people who keep it in a standardized form in general in every other aspect of their business.

Mr. MARKEY. We have a roll call on the Floor right now, and we have the opening Journal vote of the day. So I would like to proceed with consultation with the members. How would they like to proceed?

Would the gentleman from Ohio like to be recognized now to ask his questions?

Mr. OXLEY. Yes, Mr. Chairman.

Mr. MARKEY. The gentleman from Louisiana—

Mr. TAUZIN. I'll run and vote and come right back.

Mr. MARKEY. He will be recognized as he returns.

So I will turn and recognize the gentleman from Ohio, Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

I ask unanimous consent that my opening statement be made part of the record.

Mr. MARKEY. The gentleman's statement and all other opening statements have already been approved for insertion in the record.

Mr. OXLEY. Thank you, Mr. Chairman.

Chairman Breeden, I have several questions about the SEC's anti-fraud authority. The anti-fraud language of section 11 of the bill is not the same as rule 10b-5. Is it your position that the provisions of section 11 of the bill change the standard of fraud currently applied to false statements as it relates to government or other securities markets?

Mr. BREEDEN. The intent of section 11 was to make explicit for this market area that which we believe is already the law in 10b-5, not to change the law itself. It is, some would say, redundant. But after our experience in the GSE case, where we found almost 100 securities firms and banks that were engaged in purchases using false statements, all the agencies jointly thought it would be a good idea to make what is essentially 10b-5 an explicit requirement for this market.

Mr. OXLEY. Thank you.

The testimony of Mr. Wymer a couple of weeks ago and the disclosure of Goldman Sachs that its employees engaged in cherry picking—that is, the allocation of successful trades to favored accounts—raise serious questions. Does the SEC have rules against cherry picking in the equity or debt markets?

Mr. BREEDEN. Well, the self-regulatory organizations have rules against cherry picking; that is not allowable. The difficulty is knowing when it is going on because virtually every dealer that does business in volume allocates trades at the end of a day, and so determining when those trades are being allocated fairly and equitably and the trader is being honest and equitable and when they are cherry picking and segregating trades on the basis of the winners and losers is something that the SRO's and the firms' own compliance staffs have to keep a close eye on. It is not always clear on its face when that is happening.

Mr. OXLEY. Does the bill that we are talking about give you additional authority to deal with the cherry picking situation?

Mr. BREEDEN. I think the answer to that is no. We would not read it as giving us authority specifically directed to cherry picking.

Mr. OXLEY. Would you support a modification in the legislation to permit the SEC to expand its authority in that area?

Mr. BREEDEN. I don't think that is necessary, but certainly cherry picking, as far as we are concerned, is against existing rules today and, if there is a need for any further rule writing in that sense, I would not be opposed to any changes to reflect that. I would be happy to look at and consult our Enforcement and General Counsel's divisions to see whether, in their view, a change in the law is necessary or whether perhaps we ought to sharpen up the rules in that area.

Mr. OXLEY. Is the SEC currently investigating Goldman Sachs for violations of the anti-fraud rules in connection with its cherry picking violations?

Mr. BREEDEN. I would respectfully decline to answer that. It would violate the rules of the Commission for me to answer as to whether we are investigating anyone. I don't want that answer to be read to suggest that we are or are not investigating Goldman Sachs. I just simply cannot answer questions about whom we might be investigating. That is nonpublic.

Mr. OXLEY. I understand that response.

Let me ask you in a more general way: Mr. Wymer testified a couple of weeks ago that the SEC examined him on narrow grounds, three different times, but never really saw his entire operation. They were somewhat like the blind man and the elephant; they never really quite got the whole picture. My question is, in that context, what is the ability of the SEC to undertake a full investigation into all of the potential violations.

Mr. BREEDEN. I would note, number one, that there is a considerable difference between the broker-dealer examination area, where we have far greater resources, and the investment adviser area that Mr. Wymer was involved in. Broker-dealers are subject to a much more intensive oversight than we are currently able to give investment advisers. That is number one.

Number two, you do have the SRO's—the New York Stock Exchange and the NASD—that have their own very large and very active inspection programs that are applicable to all broker-dealers.

Number three, firm compliance staffs can be very, very active. In this particular case there has been public disclosure, reported in the media, that Goldman itself took action against the person on the desk that was involved in this particular situation. So that was a case in which the firm detected the activity and acted, unlike Salomon where, after it was detected, nothing changed, the person stayed on the desk, and then further events occurred. In this case, the firm itself took very rapid action to remove the person from the trading desk. So I think each of these situations needs to be looked at on their merits.

If I might just very quickly say on the previous question of the rules and cherry picking, I am reminded that the provision in the bill that would remove the prohibition on the NASD's rule-writing would allow the NASD's normal standards about ethical practices, including cherry picking, to be applied to trading in governments. They can't now be applied.

The NASD has rules for cherry picking in corporate debt, but because of the statutory bar on those rules being applied to trading in Government securities, those rules don't apply. So the provision already in the bill that would get rid of that prohibition would, in extending the NASD's rules, also extend the cherry picking rules.

Mr. OXLEY. Mr. Mullins, in your testimony you say that the Fed does not believe that a decisive case has been presented for adding statutory requirements on sales practice rules. I am sure you will grudgingly accept NASD authority over its members, but let me ask you this: Just removing the NASD prohibition would still leave banks out from underneath mandated sales practice rules currently; isn't that right?

Mr. MULLINS. Yes, although they would be regulated by the banking regulators who look at these issues.

Mr. OXLEY. Do you think there would be some kind of a gap or some kind of an anomaly from a regulatory standpoint?

Mr. MULLINS. We don't think there would be, and we haven't seen a problem in this area, and indeed I think some of it must be enforcement, because certainly the firms that you referred to in the previous question, many of these firms, are New York Stock Exchange members, including presumably many of the firms dealing with Mr. Wymer. So they had sales practice rules, and so it may be an enforcement issue.

On the banking side, we haven't seen a problem, and we feel confident in our approach to examination so that we would prefer not to have to explicitly adopt the sales practice rules, although the removal of the prohibition on the NASD I wouldn't go so far as to say we accept that "grudgingly". We think there is a case for consistency, the case Chairman Breeden referred to.

Mr. OXLEY. Mr. McDonough, one of the other witnesses has called for more attention to be paid to aggregation of orders by subsidiaries or otherwise related companies. Do existing Fed rules govern aggregation, and does the Fed monitor the Government securities dealings of entities under common control acting in concert?

Mr. MCDONOUGH. The reporting requirements under the Treasury auction rules do require that all of the entities under a corporate umbrella report jointly, and the agency involved in the supervision of each of the entities has the responsibility of checking to make sure that that is done accurately.

Mr. OXLEY. Thank you.

Mr. Breeden, one last question, if I may. In your testimony you say that 10b-5 is not enough, that the SEC needs authority over Government securities under 15(c)(2) to adopt rules "reasonably designed to prevent fraud." Instead of enforcing anti-fraud regulations, you will be defining what is fraud and designing rules governing operation of the market to try to prevent fraud. Doesn't that change the whole nature of the SEC's role in the regulation of the Government securities market?

Mr. BREEDEN. I don't think so. It is really consistent with our approach to other markets across the board. There is a distinction between the existing anti-fraud standards that apply to everyone. We already have jurisdiction over banks that violate rule 10b-5 in the securities market; it exists today; it has existed for 60 years; it is not some new regulatory empire that anybody is looking for, it is something that we have had for a long, long time. To supplement that in other markets, we have rules that, across the board, say there are certain practices that could run the risk of being used in connection with the manipulation of a market that you can't use. And we have a series of rules, 10b-6 and others, that set out certain standards, and under section 15(c) we have some authority in that area to pass rules.

Now those sections, the general rules, to avoid the necessity of bringing repeated 10b-5 lawsuits, are not applicable in this market. And we are simply saying that that exclusion—it is really the same principle as the NASD loophole—that trading in Government bonds and in Freddie Mac bonds and Fannie Mae bonds ought to be under rules that are no better and no worse than trading in AT&T bonds. We are not talking about something exotic or strange. The

dealers already understand these rules, they live under them every day, whereas they trade large volumes of the other types of securities under these rules, and we are just saying you shouldn't have a special little orchid hothouse for trading in Government bonds, it is a big enough market, it can live under the normal rules; everybody already understands them.

Mr. OXLEY. Thank you, Mr. Chairman.

Mr. TAUZIN [presiding]. Thank you, Mike.

The Chair recognizes himself now for a few questions.

Let me first of all, Mr. Mullins, concede to you that I share some of your concerns about over-regulation, and I think your analogy about the banker's problems with making a lot more money not making loans now than making loans is a real one we need to avoid, and also let me tell you, I share with you some concerns about giving two different agencies the power to require record-keeping, because I have seen that happen in many other agencies where two different agencies come out with different rules and two sets of books, two sets of paper, have to be filed because of bureaucrats simply operating differently in each shop and without talking to each other. That is a problem, and we ought to avoid it.

But let me, on the other hand, turn to a couple of issues in the chairman's bill that I think deserve a bit more discussion.

On the transparency issue, Mr. Breeden has pointed out that in large measure the existing systems that are now being disclosed are being disclosed voluntarily, that certain trades, such as between the dealer and a hedge fund, cannot appear on the screens, are demonstrated for some. I take it, Mr. Breeden, that is not customary, that is not the usual way in which firms keep records.

Mr. BREEDEN. This is the way in which one of the larger inter-dealer brokers does keep its records.

Mr. TAUZIN. But it is not the way that most of the dealers keep records, I understand.

Mr. BREEDEN. Well, it is certainly not the way most dealers in normal markets would do it.

Mr. TAUZIN. Right. And that is, I guess, where I want to focus, and that is that those dealers that are operating voluntarily today are certainly not the ones to be terribly concerned about until and unless somebody in that dealership decides to do something dishonest.

Isn't it true that so long as you have voluntary systems, that it is the player who doesn't comply with the voluntary system that you have got to worry about, the one who wants to be dishonest, and don't you have to have some regulations, some means of making sure that the player who doesn't want to voluntarily comply somehow complies, and doesn't that speak to the need for some Government requirement?

Mr. MULLINS. Yes, Congressman Tausin, and we believe that market surveillance is very important. I don't view the transparency approach as primarily a surveillance issue or approach. We have greatly intensified the surveillance of the market and feel confident that that would be sufficient to turn up any problems. We would hope that whatever needs to be done on record-keeping to make prosecution and investigation cheaper could also be carried out.

On transparency, I guess we feel that the industry is making great strides.

Mr. TAUZIN. Well, it is. I think we have heard all of that; we all agree with that; Mr. Breeden agrees with that. The concern is for those that don't want to play by those rules. If one of the players really wants to commit fraud, why would he voluntarily submit to a transparency?

Mr. MULLINS. There is a question of whether it is feasible to get every transaction, force it into this transparent mode.

Mr. TAUZIN. Well, let's talk about that for a second, Mr. Breeden. The argument about who decides what records are kept, whether it is the agency that normally worries about the economic health of this area of Government financing or whether it should be the policeman—and, by the way, us Cajun Irish are a little offended by all this Irish talk this morning.

Mr. BREEDEN. I'm part Cajun too.

Mr. TAUZIN. Everybody is really.

Let me draw another analogy perhaps. The Justice Department prosecutes violations of the IRS Code. The IRS requires us to keep records, requires us to file. If we file incorrectly, they audit us. If something is wrong, they turn it over to the Justice Department. I take it Justice probably tells IRS on occasion if their record-keeping is inadequate for the purposes of a prosecution. I take it there is communication going on. Why doesn't that system work well with your Agency and Treasury? Why can't, for example, with the current laws on the books that allow Treasury to require better records than scrolls—why can't the SEC simply report, as you have reported to us today on this practice, and indicate to Treasury that you can't do your job to police this system if, in fact, it doesn't come up with some better requirements on record-keeping itself?

Mr. BREEDEN. I am sure over the years on various occasions we have tried to emphasize the importance of not just the aggregate data, and from a monetary policy perspective what some agencies want is the aggregate data, looking at the total volumes of purchases, what interest rates are like, and so on, the total flows of funds.

From our approach, we are not focused on aggregate data, we have to look at trade by trade; we have to look at specific individual trades in which a living human being in business as a broker, whether he is employed by a bank or a securities firm, cheats his customer, and so our interest is for micro-data, if you will, rather than macro.

Mr. TAUZIN. Have you communicated that to Treasury?

Mr. BREEDEN. Oh, I'm sure that has been communicated numerous times.

Mr. TAUZIN. Have you personally communicated it?

Mr. BREEDEN. I haven't personally communicated that issue. But our staff has, Congressman.

Mr. TAUZIN. Your staff has asked Treasury for better record-keeping requirements on securities firms?

Mr. BREEDEN. Yes? No?

Ms. MCGUIRE. No.

Mr. TAUZIN. No. My point is made.

Mr. BREEDEN. Well, if I might just deal with another dimension of it, while Mr. Mullins has made a great deal about Treasury's being the rule writer, Treasury's rule making, in this area, is largely oriented and was created for the purpose largely of looking at financial responsibility of the firms. The GSA Act in 1986 came after the failure of Bevill Bresler and ESM, and you had some specialized Government securities firms that collapsed with horrendous losses; you had several New York State Government agencies that went bankrupt because of it.

Mr. TAUZIN. Are you saying Treasury can't require the kinds of records you would require to police it correctly?

Mr. BREEDEN. Theoretically, they probably can, but the whole statute was passed and assigned them to do something different, to pass rules for a different purpose.

Mr. TAUZIN. But that is not the point, Mr. Breeden. The point is, if Treasury has the authority to require these kinds of records and you have never even asked Treasury to make that requirement for you to do a better job, why should Congress step in and micro-manage and write into law new requirements that the current law literally allows Treasury to implement? Why should we jump in there?

Mr. BREEDEN. Well, it isn't micro-managing that anybody is asking you to do. This is a question in which these firms, whether they are banks or broker-dealers, are in securities trading markets. They trade on any given day. These desks are clustered very close to one another. They will be trading Government bonds at one phone, and the next phone over they are trading in municipals and securities.

Mr. TAUZIN. We know all of that.

Mr. BREEDEN. So the idea of having one set of rules that says, "Here's how you keep your records," rather than having 16 different sets of record-keeping rules would be vastly simpler and vastly less costly.

Mr. TAUZIN. I agree with you. So you think one set of rules about record-keeping is a good idea, but you have never asked Treasury to implement them.

Mr. BREEDEN. We have the other 15 sectors on which we pass the rules, so Treasury cannot pass a common set of rules that would apply to municipal securities, corporate securities, Government securities. The only Agency that can do that is the SEC.

Mr. TAUZIN. Mr. Mullins.

Mr. MULLINS. Why don't you ask Treasury simply to take over your rules in these areas and put those in?

Mr. TAUZIN. Well, I'm not sure we want to do that either.

Mr. McDonough.

Mr. MCDONOUGH. Mr. Tausin, I think it might be useful to say how we make sure or seek to make sure that nothing is going on in the market and what we do at the New York Fed in the market surveillance business if we are suspicious that something is going on. One of the great advantages in watching a market which has, as David Mullins describes it, razor-thin spreads, is, as soon as you see in the cash market or the financing market, the repo markets, that those spreads are widening, you sniff and you say, "Something may be going on here that we ought to know more about." So Mary

Clarkin, the blond lady behind me who is in charge of market surveillance, goes after it fast and moves in and inquires. We start getting daily information if we need it; we are using our gossip network, everything that we can to discover what is going on. If we come to the conclusion that there is something that is really suspicious, we turn immediately the firm in question over—we would, because we haven't had to do this yet—over to the appropriate regulatory authority, which in most cases actually is the SEC.

It is our belief that in this most important of all markets to the U.S. taxpayer the present system makes it possible within that balance between cost and assurance of success that we can see if anything bad is happening, investigate it fully, and the present structure makes it possible for the regulatory authority involved to get in there and do its job. That is why we have the view that, with the progress we have made over the last year and the progress that we assure you we will continue to have, that the present system is one that we should continue to work with, watching it evolve in a very positive manner to give the kind of protection that is needed.

Mr. TAUZIN. Let me make a couple of points in connection with that. There are some of us on this committee and in Congress who tend to be very concerned about over-regulation and duplicative authorities and all that sort of thing, but we are equally concerned about the fact that, as Mr. Breeden reports, in some cases records reflecting consumer orders were maintained in handwriting on scattered scraps of paper, spiral notebooks. In the GSE auctions, the records were not maintained after the auctions even though the records could have created evidentiary value in that case.

I mean obviously there are some very bad practices in record-keeping that ought to be immediately resolved, and the present system is not going to satisfy those of us on this panel who believe in a heck of a lot more Government regulation and those of us who believe in less.

I guess what I am saying is that if the policing authority in this area is telling us that the records are not adequate for them to do a good job in policing, I would hope that the authority that does have the right to clear that up would do so, and I would hope Mr. Breeden would make those claims and those requests of Treasury before we have to jump into the act.

Mr. BREEDEN. If I could just supplement one key factual point—

Mr. TAUZIN. Yes, please.

Mr. BREEDEN. One of the reasons we haven't asked them to do that is that the rule-making authority of the Treasury expired 2 years ago, and one of the reasons we are engaged in this debate is because that authority is sunsetted.

Mr. TAUZIN. It needs to be extended; we understand.

Mr. BREEDEN. So it would be a waste of time to go over and ask them to write rules when their authority no longer exists. So if Congress, in reauthorizing that authority, chooses to put all the rule-writing authority at the Treasury, of course we will work with the Treasury.

Mr. TAUZIN. Mr. McDonough.

Mr. McDONOUGH. Mr. Tauzin, we, as you know, at the Federal Reserve, both at the Board and at the New York bank, believe that the Treasury rule-making authority should be renewed and should be permanent.

On July 23, 1987, the U.S. Treasury issued the final regulations under the Government Securities Act. Regarding record-keeping and reporting, it says, "Newly registered Government securities brokers and dealers will be required to follow SEC record-keeping and audit rules."

Mr. TAUZIN. Staff is indicating to me that Mr. Breeden, of course, is right, that authority expired, that it was, in fact, as Mr. Breeden pointed out, for the purposes of financial adequacy. Would you have any objections if in legislation Treasury's authority was made more explicit and would be very clearly required to extend to the kind of record keeping that would give SEC all of the information it needed to properly police?

Mr. McDONOUGH. Since we believe that the Treasury should have that responsibility and the Treasury is not here today, I am reluctant to speak on behalf of the Treasury.

Mr. TAUZIN. I understand.

Mr. MULLINS. We do believe they have broad responsibility, and it is our understanding, as Mr. McDonough pointed out, that they had simply adopted the SEC's record-keeping requirements. So maybe there is an enforcement problem.

Mr. TAUZIN. Well, let's examine that quickly.

Mr. Breeden, is that correct? Did Treasury adopt the SEC's report requirements?

Mr. BREEDEN. They did in some areas, and in some areas they did not.

Mr. TAUZIN. How about in this area, this scroll area?

Mr. BREEDEN. Not in this particular area.

But if I can try and bring us back to—

Mr. TAUZIN. Well, no. Let me, please, not leave it. Are you saying that the SEC requirements in regard to this kind of record keeping have not been adopted by Treasury?

Mr. BREEDEN. There are no rules whatsoever in this area requiring standardized record keeping. The normal rules have not been extended to this area.

Indeed, Congress has followed a pervasive pattern of, in this market, providing exemptions from every particular rule. You have been urged to do it by other agencies that say, "Well, don't subject this market to sales practice rules, don't subject it to record keeping, don't subject it to transparency"—in each case because it might involve these mysterious enormous phantom costs that are going to occur. Except that these rules that they keep getting exempted from are normal everyday practice that the firms that we are talking about, that are trading an AT&T bond on one desk and a Government bond on the next, are subject to. The rules apply on one desk and not on the other, and the only way to have consistency and simplicity and low cost is to say that the rules they already live with, the computers they have already bought and already programmed to keep reports in the normal manner under the SEC rules ought to be used for Government bonds. This is not a suggestion that we get another bureaucracy over in some other agency

and start writing different rules. But it is just a question of whether you want to have a simple system or whether you want to create a byzantine and complex system.

Mr. TAUZIN. Would it be your recommendation—I draw the analogy again—that Justice should keep all IRS records and make all the rules of reporting?

Mr. BREEDEN. I have no opinion about that. It would be my recommendation that H.R. 618 be passed, because in this area it would, with very little cost, little burden, and little difference to the regulated firms, plug a legal gap that now exists and makes it difficult to bring cases.

Mr. TAUZIN. I think my time has expired, and the chairman has returned. I just want to make one final point, and that is, I tend to agree with you, Mr. Breeden, that if firms are already voluntarily providing transparency, that requiring that they provide it certainly is not going to cost them any more, provided the requirements aren't byzantine and bizarre themselves.

Second, I don't know how one can escape the logic of your argument that record keeping needs to be improved. Obviously, you can't make a case if scraps of paper are kept in an area where clearly technology allows a lot better record keeping than scrolls and bits of paper, and that is certainly true.

But in regard to Mr. Mullins' point that the entire mortgage interest, commercial, and business and personal loans across this country are dramatically affected by the sale of Government securities and that the fluctuations, as people have been reading in the last few days, in the success or failure of the Clinton administration in reducing the deficit have dramatically changed those markets and resulted in extraordinary differences in interest rates to consumers all over the country, not just to the Government—recognizing all of that, there appears to be some need for us to proceed carefully and without disrupting a marketplace that apparently is working fairly well and at the same time do as the chairman suggests and install procedures and record keeping requirements that will put a little more integrity into this system for those players who don't want to voluntarily submit transparencies and decent record keeping.

Mr. BREEDEN. Mr. Tauzin, I would agree that we should certainly proceed cautiously and carefully, and I think that is what the committee has sought to do, and I know all the agencies have worked closely with the different committees. We have written joint reports, and we have expressed separate views.

I might take one common example, because I think the fact you cite and Mr. Mullins cites, about the tie between mortgage markets and treasuries, cuts the other way.

Right now, as we speak, there is a 5-year Treasury issue that is what in the lingo of the trade is called "on special." It means that its interest rates aren't behaving like they ought to behave in accordance with the normal yield curves. Something special is going on with that security. Now it may be a squeeze in that market; it may not; it may be perfectly natural market forces that account for that. If that rate is at an abnormally high interest rate because of manipulative activity rather than because of market forces, every

homeowner in the country with a 5-year adjustable rate mortgage will pay a higher interest rate on their mortgage.

So this is not a market where, in my view, the public ought to be told, "Well, look, you just have to rely on a gossip network," as the Federal Reserve of New York has suggested, "as the enforcement mechanism." We can do better than that, I'm sorry. We just can, and we ought to.

Mr. TAUZIN. I am going to let each respond, and I'm going to get out of the chair.

Mr. MCDONOUGH. The 5-year security which Chairman Breeden mentioned is on special in the repo market, not in the cash market, and it is the cash market which affects this mortgage seeker that has been brought to our attention.

Mr. TAUZIN. Thank you.

Mr. Mullins.

Mr. MULLINS. And I would say that I suppose it reflects—well, Mr. McDonough I'm sure is looking at it—the increased issuance of private debt as rates have started to move up, and so people short this one.

The only thing that your line of questioning, Mr. Tauzin, brings to mind is the importance of having people from the Treasury here to comment on these issues.

Mr. TAUZIN. Thank you, Mr. Mullins.

I will recognize Ms. Schenk for questions, and I yield back the Chair.

Ms. SCHENK. Thank you.

I think the Irish glass ceiling is one barrier I will never be able to overcome here.

I would like to return for a moment to the issue of the multiple-agency jurisdiction. Chairman Breeden, as you know—and I am learning and reviewing the history of this bill—last year the House Banking Committee sought to amend the anti-fraud and the record-keeping and internal control and price transparency provisions of the bill. That would have given the SEC and four separate bank regulatory agencies rule-making authority. Perhaps we may be confronted with that again this year with a similar proposal.

I would just like your views, Chairman Breeden, on what you think it is going to be like having potentially five different sets of rules in this area.

Mr. BREEDEN. Five times more costly than it needs to be. To say that we are going to repeat a given function, if we need a rule on something, we will do it five separate times, rather than doing it only once, is wasteful and duplicative. I think all the studies, going back to the Hoover Commission in the 1940's and the Bush task force in the mid-eighties, have recommended better use of what we call functional regulation. Have set one set of rules and apply it across the board. You have both more costly rule-writing and less effective enforcement when you have little nuances of difference between the five different sets of rules.

Ms. SCHENK. In your prepared testimony, you noted that the SEC's existing 10b-5 and anti-fraud authority already applies to banks and that the SEC already has record-keeping authority over banks in the municipal securities area particularly. So the ones

who say that only the bank regulators write and enforce rules for the banks in the securities area, do you see them—

Mr. BREEDEN. That is totally wrong.

Ms. SCHENK. That is wrong?

Mr. BREEDEN. It is just a misstatement of history and a misstatement of the law.

Ms. SCHENK. Just following up on that, if bank regulators began writing anti-fraud rules for bank dealers, do you see that there might be a danger that this might create sort of safe harbors from the anti-fraud provisions of the securities laws?

Mr. BREEDEN. It would be an extremely damaging and dangerous path to go down. First of all, you are talking about agencies whose expertise in the case of the FDIC, for example, is deposit insurance, not securities fraud. So why would you turn over the job of writing rules about securities fraud to an agency that has no experience with it?

Ms. SCHENK. They want it.

Mr. BREEDEN. Well, I don't know that they want it. At the time of the Bush task force, all of the banking agencies recommended transferring the securities activities over to the SEC, centralizing it and not having it balkanized the way it is today. So I don't know whether the FDIC wants it.

The Banking Committee may or may not have its own jurisdictional reasons why they are interested in such approaches. I am not competent to opine on those kinds of motivations. But from the standpoint of what the public ought to care about, the question is do you have a system that is effective in preventing fraud in markets?

If I am a customer and the bank wants to compete with Merrill Lynch, and if I am going to think about either buying a security through a bank or through Merrill Lynch, am I equally protected? The answer ought to be yes, your protection doesn't vary on whether you happen to go to a State member bank, a State nonmember bank, a national bank, a federally-chartered thrift association, or a broker-dealer. You ought to get the same protection against fraud wherever you go, with a common set of rules.

Ms. SCHENK. Thank you, Mr. Chairman.

Mr. Mullins, I just have one quick question for you. It is sort of a bottom line question. If a bank commits securities fraud, isn't it the SEC, not bank regulators, that should bring an action against them?

Mr. MULLINS. Correct.

Ms. SCHENK. Good.

Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. MARKEY [presiding]. Thank you.

The gentleman from California, Mr. Moorhead.

Mr. MOORHEAD. Mr. Chairman, I have no questions this morning, but I do want to commend you for this legislation on which I have become a co-sponsor. I believe that you have refined this legislation since its original introduction as a result of input from Federal regulators and others. It is an entirely important piece of legislation.

I ask that my whole statement be put in the record, and I yield back the balance of my time.

[The prepared statement of Mr. Moorhead follows:]

STATEMENT OF HON. CARLOS J. MOORHEAD

Mr. Chairman I want to commend you for calling this hearing on reauthorizing the Government Securities Act.

In response to the failure of a number of unregulated Government securities dealers between 1975 and 1985, Congress passed the Government Securities Act of 1986. For more than the last 2 years this subcommittee has been working on legislation that will update the 1986 Act to close gaps in its web of regulation, and to create authority to address problems that have become apparent in the markets since the 1986 Act was passed.

Currently the Treasury Department is the principal regulator of this market. They work hand in glove with the Federal Reserve overseeing every aspect of it. The Treasury raises money to pay the interest and principal of the national debt by selling Treasury securities. As a regulator it wants an honest market. As the administration it wants an efficient market so that the cost to the Government of raising money is as low as possible. The fact that Treasury has two roles does not mean they conflict.

Treasury's regulation has worked very well but there have been some problems. The first was The Salomon Brothers matter and Paul Mozer. The second matter involved abuses by the selling group of dealers in Freddie Mac and Fannie Mae securities. They puffed up their statements to the agencies concerning buying interest. By saying they had more buyers than they did, they got a greater share of securities to sell. There is a lot of evidence the agencies knew about this and never tried to stop it until it became public. The entire matter was handled with fines and warnings.

I wish I could say these were the only problems in the market, but it seems that every few months there is another disclosure of scandal or possible scandal. Now it appears there may have been manipulation in the noncompetitive bidding process. Most recently, the testimony of Steven Wymer, the investment advisor who testified before this subcommittee on his way to prison, highlighted problems with our regulatory oversight of sales practices and the manipulation known as "cherry picking."

For these reasons I have joined as a co-sponsor of this legislation. I believe it has been refined since its original introduction as the result of input from Federal regulators and the effected industries. This is timely legislation that must be passed to insure the highest levels of public confidence in this most important of securities markets. I yield back the balance of my time.

Mr. MARKEY. Thank you. The gentleman's time has expired, and we appreciate his support.

Let me ask a few more questions if I could. Again, this just gets back to a philosophical discussion which economists are prone to raise as they testify before our committee which has jurisdiction over the enforcement of laws in the country.

What we always have a hard time understanding, Mr. McDonough, is why an incremental addition to the cost of record-keeping, to ensure that all of the bad actors in that particular financial marketplace are put on notice that it would be much more easily discoverable that they were engaging in nefarious activity doesn't, in fact, make the markets more efficient because you have weeded out or reduced the likelihood that those bad actors will, in fact, move into and serve as a corrosive influence on a particular financial marketplace. How do you weigh that in your mind, Mr. McDonough, as you are opposing these record-keeping and transparency changes? How do you view the improvements in efficiency as you go through and create an equation in your mind?

Mr. MCDONOUGH. Mr. Chairman, as was mentioned earlier, it is in abatement at the moment because the Treasury's rule-making authority under the GSA has expired and you wish to renew it. As you know, the Federal Reserve believes that that should be done and there not be a time limit placed on it.

The Treasury in 1987 said that Government securities brokers and dealers are required to follow SEC record-keeping and audit rules. I am surprised that in the course of time whoever has jurisdictional responsibility over the keeper of that particular scroll did not require that some more modern approach be taken. I don't know enough of the details to be able to take it beyond that.

I think what one is talking about is not whether good record keeping is a good idea or not—clearly it is—but rather whether the present system in which the Treasury has the ultimate or should be restored to having the ultimate jurisdiction in this area is good or not, we believe that it is.

As regards transparency, there has been a tremendous amount of private sector improvement in transparency. It is certainly not perfect, but it is a great deal better than it was, and I think one of the marvelous things that one has seen in the recent past is that when one of the most important brokers which happened to be in the World Trade Center had to go out of business for a short period of time, and is not fully restored to business, virtually its entire market share shifted literally from one day to the next to other brokers who are involved in GOVPX, and so at a time when I think even I when I started hearing about the World Trade Center thought we were going to have a loss of transparency, I was delighted by what happened. The private sector solution, which has improved a transparency a good deal, responded to the occasion.

So I think, again, we are not talking about, is one opposed to transparency—we, of course, are not—but rather whether the very significant progress that is made by the private sector should be encouraged; we believe that it should be.

Mr. MARKEY. OK. So, Mr. McDonough, if the New York Fed's market surveillance system relies on information available on the inter-dealer-broker screens to track what is going on in the market, if the information available on the dealer screens was no longer representative of the market for a given class or category of Government securities or was no longer sufficient to allow you to determine the prevailing market price of a security, wouldn't that complicate your market surveillance capability for that marketplace?

Mr. McDONOUGH. There is no question that we, because of our market surveillance responsibilities, think that the ongoing improvement in transparency is good. However, we do not now and never will depend completely on what we see on screens. We are constantly looking at the market, observing the market. As you know, we are a participant in it because of our repo activities and occasionally, as we did yesterday, when we buy securities outright. So we know what is going on in the market.

When we see anything from any source that makes us believe that something needs additional research, we get at it very quickly and very thoroughly, and when we reach a point where we think something is truly demanding the attention of the cops, we call them. We have not since we created market surveillance reached the conclusion that that was necessary, but I can assure you that that is what the rules are, and there is a very strong bias on my part and on the part of all of us involved in market surveillance at the Federal Reserve Bank of New York that we are not going

to hesitate for a nanosecond in calling the regulatory authorities when we should.

Mr. MARKEY. Well, I am afraid that is not the history, Mr. McDonough. That is, the nanosecond is more like a nanodecade or a nano-era in terms of how quickly the New York Fed and the Fed and the Treasury Department over the years have dealt with these issues. This is common knowledge on the street.

A congressional expert is an oxymoron, we are only experts compared to other congressmen, but we have experts that come here on all sides of the issue and testify not only in public but in private with regard to the ability to corrupt any of these marketplaces, and the experts who are interested in corrupting this marketplace tell us that it is the easiest of all the marketplaces to corrupt.

So our concern is that we have found a remarkable coincidence between improvements in the surveillance in this marketplace and hearings that are scheduled before this subcommittee. We can almost track how the hearings or the meetings are being called at the agencies based upon the need to deal with some public relations problem, and that is our real concern, that it is seen as a public relations problem: If only we can get by that hearing; if only it doesn't get that much attention; if only the word doesn't get out that this is the most corrupt marketplace in the country; if only we can lull them into believing that, in fact, the efficiency which we provide there does, unfortunately, under our present rules, have to accommodate a substantial amount of corruption; then we will survive for another day, and we will make whatever other incremental changes we have to make.

I think that our history with this whole issue, going back now 2½ years, has turned us so cynical in terms of how we view the regulators, the present-day regulators, in this marketplace that it would almost be difficult for me to fully express to you how concerned I am about the level of corruption which does exist in this marketplace today and that the Salomon Brothers scandal was, in fact, just the canary in the mine shaft, it was nothing more than the warning that there is more down there, and that thus far all I have seen is incremental change in trying to deal with a fundamental problem.

Mr. Corrigan, in testifying here more than 2 years ago, made it quite clear that he didn't see himself as an enforcement officer, which is fair. Mr. Mullin, or his predecessor who was here—I think J. Powell was here a couple of years ago; he said the same thing; nothing has changed. And I appreciate that. You don't spend any significant part of any day on this issue—that is, enforcement. It is not really the primary part of how you see yourself. I respect that.

All I wish you would do is just respect our views and the public's views, but other participants, other than those with whom you speak on an ongoing basis, Mr. McDonough. I am just afraid that on issues like this it has turned too much into a jurisdictional, inter-agency dispute, which then manifests itself in public here, using veiled references to efficiency in the market or to changes which are made voluntarily, to mask the fact that you are more concerned about the prerogatives of your historic agencies than you really are about the integrity of the marketplace.

That is of most concern to me, because I don't think this is a very difficult issue, to be quite frank with you. It should not have consumed 2½ years of the subcommittee's time, I will tell you, regarding an issue which, in my opinion, would not have any significant impact on the market whatsoever, notwithstanding Mr. Mullins' testimony. I just cannot, for the life of me, understand how you can elevate something which is so obviously needed to this level of dispute.

I would like, Mr. Breeden, if you could, to give us some sense about what is gained by giving you this price transparency backstop authority supplementing what Mr. Mullins or Mr. McDonough or their agencies might want to put on the books.

Mr. BREEDEN. Mr. Chairman, I concur that there is an element of bureaucracy and agency interest in some of these debates. The Fed's testimony, in its written form, suggests there shouldn't be any record-keeping authority, and the argument today has become that the Treasury ought to do the record keeping, not the SEC. Those are somewhat different arguments.

I don't want to over-regulate the market. I don't think we are talking about anything unusual or unique or costly. I think I have a pretty good track record of trying to make sure that the SEC's regulations are cost effective and not burdensome. We wouldn't be proposing it otherwise.

But every one of these firms has to know who they bought from or whom they sold to and at what price and at what time. They can't do business without knowing that. It is a simple little question of whether we can mandate that they give us that information in a form that will make it easy for us to piece together what happened in a marketplace and find out whether there was unlawful activity or not.

Now there are people who do not want to see us have an easier job of it. Gilbert in "The Pirates of Penzance," said, "When constabulary duty is to be done, the policeman's lot is not a happy one." People like to make it as hard as possible for people to oversee what is going on. I understand that is a concern that people in the market might have, but what we are really talking about in this legislation is something, I think, as you mentioned, that is pretty simple; it is keeping records that are already kept in a form that is accessible and usable to have cases that can be presented to a judge and a jury.

If nobody wants us to be able to do that, fine; I'd rather be told that we are going to repeal 10b-5 as to the banks' securities business and just have them have the honor system. But if people want us to try to enforce the law, then we have got to be able to get evidence to bring the cases, and the current system can be improved.

Mr. MARKEY. This raises the question then of why the SEC, who is, after all, is the Agency which is going to use these records, shouldn't have the primary role in drafting the rules to ensure that the information is usable to the enforcement agency.

After all, Mr. McDonough and Mr. Mullins, you both agree that you are not in the enforcement business. So wouldn't it make sense, at least in the delegation of authorities in a complex government, to give the responsibilities to the Agency that ultimately is going to have responsibility for the use of that information?

Mr. MULLINS. I think Congressman Tauzin used the analogy of the IRS and the Justice Department. We do think the Treasury is in the best position to weigh the impact of regulation on market participants and taxpayers. They have a strong incentive to protect this market.

Now I do think that the SEC and others should communicate with Treasury if they think there is a problem here, but we would oppose creating overlapping authority here in yet another area of balkanized—

Mr. MARKEY. But is this balkanized, Mr. Mullins?

I mean if there is a murder in the bank, Mr. McDonough, you don't investigate, the local police or the State or Federal police would investigate. If you as a banker have, unfortunately now, participated in a deal that has hazardous waste materials on some construction site, it is the EPA or the State environmental agency that comes in and deals with the issue and has responsibility for oversight. If there is a minority or an affirmative action hiring problem in an institution, it is the relevant agency that comes in, it is not the banks, and that is balkanization, I guess, if you want to use it in its pejorative sense. But, in its most positive light it is used in a way to ensure that those who are given primary responsibility for advancing agreed upon societal goals are given their opportunity to come in and to use their expertise, and I don't understand what is wrong with that, Mr. Mullins.

Mr. MULLINS. We don't disagree with that. The SEC is the person to do the enforcement, and what we disagree with is also giving them duplicative rule-writing authority as well. It is the overlapping rule-writing authority we object to.

Mr. MARKEY. It is not duplicative. We will give to them the ability to be able to put together the rules, and you say you are not an enforcement agency, so how can it be duplicative if the agency which is an enforcement agency is going to ensure that the rules are constructed in a way that gives them their enforcement information?

You clearly admit, both of you, that you do not have the expertise at your relevant agencies to be able to do this.

Mr. MULLINS. Nor do we seek it.

Mr. MARKEY. I know that.

Mr. MULLINS. Again, my suggestion is that this is an issue in which it would be very useful to get the perspective of Treasury, who does have the primary regulator role here.

In terms of the turf issues, we have no regulatory jurisdiction at issue at all in this debate, and our only concern is what is best for the market and the country.

Mr. MARKEY. You have a philosophical difference of opinion with us, which I think is probably unbridgeable, and that is valid, and we can accept that as a perspective—you know, efficiency over other values.

Mr. MULLINS. We have seven members of the Board.

Mr. MARKEY. I appreciate that, and I am sure that they are selected from a broad cross-section of America, meeting all the Clinton diversity elements.

Mr. MULLINS. We have members from Arkansas.

Mr. MARKEY. Bankers from Arkansas, bankers from California.

The problem that we have here is that, amongst other things, Treasury is the issuer as well, and you get into a conflict. It is the same conflict that we have in other areas where agencies are set up. The Nuclear Regulatory Commission is set up to regulate nuclear power; the Atomic Energy Commission is set up to promote nuclear power.

Now you are promoters, and that is fine. You have a good rule. You are basically the fiscal chamber of commerce in terms of your attempts to convince this country and the rest of the world this is a great place to invest and we are very efficient and we will try to work with you to make it more of a comfortable environment for you. That is a very important role, and we don't mean to demean it in any manner, shape, or form. What we have a problem with is when you demean the other part of the system that also has a role.

We set up Glass-Steagall, and we know that it has now basically been back-doored through every possible way imaginable to seek its undermining, but essentially the philosophical insight that was inherent in the construction of Glass-Steagall is still valid, which is that you need to have different agencies responsible for different roles. The SEC is the cop, and the bankers are the promoters. That is fine as long as we can continue to accept the legitimate conceptual distinction which is made between the roles.

As we hear you today, we still don't, I think, elicit the proper respectful tones in terms of the functional regulation responsibilities which the SEC was tasked with, the expertise which that agency has developed, and the absolute consistency which our committee has with the Banking Committee and others with the efficient, orderly transfer of capital from investors into the hands of CEO's in this country. We have the same goal. But you are not willing, unfortunately, to give enough attention to or respect for the other side of the coin, and that is fine. The Atomic Energy Commission has it.

You can go down agency after agency that we have to split off in terms of its promotional and regulatory functions because of that psychic barrier which is created in people's minds as they determine at age 15 or 16 where they want to work for the rest of their life, and it makes a lot of sense while you can't deal with this, and that people who want to work for the SEC take another view of the world as well, each of them legitimate if they could be harmonized.

The balkanization which you speak about is not that in fact but, in fact, delegation of authority to various parts of the Government that have primary responsibility for, expertise in, and interest in it.

I hate to break off here, but I would ask each of you to give us a 1-minute summation of what you want the committee to remember as we are going along, because I will have to call the second panel to give them a chance to testify, and I would ask if we could go in the same order—if you, Mr. Mullins, could give us your summation to the committee.

Mr. MULLINS. I would just say we view this as central bankers and, I would agree, not as enforcement agents, even though at age 15 I doubt that I knew what a central banker was. We view this as a very important market, as everyone does, and believe that it

is quite important that we be very careful in assessing the potential impact on this market of making major shifts in regulatory authority. Our judgment is—which is a unanimous judgment from the Chairman and the entire Board of Governors—that indeed there may be significant risks involved to the smooth functioning of this market and to taxpayers from engaging in a dramatic change in regulatory authority.

Thank you, Mr. Chairman.

Mr. MARKEY. Mr. McDonough.

Mr. McDONOUGH. Mr. Chairman, I became a central banker only at the age of 57.

Mr. MARKEY. You became a banker at which age?

Mr. McDONOUGH. Actually, at age 33, after being in the U.S. Navy and the State Department.

I think I could perhaps help best by saying what has changed since the Salomon Brothers scandal at the Federal Reserve Bank of New York. As you know, at that time we were in what we called the dealer surveillance business, which was to make sure that we had creditworthy counter parties. We have had a massive change to the market surveillance area, which is to look at the market in its entirety and its actions.

We believe that our capability, working with the other agencies—the SEC, the CFTC, the Board—has made a tremendous amount of progress in making it less likely, a good deal less likely, that the kinds of things that we saw in the Salomon Brothers case will happen again. Nobody under any system, including the proposed legislation, can give you assurance that it will never happen again. But we believe that the Federal Reserve Bank of New York, with tremendous cooperation from all of the agencies involved, has done a great deal to make this market safer, more efficient, and better supervised for the benefit of the taxpayer.

Thank you.

Mr. MARKEY. Thank you.

Mr. Breeden.

Mr. BREEDEN. Mr. Chairman, I, too, agree that this is a vital market and that there is a paramount public interest in keeping the cost of financing as low as possible. To the degree that the market becomes seen as one where it is easy to commit fraud, there will be fewer participants in the market, it will be less liquid and less efficient, and the cost over time of financing the Government will go up, not down. That is what brings us all here in good faith, to try and figure out what is the best way to assure that we have an efficient and an honest market. Those goals should not be inconsistent; they can be consistent.

Just as people have been talking about the IRS here, the IRS, in fact, has authority very much like the SEC. They bring civil enforcement actions. They are the ones who enforce their own record-keeping requirements. The Justice Department brings criminal actions in the IRS area, the same way the Justice Department brings the criminal actions for securities fraud. But the IRS sets the record-keeping requirements, and it then enforces them. It is the enforcement agency. Here, we are the enforcement agency, and we ought to be able to set the record-keeping requirements.

What is at issue here, I think, is a fairly simple question of whether we want to balkanize an efficient trading system. I have been in the trading room of most major firms in this area, and when you walk into a trading room, you walk into an array of people at phones and looking at screens, and they are trading fixed income, or they are trading equities. The fixed income will include RTC securities, Treasury securities, Freddie and Fannie securities, it will include AT&T—corporates. What is being suggested here is that, although every single security being traded in that entire trading room is under the record-keeping requirements of the SEC, one little sliver of that market ought to have a different agency that needs to start writing the rules about what needs to be kept, and the computer systems of all these firms need to be able to track and record records on fixed income except for Government fixed income. Now that is balkanization.

What we are arguing for is consistency, functional regulation, simplicity, and if we want to trade securities, then there should be a set of rules that you have to follow; if you don't want to be in that business, that is fine, nobody makes you go into it. But what we are trying to promote here is the idea of consistent enforcement and simple enforcement of the law, and I regret that sometimes the issue of agency interest gets in the way of what needs to be our paramount focus, which ought to be making sure that, for the people who don't happen to be honest, we make the system difficult for them to abuse, and we can do better than the system that exists today.

Thank you.

Mr. MARKEY. Thank you, Mr. Breeden, very much.

We do want to resolve this issue soon, and to the extent to which it is necessary for us to make clear the extent of the corruption in this marketplace and the extent to which there is a complete mismatch between the existing regulation and the corruption which is out there, then this committee will do so.

We would hope that we would be able to negotiate out something, but, if necessary, we will resort to increasing the numbers of hearings and new witnesses that we will bring in here to demonstrate clearly the inadequacy of the existing system. It just would be our hope that we could work something out on a rational basis rather than forcing the subcommittee to take more dramatic testimony from witnesses before this committee that would be much more palpably obvious to the ordinary investor as to what is going on.

Thank you all very, very much.

Mr. MULLINS. We would be happy to work with you.

Mr. MARKEY. Our second set of witnesses: Mr. Michael Basham is the managing director of Smith Barney; and Mr. Randy Strausberg is the president of Top Gun Capital Management, Inc.

Ladies and gentlemen, if we could please begin. I would ask everyone to please sit down and for the witnesses to be seated.

We will begin with Mr. Basham, who is managing director of Smith Barney, or, for the purposes of today's hearings, "Smith Barney." That is hopefully not in his testimony however.

So whenever you are comfortable, Mr. Basham, please begin.

**STATEMENTS OF MICHAEL E. BASHAM, MANAGING DIRECTOR,  
SMITH BARNEY, HARRIS UPHAM & CO.; AND RANDY M.  
STRAUSBERG, PRESIDENT, TOP GUN CAPITAL MANAGE-  
MENT**

Mr. BASHAM. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, it is a pleasure for me to respond to your request to appear before you to discuss H.R. 618, the Government Securities Reform Act of 1993.

At the outset, I would like to make it clear that my testimony and my responses to your questions represent my own views and are not intended to represent those of my employer, Smith Barney, Harris Upham, soon to be Smith Barney Shearson.

Your invitation asked me to respond to a series of questions as well as to provide the subcommittee with my views on the major provisions of H.R. 618, and I am happy to comply. I would first like to address H.R. 618, the Government Securities Reform Act of 1993.

With respect to section 2, the extension of the Government securities rule-making authority, the subcommittee should permanently extend the Treasury's rule-making authority under the Government Securities Act of 1986. Congress made the correct judgment in 1986 concerning the basic regulatory structure of the market for Government securities. The various regulatory agencies, the GAO, market participants, and industry representatives all agree that the Treasury has done a good job as the rule-maker.

Because the regulatory objectives established by Congress when it enacted the GSA have been successfully met, another sunset provision designed to review the efficacy of the regulatory structure is not necessary.

With respect to section 3 on record keeping, under the Government Securities Act of 1986 Treasury was granted the authority to promulgate rules concerning record-keeping requirements for all participants in the Government securities market. Under H.R. 618, the Treasury's authority would be renewed and the SEC would also be granted authority to adopt rules on record keeping. There is no identifiable need for duplicative or overlapping layers of regulatory rule-making authority. To the extent the subcommittee believes enhanced record-keeping rules for enforcement purposes are necessary, Treasury should be required to develop these rules in consultation with the SEC.

With respect to section 4, large position reporting, the most important provision of H.R. 618 would grant Treasury the authority to adopt rules requiring large position reporting for all market participants. I would recommend to the subcommittee that the legislation require the Secretary of the Treasury to adopt large position reporting rules.

Disclosure of a large controlling interest would make it more difficult for market participants to manipulate the secondary market without the knowledge of regulatory agencies. Requiring large position disclosure will also act as a deterrent to manipulative practices. In terms of enhancing regulatory oversight of the Government securities market, eliminating manipulative, and collusive practices and protecting market integrity, this is the most important step this subcommittee could take.

With respect to section 5, prevention of fraudulent manipulative acts and practices, extending the SEC's existing anti-fraud and manipulation authority over regulated brokers and dealers to the Government securities market is a positive step that will further enhance market integrity.

Section 6, broker-dealer supervision responsibilities: The New York Stock Exchange and the National Association of Securities Dealers currently have rules requiring their member firms to establish procedures to ensure compliance with applicable securities laws and regulations. Additionally, all financial institution regulators have similar authority. As a result, the provision requiring brokers and dealers to establish separate compliance and control procedures for Government securities would appear to be redundant and unnecessary.

Section 7, sales practice rule-making authority: The proliferation of financial instruments that are Government securities and that pose greater risk than traditional Treasury or agency securities necessitates uniform sales practice rules in order to protect less sophisticated investors who have historically been attracted to the Government securities markets because they seek safe investments.

While protecting investors is vitally important to the integrity of the marketplace, inconsistent or heavy-handed rule-making can have the unintended result of negatively impacting market liquidity and efficiency. The inevitable consequence of this would be increased cost to the taxpayer for financing the deficit.

Of all the agencies, only Treasury has a vested interest in minimizing the cost of financing the public debt by maintaining both the efficiency as well as the integrity of the Government securities market. Treasury, with its superior understanding of the market for its own securities, is also best positioned to determine the consistency and the market liquidity impact of proposed sales practice rules.

With respect to section 8 and market information, the threat of a Government-mandated effort was the catalyst for voluntary industry price dissemination efforts, and, as a result, Government securities price and volume information dissemination has become a reality. Street efforts to be responsive to customer demands for new services should increase and enhance the information available to market participants.

However, dealers did not willingly give up the competitive edge that nontransparency of prices provided them, and in the short run there may be some slight chance that price dissemination efforts may stall or may not respond to customer demands for more and better information. As a result, some appropriate stand-by mechanism to ensure that private market efforts continue to be successful is warranted. H.R. 618 would appear to go far beyond what is necessary to ensure the success of the private sector initiatives. I believe it is important to note that a lot has already been accomplished in the price dissemination area without Congress passing legislation.

I would like now to respond to the written questions that were included in your invitation to testify.

Is it possible, without breaking Treasury auction rules, to create artificial shortages in the Government securities market in order to control or manipulate market prices?

Yes. For example, three bidders acting in concert could tender for the 35 percent maximum amount Treasury will allow any bidder to purchase, with each bidder being awarded one-third of the issue auctioned. While Treasury auction rules have not been violated, this concentration of ownership could result in market manipulation of the new issue if the owners manipulate the supply they make available to the secondary market.

How could a deliberate manipulation of the market occur? What trading strategies might be employed? How would a manipulator profit, and how would other market participants be affected?

Most deliberate market manipulations involve some attempt to restrict the supply of a security in the markets. To accomplish this, the manipulator would need to obtain control of a substantial portion of the available supply of a security. Control can be established by outright ownership or by collusion among several owners. The manipulator profits when the price of the security goes up as a result of market demand substantially exceeding the available supply. Obviously, market participants who need to purchase the security pay a higher price than they would in the absence of the manipulation. Additionally, market manipulation hurts issuers of securities by driving away market participants who fear losses, thereby reducing market liquidity.

What can regulators do to better detect and combat the risk of fraud and manipulation in the Government securities market?

With respect to the current regulatory structure, I think it is important to understand that it was the existing surveillance and enforcement mechanisms that ultimately forced Salomon Brothers admissions of wrongdoing in August 1991. My own involvement in those events suggests to me that for the most part the process worked. With a multitude of appropriate laws and regs available to various enforcement agencies, what seems to be needed is more effective surveillance and enforcement, not broad sweeping changes in the regulatory environment.

More effective surveillance will be the result of a requirement for all market participants to report their control of large positions in a security to the appropriate regulatory authority. The natural end result of enhanced market surveillance will be effective enforcement of current laws dealing with manipulative practices and collusion.

What should regulators look for when trying to distinguish a manipulative market squeeze from one resulting from natural market forces?

The most significant feature that distinguishes a manipulative squeeze from a natural squeeze is concentration of ownership. By way of example, in May 1986 the 9¼ percent Treasury bond maturing February 15, 2016, suffered a severe secondary market squeeze resulting in significant losses to those who had shorted it as part of their secondary market trading activities.

At the time, ownership of the 9¼ percent Treasury bond was spread across a large diverse group of buyers with no one owner having a large enough position that would allow manipulation of

the price. This was a squeeze that resulted from the independent decision making of multiple owners and sellers, or natural market forces. In contrast, the 2-year note squeeze in May 1991 came about as a result of 2 or 3 market participants controlling the outstanding supply of the entire issue. This concentration of ownership is suggestive of a manipulative squeeze.

What steps can regulators take to respond to an artificial squeeze?

The proper response to a manipulative squeeze in the market is aggressive prosecution of the perpetrators of the squeeze. Aggressive enforcement should be the most effective deterrent. There are only a small number of market participants who have the capital and the sophistication to perpetrate a manipulative squeeze on the Government securities market. As a result, the universe of potential transgressors is very small, which suggests that sweeping regulatory reform designed to deal with a broad, pervasive threat is unnecessary. Again, enhanced surveillance as a result of large position reporting should result in more effective enforcement of existing laws against collusion and market manipulation.

The general reexamination of the Government securities market over the last 18 months has been a worthwhile exercise for all market participants. A fair and open market is vitally important to the Federal Government's efforts to fund the deficit. However, I would encourage the subcommittee to focus on the fact that, as with the loss of investor confidence, poorly designed regulation can have an equally disastrous impact on the cost of borrowing by driving away those who provide the Federal Government with the funds it needs.

Mr. Chairman, that concludes my statement. Thank you.

Mr. MARKEY. Thank you, Mr. Basham, very much.

Mr. Strausberg.

#### STATEMENT OF RANDY M. STRAUSBERG

Mr. STRAUSBERG. Mr. Chairman, I want to thank you for the opportunity to testify on the issue of Government securities regulation. I have spent my entire career involved with the market first at the New York Fed and later at a number of primary dealers. I was a trader, salesman, I managed the Government Securities Department at Nikko Securities, a very large Japanese firm, and, consequently, I feel a personal involvement in maintaining the integrity of the market even at the cost of greater regulation. We would fool ourselves to imagine that dishonesty and covetousness could be restrained by written laws which would catch the weak and the poor but easily be broken by the mighty and the rich. The proper goal of regulation is to assure that the Treasury obtains the lowest long-run cost of financing. Such a goal requires the market to attract the widest variety of buyers and sellers, allow for efficient risk management, result in the narrowest bid-to-offer spread, offer the greatest liquidity, and generate the most derivative uses. It also reminds the regulator that morality is not in conflict with efficient markets.

The Treasury must avoid a severe reduction in the size of individual long-term bond issues. Skimpy issues invite abuse and will require frequent unscheduled reopenings till these issues remain liquid and trade in line with similar securities.

Restrictions on the size of bids at auctions will not prevent artificial shortages. Such limits do not restrict ownership, and I do not recommend any. We shall have to monitor other methods of accumulating and controlling securities. There are futures markets, swaps, options, STRIP's traded by nonregulated dealers, banks, foreign monetary authorities, and hedge funds in all time zones.

In particular, we need to address the issue of common control and foreign unregulated subsidiaries. This does not imply that any abuses have occurred, but it is the nature of regulation that creative players will find a way to defeat it. Vigilance requires information.

Manipulation requires the creation of an illusion in order to encourage other participants to pay an inflated price. Market and financing prices may indicate a shortage. Players attempt to tighten an issue in the financing market by taking them "off the street" to a lender that will not recycle the securities.

With the advent of screen-based trading, the illusion can be assisted by commentary on information systems and dissemination of quotes instantly. The use of misinformation can be just as manipulative as no information.

The greatest cost to the Treasury results from the loss of hedging vehicles. A hedge, by definition, must have a definable relationship to that being hedged. When hedging securities are hard to borrow, when yield spreads to surrounding issues change unpredictably, when traders lose money simply by servicing their clients, the market will become less efficient; traders will bid lower and widen their bid-to-offer spread; other things being equal, yields will be higher than they ought to be. It is irrelevant whether the price anomaly results from manipulation or natural forces, a trader's reaction is the same. As a result, the Treasury should adopt a clear cut policy for reopening tight issues regardless of the cause. A statistical measure of the market's difficulty with an issue should be developed.

In regard to H.R. 618, I think it necessary to exempt small dealers from burdensome record-keeping requirements. Any information obtained from dealers or other market participants should be held in confidence and used only by agencies directly involved in securities regulation. Information systems sponsored by dealers or inter-dealer brokers should report trades in real time with the size of bids and offers displayed. The date and time of last trade should also be displayed.

Price manipulation can occur regardless of Treasury bidding rules. Provided information is confidential, position reporting worldwide would assist in developing measures of tightness and clear-cut parameters for response.

[The prepared statement of Mr. Strausberg follows:]



M.G. Tivon Group

**Written Comments Regarding H.R. 618** -- Randy M. Strausberg

Mr. Chairman, members of the Telecommunications and Finance Subcommittee,

I want to thank you for the opportunity to testify on the issue of Government securities market regulation to prevent fraud and manipulation. I have spent my career in the Government securities market, first at the New York Fed and later at a number of Primary dealers. The market can serve the needs of the Treasury, the Fed, investors, borrowers, foreign monetary authorities and speculators if integrity can be maintained. But, we would be foolish to " imagine that dishonesty and covetousness could be restrained by written laws which would catch the weak and poor, but easily be broken by the mighty and rich. "\*\*

Prior to addressing this issue, however, I think it necessary to define the goal of any regulation. Is it to provide a level playing field so that free market players can maximize their profit? Is it to provide a deep and broad market so the Fed can carry out its monetary policy responsibilities? Is it to allow the Treasury to issue its debt at the lowest possible price over the long term? These goals are not always consistent. While I strongly believe in free markets, I do not believe that free markets are automatically efficient and honest. Sometimes the Invisible Hand does not find the optimal allocation of resources at the best price; it simply finds its way into your pocket.

Government securities regulation has lagged behind other markets because we were never concerned with "insider information" about the issuer. Also, the buyers

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had traditionally been sophisticated institutions that did not need protection. A small community of dealers, in a close relationship with the Fed, earned a comfortable living distributing Government securities. Activities which in other markets are clearly prohibited as price manipulation are routine in Governments. This is especially so with the advent of screen based trading and significant trading away from the home market, either overseas or through derivatives.

I was particularly struck by this phenomenon when I ran the Government department at Nikko Securities, a Japanese owned Primary dealer. At the time, Japanese investors were the single largest player in the long-term bond auctions and often ten year note auctions as well. Quite often, during refundings, I would be asked for a comment by a news service on expected Japanese interest in auctions. I began to notice that sometimes when my remarks hit the tape, the market would have a price reaction. I am not in favor of restricting such comments since the alternative is to restrict the information to a handful of inside players. I simply point out that the question of manipulation goes far beyond an artificial squeeze or shortage; with instant dissemination of news to a great many market participants, misinformation has as great a potential for manipulation as no information.

In answering your specific questions, I assume the goal of regulation to be the broadest need - to permit the Treasury to borrow at the lowest possible cost over the long run. A market with unquestioned integrity based on the highest credit available will attract the most buyers and sellers, allow for efficient risk management, result in the narrowest bid to offer spread, offer the greatest liquidity and generate the most derivative uses, all of which will lead to the lowest possible cost to the Treasury.

This assumes that the Treasury will itself avoid policies that lend themselves to shortages and squeezes. If the Treasury continues to reduce the issuance of longer securities, it may have to go to a regular cycle of frequent re-openings, so these issues remain liquid and trade in line with other similar issues. As the benchmark for all long term securities, we can ill afford a stray bellwether.

As to the question posed by your letter, yes, it is possible to create artificial shortages without breaking Treasury auction rules. Such restrictions impose no limits on ownership and I do not propose any. We should not in any way prevent legitimate buyers from accumulating Government securities. In being more vigilant about administering our regulations, we can prevent the temptation to challenge them.\*\*

In particular, we need to address the issue of common control of buyers and foreign subsidiaries. Common control might mean that a single large bank buys an issue for its trading department, portfolio, trust department, swap group and other derivative uses. For a dealer, it might mean purchases by managed funds as well as the trading department. In Japan, it might mean purchases by group related companies also. With 24 hour trading, we must address subsidiaries around the world. This does not imply that any abuses have occurred but it is the nature of regulation that creative players will find a way to defeat it. Vigilance requires information. Required filings should not be made public.

Manipulators can profit if they can lay off a sufficient amount of "overpriced" securities at a greater than normal price. This requires the creation of an illusion. Since disgorging a large amount of the squeezed securities would cause a price

decline as soon as the shorts have covered, it is possible for the balance of the issue to sell at a "discounted" price. This requires keeping the issue tight in the financing market so it is difficult to borrow and forces the shorts to cover - in other words, you may borrow in the repurchase agreement market, while selling your actual position at inflated prices.

Other uses involve related markets. Since the Treasury market is the benchmark for other markets, even short term squeezes can have benefits if it permits the sale of other securities at inflated prices.

The major cost of shortages and squeezes is the loss of a useful hedging vehicle. When traders are afraid to use the current or "on the run" securities to hedge, their ability to manage risk is diminished. In such circumstance, bids will weaken and bid to offer spreads will widen. A hedging vehicle must necessarily have a predictable relationship to the security being hedged. When a hedging security is difficult or expensive to borrow, when yield spreads to surrounding issues change from the norm significantly, when traders lose money simply by servicing their customers because spreads go "out of whack", the market will become less efficient. The Treasury's cost will go up. In that regard, it is irrelevant whether a long lasting or pronounced price anomaly is artificial or results from natural market forces. From a market standpoint, they should both be treated the same way. The legal issue is for others to address.

The best known example of a natural forces squeeze is the 9-1/4% T-Bond due Feb. 2016. At the time, bond yields were about 7.4%, resulting in a market price for this issue of about 123. Japanese insurance companies owned a significant share of the issue. Because they were only permitted to pay dividends from income

and not from capital gains, they desired to keep these high yielding bonds. Dealers had gotten short in the normal process of preparing for the auction of a new issue. Unfortunately, when the Japanese did not sell their bonds in exchange for the new issue, dealers had no way to cover. When they purchased other bonds or futures to temporarily hedge, the spread between the 9-1/4's and other bonds changed dramatically, especially since the rest of the bond market began a 12 point decline. These bonds moved "out of line" by about 6 points (6% in price) to futures and other bonds. On a \$9 billion issue, that is about a \$500 million mispricing from natural forces. Does it really matter if it was deliberate? The following nine months were extremely volatile. Long term rates moved up and down about 1 full percent twice during that period. I believe the losses suffered by dealers, because their hedging vehicles failed, contributed to the subsequent volatility.

If damage to the market can be caused by both deliberate and natural shortages, the Treasury must adopt a clear cut policy with regard to re-opening of tight issues. I see no reason for a bias to bailing out the shorts, if there are no fraudulent practices from buyers. If hedging is becoming difficult, there must be a statistical way to measure that difficulty. Such a method will establish an objective standard for re-opening. The buyers of an issue should certainly know what standards the Treasury will use simply because the absence of a standard leads to uncertainty and uncertainty leads to instability. Speculators should not be punished because they identify a shortage and move to take advantage of it. Being a speculator is a normal market function. Without them, price signals cease to exist.

In regards to H.R. 618, the Government Securities Reform Act of 1993, I believe the committee has identified the key need for information. I believe that certain

points need to be emphasized to prevent the regulatory function from clashing with the efficiency of the market.

**A.** Smaller broker-dealers should be exempt from reporting and record keeping requirements beyond routine NASD requirements. These dealers are not the source of squeezes and manipulation. Burdensome record keeping can only cause inefficiency and raise the cost to the dealer and the investor for no useful purpose. These dealers are an important part of the distribution network for individuals and small institutions. An annual volume in Government securities exceeding some high level - at least \$10 billion - would trigger additional requirements.

**B.** All information on positions and strategies must be considered proprietary. Before releasing information to any agency not directly related to securities regulation, contributors should be notified and given an opportunity to challenge the release. This is especially true for information received from non-dealers and foreign entities. Without a guaranty of privacy, participation in the market may be inhibited.

**C.** Every entity whose positions exceed certain percentages of an issue, both in outright positions and financing positions, should report.

**D.** Information systems sponsored by dealers or inter-dealer brokers should report trades in real time with the size of bids and offerings displayed. For "off-the-run" securities, the date and time of last trade should be displayed. The public should have all of the trade information available on dealer screens.

Manipulations can occur regardless of Treasury bidding rules. Such practices require control over both the ownership of the security as well as the market for borrowing the security. Regulators need to monitor the activities of major players worldwide but with a guarantee that information gathered will remain confidential.

Additionally, the Treasury must develop a clearly defined rule for re-opening a tight issue, based possibly on time duration, price or yield spread to some standard and volatility compared to surrounding issues, regardless of the cause of tightness.

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\* Anacharsis, quoted in Plutarch

\*\* Diodotus, quoted in Thucydides

**Outline of Major Points regarding H.R. 618** -- Randy M. Strausberg

1. The best goal of regulation to prevent market abuses is the lowest borrowing cost to the Treasury, which requires efficient markets with broad participation.
2. The expansion of a cozy community of dealers and professional investors to worldwide participation has left regulators far behind in uncovering potential abuses in Government securities.
3. Without frequent re-openings, reducing the size of bellwether issues will lead to shortages and squeezes.
4. Common control of buyers around the world requires more extensive data collection from dealers and market participants.
5. From a practical view, the loss of hedging vehicles will reduce liquidity and cause inefficiency. Whether this results from manipulation or natural shortage, a clear cut policy for relieving squeezes must be developed.

Mr. MARKEY. Thank you, Mr. Strausberg, very much.

Mr. Strausberg, why are you here? What is your concern?

Mr. STRAUSBERG. Well, essentially, I would like to give a trader's perspective. I am not a lawyer; I can't comment on individual aspects of who has what regulatory authority. But essentially, as someone who has always been involved in the market, I see always the possibility of manipulation, the possibility of abuse. Having traded for 20-odd years in Government securities, I think it is just a different perspective that I would like to share with you.

In my written comments I added a section about the 9¼ of 2016. It is a very famous issue from the spring of 1986. There was essentially an accumulation of securities by Japanese insurance companies at that time, and so I am using this example to show you why I think I want to give you a trader's perspective.

At that time, the Japanese insurance companies owned about two-thirds of that issue, and essentially that issue came out in February. There was a new issue coming out in the May refunding. Dealers took their normal positions, getting short, selling the new securities in anticipation that the owners of the previous securities would let them out and buy the new securities in its place.

Unfortunately, they weren't aware that the Japanese insurance companies had a restriction and could only pay dividends to their clients based on interest earned and they couldn't at that time use the capital gains. At that time, interest rates were rather low. A new issue came out finally with a 7¼ coupon, and so the 9¼ were trading at a price of something like 123.

Essentially, two-thirds of that issue stayed in Japan. It wasn't deliberate, it wasn't illegal, they didn't collude to the best of my knowledge, but essentially that issue traded six full dollar points out of line with the rest of the market. Essentially, the bond market began to decline after the May refunding. The bond market declined about 12 or 13 points; that issue declined 6 points.

People who had shorted that issue ended up buying Treasury futures and other bonds against it and essentially had their issues, their hedging vehicles, go down 12 or 13 points while their shorts, of course, only went down about 6 or 7 points.

I believe as a result of that disaster for the dealer community—and just to give you a measure of what it means to be out of line by 6 percent, that is a \$9 billion issue, so 6 percent amounts to something like \$450 or \$500 million of difference in value from what that issue ought to have been. Essentially, the market then dropped 13 points, rallied 12, dropped 15, and rallied 10. That kind of volatility cannot be helpful to the Treasury or to investors.

Mr. MARKEY. So the Treasury needs large reporting authority.

Mr. STRAUSBERG. Well, whoever needs large reporting authority. I think you need to track who owns large positions in Government securities in individual issues.

Mr. MARKEY. Thank you.

Just so I can help to get your philosophical perspective for coming in here, you are a participant in this marketplace, Mr. Strausberg?

Mr. STRAUSBERG. Well, right now I am starting a small dealership. But yes, for 20 years I was at primary dealers, I was at the New York Fed, I managed a large Government securities depart-

ment, and obviously observed that particular instance from the perspective of a Japanese dealership.

Mr. MARKEY. But just broadly though, in terms of the need for price transparency, the need for better record keeping, so that there is more information out there, if you are not the biggest player in the biggest firm, how necessary is this in order to make the market more honest?

Mr. STRAUSBERG. I think for the regulator, I cannot see how today's derivative instruments, world-wide trading, hedge funds all around the world trading Government securities, unless you can somehow gather information on who the players are and what the positions are and what they own on a world-wide basis, I cannot possibly see how you could identify any potential for abuse.

Mr. MARKEY. So do you think there is a substantial winking that goes on in firms across the whole scene? You know what I am saying—winking about what they are able to do because they know there is absolutely no chance of detection.

Mr. STRAUSBERG. Oh, of course.

Mr. MARKEY. There is?

Mr. STRAUSBERG. Of course. I am not going to sit here and tell tales, but the fact is that people understand that they can do things and get away with it, and they do.

Mr. MARKEY. Right now? Every day?

Mr. STRAUSBERG. Yes, absolutely.

Mr. MARKEY. And they would be illegal if we passed this Act. They would not be engaging in those activities—

Mr. STRAUSBERG. Well, I don't want to comment specifically. You know, I am not a lawyer enough to answer that question, but the answer is certainly NASD sales practices—I don't see any problem with that whatsoever applying to every kind of security, and I do think regulatory agencies should have this position-gathering information from again—and I want to say around the world.

I will give you one example. There is a new hedge fund—new, let's say, the last 6 months—from Bermuda of all places. The question is, where did they get money from? I have heard it was through an Austrian bank, I have heard it was through the Channel Islands from Middle Eastern interests. But the point is, this is a new player with over \$10 billion of positions and no one even knows who they are or what they have, and they are in Bermuda.

Mr. MARKEY. All right.

Let me go to Mr. Basham.

Mr. Basham, you heard this problem. How can it be rectified?—if you think it is a problem. Is it a problem?

Mr. BASHAM. Well, the identity of the offshore hedge fund based in Bermuda—I am not necessary sure the identity of the financial backers is such a problem in terms of market integrity.

Mr. MARKEY. Mr. Strausberg?

Mr. STRAUSBERG. I am not saying we need to know the name of the guy who has the money, but we need to know that this hedge fund has large positions if, in fact, they have large positions.

Mr. MARKEY. Do you agree with that, Mr. Basham?

Mr. BASHAM. Absolutely.

Mr. MARKEY. You do. Then do you support that provision in the legislation that would have that large position authority given to the Treasury and mandate that they develop it?

Mr. BASHAM. Yes, sir, I would.

Mr. MARKEY. You would. OK, fine. So we can solve that problem as far as you are concerned.

What else have you got, Mr. Strausberg? Any other problems that you can think of?

Mr. STRAUSBERG. Well, as a person who is not sitting at a primary dealership right now, I get to look at GOVPX an awful lot, and, having been at a large dealership where there is a constant flow of information and customer business going through, where you can have a day-to-day pulse on the repo market and so forth, so you can find out what is going on, it is a lot different when you are sitting out in the hinterlands and all you have to depend on is GOVPX, and you begin to see some of the faults in GOVPX.

For example, the information doesn't come across real time, so, for example, if trades are working up—let's say two dealers are having a trade and one guy hits a bid and says sell 5 million, 10 million, 50 million, and so forth, and works up the trade, you don't really get to see that until the trade is over; you don't see it as it is happening. So, suddenly flashing across the screen might be, 100 million was done with some time delay.

In addition, there are any number of off-the-run issues that appear on GOVPX and may not trade every day or every 5 minutes. I believe you should have the date and the time of the last trade. I mean that is important information for especially small dealers around the country.

Mr. MARKEY. Let's go to Mr. Basham.

What do you think?

Mr. BASHAM. With respect to GOVPX, Mr. Chairman, clearly you want as much price transparency as you can technologically provide in the marketplace.

To the extent that the current technology probably would not allow every single piece of information that someone might like to see to be transmitted, obviously that is going to take time and new technology or an investment of capital to make that happen.

But in terms of the issue of transparency itself, obviously it is a good thing; the more information the better.

Mr. MARKEY. Then why is there a technological obstacle to getting—the information is now with the dealers, right?

Mr. BASHAM. Correct.

Mr. MARKEY. What is the technological obstacle to getting it to the public? Why can't the public get it? We are the telecommunications subcommittee here as well, and so we have both—

Mr. BASHAM. Correct. Mr. Chairman, I am not an expert. All I will do is relay to you, this is an issue that I pushed quite actively when I was at the Treasury Department, and in terms of the PSA GOVPX effort we were constantly being told that there was literally a limit to the number of lines of information that could be provided on the current computer technology they were employing for GOVPX. To the extent that—to provide more information literally would require more blocks, more lines on the screen, would

require an investment of additional money, and providing new hardware.

Mr. MARKEY. Well, again, we don't think we are really recommending anything that is too revolutionary here. It is just that there should be a telescoping of the time frame it takes for the modernization of this communications system. You know, we have to battle with the Merc all the time; they like this open outcry system; and maybe—you know, just maybe, if we really work hard, we will be able to figure out, you know, if they are telling us 6 or 7 years ago how to put this up there so everyone can see what is going on in these markets. We appreciate the difficulty there. You could have maybe a year, but it takes decades sometimes to get people to move, which makes sense; the people who already have a stake in the existing market don't want to get out any additional information.

Mr. Basham, Mr. Strausberg, I would also like to ask your comment on proposals to split rule-making—anti-fraud, record keeping, internal controls, price transparency provisions of our bill—between the SEC and four separate bank regulatory agencies. Does it make any sense to have five potentially different sets of rules in this area, Mr. Strausberg?

Mr. STRAUSBERG. Well, again, you are getting into legal questions, but the Municipal Securities Rule-Making Board, as you know, regulates municipal bond dealers, and as far as I understand those laws, the enforcement belongs to the agency that happens to regulate that particular entity, so if you are a securities dealer it is the NASD, if you are a bank it is a bank regulator. So there is an example where we do have split enforcement. Whether or not that works, I can't answer that.

Mr. MARKEY. OK.

Mr. Basham.

Mr. BASHAM. Where there are different securities, there are different markets. I will say, Mr. Chairman, that the Government securities market is somewhat unique in terms of who it benefits. Obviously, to the extent that the SEC historically has had its role of protecting the purchaser or the end user—

Mr. MARKEY. It is not unique in terms of who it victimizes.

Mr. BASHAM. No, sir, not at all. To the extent that you have individual investors who could be victimized by unscrupulous practices or practitioners, certainly, that is always a possibility.

But, you know, the SEC has got one primary focus, and that is essentially to protect investors, to make sure they get all the information they need to have to make investments and to protect them against unscrupulous practices.

To the extent that the Treasury market is not the penny stock market, you know, it is the other side of the equation, the issuer, the American taxpayer, as got a vested interest in that market as well, you know, that suggests to me that you do need potentially a different perspective on that market than you might on the penny stock market or the over-the-counter market or listed stocks.

Mr. MARKEY. OK.

Mr. Basham, you were responsible for putting in that 35 percent role that Mr. Mozer and others—were you not the primary Govern-

ment official tasked with the responsibility for putting that on the books?

Mr. BASHAM. Yes, sir.

Mr. MARKEY. So I appreciate your concern about this marketplace. But I wonder whether or not you accept the view of the administration that you served in, their view with regard to functional regulation—that is, that the agency that is the agency of expertise should continue to move wherever those types of responsibilities trail them as the marketplace changes.

Mr. BASHAM. We had a somewhat unique perspective. Again, it was a different market. We thought we were the only agency that really had both perspectives in the forefront of our minds, not only investor protection, which gets to the heart of protecting the integrity of the market—obviously, if the integrity of the market comes into question, that will impact the cost of financing the deficit. By the same token, regulations, and not heavy handed, per se, but even at the margin, incremental regulatory authority that could chip away at the efficiency and liquidity of the market we had to be concerned about too. So we thought we were a unique agency in that respect.

Mr. MARKEY. OK. I apologize, we are going to have to wrap it up, and I would ask that each of you give us a 1-minute concluding statement, if you would. We will begin with you, Mr. Basham, and then we will ask you, Mr. Strausberg, what it is you want us to remember as we are going through our proceedings here.

Mr. Basham.

Mr. BASHAM. Mr. Chairman, I think essentially as an individual—and I will try not to let my former organizational bias enter into this, but as an individual, with the Treasury Department, I obviously had the responsibility for assisting the Secretary in his role as the rule-maker for the market under the Government Securities Act of 1986. I was a champion of price transparency, of sales practice rules, and of large position reporting. I can't say that I find much about the legislation, other than the jurisdictional issues, that I would find fault with.

My only caution would be that this is a market that, again, is not just one where the primary focus should be on protecting the end user of the product that is being created but also the issue of the product; the American taxpayer is not IBM or Exxon Corporation.

Mr. MARKEY. Thank you.

Mr. Strausberg.

Mr. STRAUSBERG. Thank you.

I think the essence is, when you say that the Treasury should be able to borrow at the lowest cost, that requires a lot. It requires efficient markets, it requires information, requires integrity, it requires an ability to prevent abuse, and it also requires an ability to deal with natural shortages.

I know everyone has made a distinction between a natural shortage as opposed to an abusive shortage. As a trader, I don't make that distinction. The fact is, the Treasury needs the information about who owns Government securities—or someone needs the information about who owns large positions, whether outright or in the financing market, and, in essence, needs to be able to deal with

the problems of reopening issues to straighten out anomalies in the pricing structure, because it is essentially those anomalies which make traders afraid to deal in the marketplace, and being afraid means high volatility, and high volatility means higher cost.

Mr. MARKEY. Thank you, Mr. Strausberg. We thank both of you. As you can see and the other witnesses to this proceeding this morning can obviously see, this is going to build to a boiling point before the end of this year, and we would hate to take Mr. Strausberg's insight—

Mr. STRAUSBERG. Is that the Irish pronunciation of my name?

Mr. MARKEY. It is the Boston pronunciation, actually imitating the British accent. It kind of goes from the Kennedys imitating the Cabots and the Lodges and then the Markeys imitating the Kennedys imitating—and so it goes on.

In fact, this accent—they did a PBS special about 5 years ago on the etymology of the English language, and they took one person speaking in downtown Boston, and they tracked it all the way back—this Irish guy in Boston—they tracked it all the way back to the Irish imitating the British to this town about 80 miles north of London, and they put a microphone on a guy of the exact same age in that town, and he sounded just like someone from Boston who had carried on this accent. So we are all products of where we come from; whether it be the banking industry, securities industry, or our ethnic origin, it is hard for us to break that track.

Nonetheless, I think that Mr. Strausberg's concern, as reflected by others who have given us their insights on this subject, is that in the real world there are big problems, and the ability to scam this market is substantial. They can do it almost without regard to any real likelihood of apprehension.

This wink-winking that goes on in this market, and has always gone on in this market, is going to end, and we will do whatever it takes in this committee in order to make this much more public and to make firms who are engaging in it much more public in terms of who they are and what we already know about these firms who are allowing it to be tolerated inside of their firms. If necessary, we will begin naming names, we will begin bringing much more public light on to this subject across the whole public securities arena. We don't want to do it, we want to negotiate it out, but we are not going to do it unless and until we get a positive resolution to this issue.

We don't think we are asking for a lot here, just that the information be made more public. Those who are going to block us will run the risk, as a result, of forcing us to raise the visibility of the firms and others who are engaging in and tolerating this activity. We would hate to do that, but we feel it necessary to do so in order to get a positive resolution of the issue. We just say to all out there, beware, it is on the horizon unless we get a quick and reasonable, respectful resolution of this issue.

We are not going to stop until we get this question answered, and I just want everyone in this audience who may represent whatever interest to understand what is being invoked in terms of this subcommittee's need to raise the visibility of the firms who have inside of their activities right now concerns which Mr. Strausberg and many others have talked to us about privately that must be

altered and can only be altered if this information is put into the hands of the proper regulators.

With that, we thank all of you, and this hearing is adjourned.

[Whereupon, at 12:13 p.m., the subcommittee was adjourned, to reconvene at the call of the Chair.]

[The following material was received:]



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

ALAN GREENSPAN  
CHAIRMAN

February 1, 1993

The Honorable Edward J. Markey  
Chairman  
Subcommittee on Telecommunications  
and Finance  
Committee on Energy and Commerce  
House of Representatives  
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter of December 17, 1992, which requested information about the Federal Reserve's operations in the market for U.S. Treasury securities. The Federal Reserve operates in this market primarily to implement monetary policy, with the size and timing of the operations determined by the reserve needs of the banking system and the stance of policy. These transactions generally represent only a small share of total market activity and go smoothly because of the breadth and depth of the market.

We also execute transactions for correspondents, primarily foreign official institutions. In such cases, we basically fill the investment orders of our official correspondents who hold a share of their dollar assets in U.S. Treasury instruments. These institutions are attracted to Treasury securities in large part because of the presence of an active and liquid secondary market.

I hope that you find these comments and the enclosed specific responses to your questions helpful.

Sincerely,

A handwritten signature in dark ink, appearing to be "Alan Greenspan", written over the word "Sincerely,".

Enclosure

A. The Federal Reserve's Portfolio

(Questions 1, 3 and 4)

1. What percentage of the Federal Reserve's \$300 billion portfolio is in: A) Treasury bills; B) Treasury securities with remaining maturities up to two years; C) Treasury securities with remaining maturities from two to five years; D) Treasury securities with remaining maturities from five up to ten years; and, E) Treasury bonds with remaining maturities of ten years or longer?
3. When purchasing securities for the Federal Reserve's portfolio, what are the determining factors used to choose which securities to buy?
4. What has been the mix between "on-the-run" versus "off-the-run" issues purchased for the Federal Reserve's portfolio for each of the past three years?

At year-end 1992, the Federal Reserve's portfolio of Treasury securities stood at \$303.4 billion, an increase of \$30.8 billion over the course of the year. The maturity distribution that you requested is attached in Table 1.

A central consideration in the management of the composition of the Federal Reserve's portfolio is to maintain ample liquidity; we also remain sensitive to the general goals of Treasury debt management policy and to the smooth functioning of the market as a whole. An important influence on the structure of our portfolio is our policy with respect to replacing maturing securities. As a general rule, the Federal Reserve rolls over existing holdings of securities into securities with original maturities that are generally the same as those of the maturing issues. This policy implies that the exact maturity structure of the portfolio reflects the pattern of acquisitions over an extended period of time.

In Treasury auctions, the Federal Reserve is awarded new securities in exchange for maturing issues on a noncompetitive basis, accepting the price established by competitive bidders. In the case of Treasury coupon offerings, the amount sold to the Federal Reserve augments the total sold to the public. Since the Federal Reserve's rollover operations do not impact the amount sold to the public, there is no market effect from these exchanges. In the case of Treasury bills, where our award is made from the publicly available amount, we seek to keep our distribution across issues relatively uniform to minimize any potential market effect.

While the bulk of the specific securities in our portfolio were acquired through rollovers, any increase in the size of our holdings must come from purchases in the market of outstanding issues. Needs to make such purchases arise from monetary policy decisions and from changes in the demands for reserves and currency. Such needs develop unevenly over the year, with a heavy element of seasonality. Thus, outright purchases from dealers in the market tend to be relatively infrequent, occurring 4 to 6 times a year in the last five years. (Outright sales of bills are executed occasionally when there is a large seasonal abundance of reserves, but market sales have rarely been arranged more than once a year.) I also should note that purchases or sales can be made directly with our foreign official correspondents when our needs are mutually compatible.

In planning a market purchase, we first consider the type of security to be acquired--Treasury bills or Treasury coupon issues (notes and bonds). The decision to purchase bills or coupons rests on the current structure of our portfolio, our assessment of the prospective reserve situation, and the relative supply conditions in each market. Having decided on the type of instrument, the selection

of specific issues is fairly straightforward: We ask for offerings across the full maturity spectrum and select those that are most attractively priced vis-a-vis the surrounding issues on the yield curve. The operations are competitive and purchases are made on a best-price basis. In choosing among issues, we also take account of our existing holdings of a given issue to avoid undue concentration.

As you know, "on-the-run" securities often command a premium for liquidity, and their availability may be circumscribed by heavy use as hedging vehicles. These characteristics are reflected in a lower yield, which makes it less likely that we would be shown these securities or that, if offered, we would purchase them under our best-price approach. Thus, the proportion of these issues in our coupon purchases in the market has tended to be relatively modest, ranging from about 0.4 to 4.3 percent of our market takings in coupon operations over the last two years. (There were no market purchases of coupon issues in 1990.) For bill operations, the share averaged 15 percent over the last three years. (This figure leaves out one purchase in which 56 percent was on the run. On that occasion, a debt ceiling limitation had caused bills to mature a day before they were replaced, preventing the Fed from receiving any twelve-month bills at the auction and, thereby, increasing the amount available to the public. The Desk consequently acquired some portion of its typical share in a market purchase a few days later.)

**B. Custody Holdings for Foreign and International Accounts**

(Questions 2, 5 and 6)

2. What percentage of the Federal Reserve's \$300 billion customer safekeeping portfolio is in: A) Treasury bills; B) Treasury securities with remaining maturities up to two years; C) Treasury securities with

remaining maturities from two to five years; D) Treasury securities with remaining maturities from five up to ten years; and, E) Treasury bonds with remaining maturities of ten years or longer?

5. When purchasing securities for a customer safekeeping account, what discretion is the Federal Reserve Bank of New York allowed in making decisions as to which particular securities are purchased?

6. What has been the mix between "on-the-run" versus "off-the-run" issues purchased for customer accounts for each of the past three years?

At year-end 1992, holdings of marketable Treasury issues in custody for foreign and international accounts at the Federal Reserve Bank of New York stood at \$281 billion. The maturity distribution that you requested is attached in Table 2.

Foreign central banks and international organizations that may hold a portion of their dollar-denominated investments in custody at the Federal Reserve Bank of New York do so at their own discretion. The choice of investing in dollars, and in Treasury securities among other dollar-denominated securities, is their own and can be executed using the correspondent services offered by the Federal Reserve Bank of New York or by private market participants.

As agent for its foreign correspondents, the Federal Reserve Bank of New York purchases securities based upon the specific instructions provided by the foreign authority. These instructions either are received with the order to purchase securities or are standing instructions on file at the Bank. Most purchases are made under standing instructions and are triggered by the receipt of funds into a correspondent's account. Standing instructions typically specify the type of security to be purchased (bill, note, bond) and its required maturity range (such as, up to three months or up to six

months). The Bank's discretion involves choosing issues within the required maturity range and it typically opts for the security offered at the price most favorable to the correspondent, with some view toward distribution as well.

Less frequently, we receive specific orders to purchase a designated security or a security in a designated maturity range. As an example, a specific order to purchase a five-year maturity might permit this Bank discretion of 1 to 3 months on either side of 5 years.

During the last three years, the bills we purchased for foreign correspondents largely have been off-the-run securities--only about 12 percent of the securities were on the run. With regard to the considerably smaller volume of transactions in coupon securities, about 30 percent of our foreign correspondents' purchases of notes and bonds were of on-the-run issues in 1990 and 1992; in 1991, that figure was 62 percent.

C. Securities Lending

(Questions 9 and 10)

9. What is the Federal Reserve's policy regarding lending securities from its own portfolio to primary dealer firms when such securities are trading "on special" in the repo market?
10. What is the Federal Reserve's policy regarding lending customer securities to primary dealer firms when such securities are trading "on special" in the repo market?

The Federal Reserve established a lending facility in 1969 in order to help avert market delivery failures which could impair the smooth functioning of the market and, hence, our ability to operate in it. The terms and conditions under which securities are made

available from the System's portfolio are not conditional on an issue being "on special" in the repo market. In practice, much of our lending takes the form of items that are on special because those actively traded issues are most likely to experience delivery failures.

I should add, however, that we do not lend for short sales, we limit the amount of a security lent to a dealer at any time, and our holdings of some issues are small enough to require rationing in cases of heavy demand. The value of the securities we have out on loan to primary dealers on any given day generally totals only a few hundred million dollars. By contrast, dealers borrow or reverse in hundreds of billions of dollars in securities each day. Thus, for the purposes of repo market specials, we characterize the program as useful, but not a major factor.

Our foreign and international accounts, as noted above, determine their own portfolio needs and uses. It is their decision whether to lend securities or engage in repos, as well as setting the terms and conditions under which they do so. We do not operate such a facility on their behalf.

D. Open Market Repurchase Agreements

(Questions 7, 8 and 11)

7. When conducting open market repurchase agreement (adding reserves) transactions with primary dealers, what is the Federal Reserve's policy regarding accepting collateral that is trading "on special" in the repo market?

8. Since January 1, 1991, how many times has acceptance of "on special" collateral happened when conducting repurchase agreement transactions with primary dealers?

11. What specific steps, if any, does the Federal Reserve take to mitigate the potential that its open market operations with primary dealers might exacerbate the potential for short squeezes in the Treasury market?

When we provide reserves through repurchase agreements, all Treasury issues are acceptable as collateral. Our objective is to inject the appropriate volume of reserves in the most efficient manner, and we have no need to acquire specific issues for this purpose. Thus, we do not pre-screen collateral when accepting propositions.

In the repo market, issues appear and disappear "on special" with great frequency, even from one hour to the next, and it is common for several issues to be on special on most days. Many of these securities are considered to be lightly special because their rates are not far from general collateral rates and because they are on and off special so quickly. We have no difficulty in taking these securities in our operations.

Issues that are more deeply on special are another matter, however. We track these at the Open Market Trading Desk and in our Market Surveillance area. We prefer not to take items for which there is a great demand in the repo market, and given such demand, we are not usually shown these issues. If we do get them, we review the surrounding circumstances and, as appropriate, contact the submitting dealer firm to advise it that we prefer not to be shown this kind of collateral. Since mid-September 1991, when we began to maintain a database of the information needed to address your question, we have been shown securities that were on significant special--that is, about 50 percent of the general collateral rate--only three times. In order to respond to your request, we reconstructed data for the first nine months of 1991. While the data "series" is not identical, we used the same concept of significant special described above. There were 5 occasions when we were shown such collateral in that period. I should place this in context by noting that the total of 8 occasions over the two-year period in question came amid thousands of collateral items that we received.

Table 1  
**Federal Reserve System Portfolio  
of U.S. Treasury Securities**  
(December 31, 1992: Commitment basis)

	<u>Millions of Dollars</u>	<u>Percent of total</u>
Treasury bills	150,219	49.5
Treasury coupons		
within 2 years*	70,184	23.1
2 to 5 years*	36,324	12.0
5 to 10 years*	18,903	6.2
over 10 years*	27,805	9.2
Total	303,435	

\* remaining maturities

Table 2  
**Marketable U.S. Treasury Securities Held in Custody for  
Foreign and International Correspondents at F.R.B.N.Y.**  
(December 31, 1992)

	<u>Millions of Dollars</u>	<u>Percent of total</u>
Treasury bills	89,778	32.0
Treasury coupons		
within 2 years*	94,179	33.6
2 to 5 years*	65,767	23.3
5 to 10 years*	21,756	7.8
over 10 years*	9,144	3.3
Total	280,624	

\* remaining maturities

**TESTIMONY OF PETER A. ROBERTS  
CHAIRMAN, COLLEGE SAVINGS BANK  
PRINCETON, N.J.  
before the  
SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE  
COMMITTEE ON ENERGY AND COMMERCE  
U.S. HOUSE OF REPRESENTATIVES  
March 17, 1993**

Mr. Chairman and Members of the Subcommittee, I am Peter A. Roberts, Chairman of College Savings Bank, a savings institution formed for the primary purpose of originating and marketing certificates of deposit designed to assure funding for college costs. Prior to forming College Savings Bank in 1987, I was a general partner of Lazard Freres in charge of its Government securities trading desk.

While H.R. 618, the "Government Securities Reform Act of 1993," provides welcome improvements to the market for Government securities, one aspect of the system which has not been adequately addressed by H.R. 618 nor in the numerous committee hearings on the subject is the Government's own activities relating to the marketing of its securities. Specifically, there is little if any mechanism for ensuring the relevant agencies are completely forthright when selling Government securities to the general public.

For the past several years, the Department of Treasury has been engaging in deceptive advertising on behalf of its U.S. Series EE (Education) Savings Bonds. While undertaking a massive and tremendously successful campaign to tout these securities as "tax free for college", Treasury has regularly failed to note that significant restrictions apply which reduce or completely eliminate the favorable tax treatment of these instruments for many American families. The result is that many parents will find out too late that they have insufficient savings to provide for their children's education due to undisclosed tax consequences or eligibility rules.

After much effort on my part to encourage Treasury to disclose this information to potential buyers, as well as a great deal of press coverage concerning the deceptive nature of the Savings Bond advertising campaign, the Department in 1991 announced that it would begin disclosing the limitations in future advertising. I have attached a letter from the Executive Director of the Savings Bond Division explaining this new policy, which I would like to be included in this record.

Although I am pleased that Treasury has announced its intentions to inform consumers of this critical information, I remain concerned about their refusal to take any steps to inform past purchasers of Savings Bonds who otherwise may remain unaware of these limitations until they seek to redeem the bonds for their children's education. Furthermore, I am concerned that Treasury has not engaged in a bona fide recall of the deceptive advertisements. Attached for the record please find an example of the aforementioned advertisement appearing in the March 1993 issue of the 900,000-circulation *Working Mother* magazine. Consumers continue to be misled.

Despite Treasury's claimed acquiescence in changing its advertising policy, there remains no real oversight concerning the manner in which many Government securities are marketed to the public. The Government Securities Act of 1986 gives the Secretary of the Treasury the power to promulgate regulations with respect to transactions in Government securities by dealers and brokers which are "designed to prevent fraudulent and manipulative acts and practices and to protect the integrity, liquidity, and efficiency of the market for government securities..." P.L. 99-571, Sec. 101. While this language gives Treasury the authority to regulate the advertising practices of private dealers and brokers of Government securities, no independent review exists for Treasury's own conduct in marketing Government securities to the public. In this regard, it must be remembered that the success and integrity of the Government securities markets ultimately depend on the reputation of the Federal government. Deceptive advertising such as that by the Savings Bonds Division can only harm the market in the long run.

I appreciate you allowing me the opportunity to address the Subcommittee on this important issue.



DEPARTMENT OF THE TREASURY  
U.S. SAVINGS BONDS DIVISION  
WASHINGTON, D.C. 20226  
December 24, 1991

Mr. Garret G. Rasmussen  
Patton, Boggs & Blow  
2550 M Street, NW  
Washington, DC 20037-1350

Dear Mr. Rasmussen:

This is in response to your letter of October 18, 1991, concerning our new policy with respect to Savings Bonds advertising. After review by the Department and informal consultation with the Federal Trade Commission, the Savings Bonds Division has undertaken the following actions to clarify some of its advertising of the tax-exclusion for education feature of Series EE Savings Bonds.

The Division has ceased publishing small space print advertisements containing unqualified statements that the Bonds are tax free for education. The Division has asked the public service directors of broadcast stations to cease airing certain public service announcements which do not clearly state that limitations apply. All future print and broadcast advertising addressing the education feature will, at a minimum, clearly indicate that maximum income and other limitations apply. As much of our advertising has provided in the past, future advertisements will encourage the public to seek additional information from the Savings Bonds Division and financial institutions. Finally, the message on our 800 information line (1-800-US-BONDS) has been revised to contain information on the limitations on the availability of the tax-exclusion for education feature.

The Division does not intend to undertake a mass mailing to individuals who purchased Savings Bonds after December 31, 1989. We believe that, taken as a whole, the public information on the tax exclusion for education feature which the Department has distributed in the past, coupled with actions described above, adequately address the concerns you and Mr. Roberts have expressed in your communications with us.

Sincerely,

A handwritten signature in cursive script, appearing to read "Thomas E. Anfinson".

Thomas E. Anfinson  
Executive Director

○

# WorkingMother

MARCH 1993

**Now  
Tax Free  
For  
College**



**U.S. Savings  
Bonds**

A public service of this publication.

page 86

ONE HUNDRED THIRTY CONGRESS

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 THOMAS J. HARTON, NEW YORK  
 RICHARD H. LINDSAY, CALIFORNIA  
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**U.S. House of Representatives**  
**Committee on Energy and Commerce**

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

Washington, DC 20515-6119

ROOM #2-2-8  
FORD HOUSE OFFICE BUILDING  
PHONE 302-226-1114DAVID H. MOULTON  
CHIEF COUNSEL AND STAFF DIRECTOR

March 19, 1993

The Honorable Richard C. Breeden  
 Chairman  
 Securities and Exchange Commission  
 450 5th Street, N.W.  
 Washington, D.C. 20549

Dear Mr. Chairman:

As you know, the Subcommittee on Telecommunications and Finance has been investigating the nature and adequacy of current regulation of the government securities market, and abusive or illegal trading practices affecting the fairness and integrity of this market.

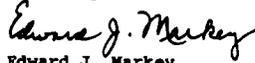
This morning's Washington Post reports that a 35-year-old college dropout with a bogus financial statement duped several government securities dealers into carrying out approximately \$1 billion in trades in government securities resulting in losses totaling \$550,000 (See "Wall Street Firms Duped by 'Trader,' SEC Alleges," Washington Post, March 19, 1993, p. A1).

This report is deeply troubling to the Subcommittee, and I request that the SEC staff provide the Subcommittee staff with an immediate briefing on the facts and circumstances surrounding the events described in the Post article. In addition, I request your assistance and cooperation in responding to the following questions:

1. How do government securities brokers and dealer verify the identity and creditworthiness of the counterparties they trade with?
2. Are the policies and procedures employed by government securities brokers and dealers adequate to prevent or minimize the potential for con artists, unregistered broker-dealers or uncreditworthy broker-dealers from being allowed to trade?
3. Does the Commission see any need for improvement in the policies and procedures employed by government securities firms to prevent or minimize the potential for government securities firms from being victimized by a recurrence of the types of abuses described in the Post article?

Thank you for your assistance and cooperation in responding to the Subcommittee's request. I request that your response to these questions be forwarded to the Subcommittee by April 9, 1993. Should you have any questions regarding this request, please have your staff contact Jeffrey S. Duncan of the Subcommittee staff at 226-2424.

Sincerely,



Edward J. Markey  
 Chairman

ONE HUNDRED THIRD CONGRESS

EDWARD J. MARKEY, MASSACHUSETTS, CHAIRMAN  
 W. J. BILLY, LOUISIANA  
 RICK BOUCHER, VIRGINIA  
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**U.S. House of Representatives**  
**Committee on Energy and Commerce**

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

Washington, DC 20515-6119

ROOM #2318  
 FORD HOUSE OFFICE BUILDING  
 PHONE (202) 226-2424

DAVID H. MOULTON  
 CHIEF COUNSEL AND STAFF DIRECTOR

March 29, 1993

The Honorable Richard C. Breeden  
 Chairman  
 Securities and Exchange Commission  
 450 5th Street, N.W.  
 Washington, D.C. 20549

Dear Mr. Chairman:

Thank you once again for your testimony at the Subcommittee's March 17, 1993 hearing on H.R. 618, the Government Securities Reform Act of 1993. Your appearance before the Subcommittee was extremely useful in informing our deliberations on this important legislation.

In order to address certain issues raised in connection with the Subcommittee's March 17, 1993 hearing, I would greatly appreciate your assistance and cooperation in responding to the attached follow-up questions.

Again, thank you for your assistance and cooperation in responding to the Subcommittee's request. It is requested that a response be provided within 10 working days, or no later than close of business on April 12, 1993. Should you have any questions regarding the Subcommittee's request, please have your staff contact Mr. Jeffrey S. Duncan of the Subcommittee staff at 226-2424.

Sincerely,

*Edward J. Markey*  
 Edward J. Markey  
 Chairman

Enclosures

**POST-HEARING QUESTIONS FOR CHAIRMAN BREEDEN  
IN CONNECTION WITH  
MARCH 17, 1993 SUBCOMMITTEE HEARING ON H.R. 618**

1. The Public Securities Association recently submitted a statement for the record of the Subcommittee's hearing on H.R. 618 which asserts that Section 11 of the bill is "overly broad and may go beyond the stated objective" of making the use of false or misleading statements in connection with any bid or purchase of government securities an explicit violation of the federal securities laws. In your oral testimony, you indicated that you saw Section 11 as making explicit for this market area "that which we believe is already the law in 10b-5, [but] not to change the law itself." Please provide the Subcommittee with your analysis of and response to the assertions made in the PSA statement regarding Section 11.
2. During your oral testimony, you mentioned that "there is a five-year Treasury issue that is on what in the lingo of the trade is called on special" and that it was possible for the existence of such specials could have an adverse impact on interest rates affecting seekers of home mortgages. Mr. McDonough stated that the issue in question "is on special in the repo market, not in the cash market, and it is the cash market which affects this mortgage seeker that has been brought to our attention." The attached letter from Mr. Randy Strausberg suggests that tightness in the repo market also affects interest rates. Do you agree with Mr. Strausberg's or Mr. McDonough's analysis? Why?
3. In your response to a question from Representative Oxley regarding the need to modify the federal securities laws in order to address so-called "cherry picking" abuses in the government securities markets, you stated that "I would be happy to look at and consult our enforcement and general counsel's divisions to see whether, in their view, a change in the law is necessary or whether perhaps we ought to sharpen up the rules in that area." Please inform the Subcommittee whether you believe there are any legislative changes affecting either the Government Securities Act of 1986 or the Investment Advisers Act of 1940 which would be advisable to respond to the problem of cherry picking abuses. In addition, please inform the Subcommittee of any SEC rule changes being contemplated for this area.
4. The Subcommittee recently received a letter from New York Fed President Corrigan which attributed several recent short squeezes in the market for Treasury securities to "natural market forces." In general, how does the SEC determine whether a short squeeze in the Treasury market results from natural market forces or fraudulent and manipulative activity?
5. Press reports have referred to the short squeeze that occurred in the April 1991 2-year Treasury notes as the

"forgotten squeeze." New York Fed President Corrigan recently wrote the Subcommittee that for a time, the April 2-year traded at "an even greater cash market premium than the May 2-year note" that resulted in Salomon Brothers' troubles. Is there any information you provide the Subcommittee for the record at this time regarding the SEC's inquiries into the causes of this particular squeeze and whether any manipulative activity may have occurred?

6. Last year's Joint Report highlighted abuses associated with noncompetitive bidding for Treasury securities and indicated that the Commission was pursuing investigations in this area. Last year, Cantor-Fitzgerald publicly confirmed the existence of an SEC's investigations into their noncompetitive bidding practices to the press, but vigorously denied any wrongdoing. More recently, press reports have indicated that the Discount Corporation disclosed to its shareholders that "the staff of the Securities and Exchange Commission ("SEC") has advised the registrant that they contemplate bringing an administrative proceeding against the registration" alleging violations of the federal securities laws in connection with submission of noncompetitive bids. Is there any information you can provide the Subcommittee for the record at this time regarding the SEC's findings and conclusions regarding potential wrongdoing in the noncompetitive bidding area?



M.G. Tivon Group

Congressman Edward J. Markey  
 Chairman, House Subcommittee on  
 Telecommunications & Finance  
 Ford House Office Bldg., Rm. 316  
 Washington, D.C. 20515-6119

March 24, 1993

Dear Mr. Chairman,

As further evidence of my view that squeezes and shortages lead to losses in hedging vehicles and higher costs to the economy, I have collected some statistics which follow. My view is that traders cannot properly hedge their risk when current issues are severely squeezed out of line with other surrounding issues. As a result, they will bid lower than the market price and, thereby, receive higher yields on securities purchased so they can, in turn, re-offer to customers at higher yields.

Once a sale is completed, dealers, unable to efficiently hedge, will attempt to maintain lower inventories, so that when customers wish to buy, dealers will offer at higher than the market price, to assure they can buy back the issue sold. Common sense tells you that this process results in higher than normal volatility. Higher volatility affects the decision making process of every participant in the credit market negatively, from the home buyer to the home builder who cannot forecast a mortgage rate three months down the road at closing time; to the business person planning a new factory with long term borrowed money.

The 9 1/4 of February 1986 and the 7 1/4 of May 1986, issued in February and May of 1986, respectively, will illustrate the problem. (The 7 1/4 were so out of line that they were reopened for additional issuance in August of 1986.) The 9 1/4 issue was owned for the most part by Japanese holders. By May, the 9 1/4 was trading at about 20 basis points lower than the yield curve. The new 7 1/4 issue was also bought heavily by the Japanese and it too traded at lower than normal yields; by August, as much as 30 basis points lower than the 9 1/4.

220 Archers Point  
 Longwood, Fla. 32779  
 (407) 333-9500 Fax (407) 333-9506

In perspective, a trader who had sold short the 9 1/4 bond and hedged with futures would have lost almost four points in price and financing in one month, from May 8 to June 2, 1986. That is a loss of \$40,000 per million, or a total of \$360 million on the entire issue, in one month. This issue remained out of line for several months more, as did the 7 1/4 issue until August 1986, when it was reopened by the Treasury. In total, losses from misalignment in both the actual cash market and the repurchase agreement market easily totaled over \$500 million over several months.

How did this affect the economy and the Treasury? Enclosed is a chart showing bond futures prices in 1986 and 1987. Each line represents the range of prices for one month. As you can see, these ranges were larger than at any time in the years before. As prices rise interest rates decline; as prices fall, interest rates rise.

If you were a home buyer, business person, the Treasury or anyone involved in borrowing or lending, consider this:

In April of 1986, when the tightness in 9 1/4 bonds began, bond yields were 7.20%.

By June, 1986 ----- 8.2%,  
 By August 1986 ----- 7.3%  
 By September 1986 -- 8.1%  
 By January 1987 ----- 7.25%

By May 1987, bond yields rose to 8 3/4% and by October 1987 were almost 10 1/2%.

Loss of hedging vehicles exaggerates the swings in prices and yields. Business and buying decisions are impeded when rates are so volatile. On an average home mortgage of about \$80,000, that 1% swing in rates is about \$70 per month in a mortgage payment. That happened four times in eight months, before rates rose dramatically in 1987.

#### Repo Finance Distortion is Costly Too

Tightness in the repo market also affects interest rates. Much has been made in testimony of the supposed difference between a squeeze in cash market prices that forces issues out of line and a squeeze in repo rates that "only" affects financing. This contention is misleading.

When repo rates on a particular issue decline because the issue is on "special", an arbitrageur may purchase the security and sell in the forward or futures market at a lower price than otherwise. For example if a ten year issue has a 6% coupon and the repo rate is 3%, the owner earns about \$85 per day per million in positive interest carry, since the interest earned is greater than the interest on the money borrowed to finance the security. If the repo rate is one percent, then positive interest carry is \$140 per day per million, a difference of \$55 per day. Over three months, that is about \$5000 of difference per

million of securities. An arbitrageur may sell at lower and lower prices ( higher yields ) before hitting break even, just because of the lower repo rate. In yield, that is a difference of eight basis points higher in interest rates on ten year notes three months forward. How does that affect the real world?

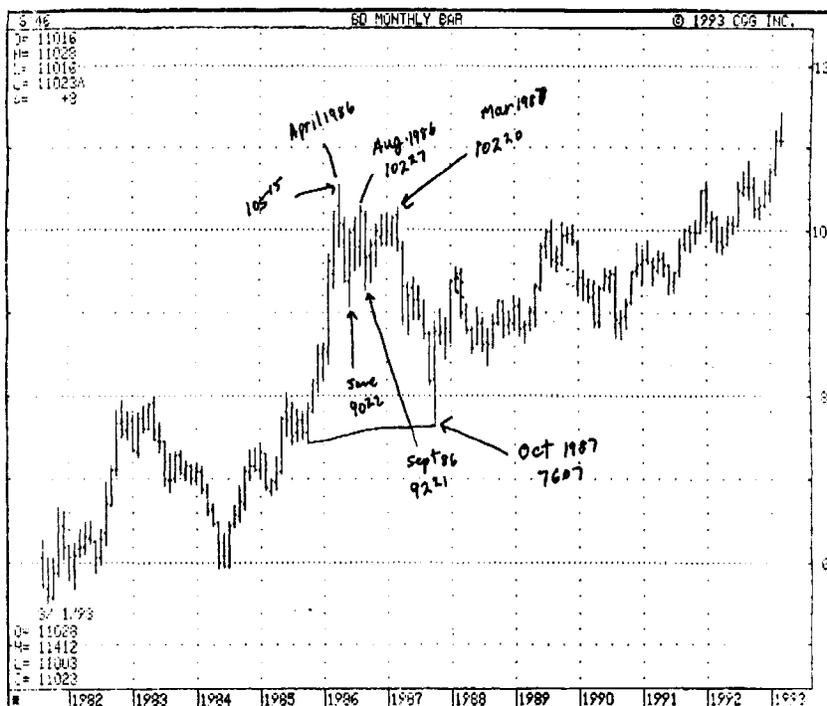
Every forward commitment for mortgages will be at higher interest rates affected by the ten year repo rate because forward prices used to hedge commitments will be lower. Every option used to hedge risk or forward swaps used to fix rates for business borrowers will result in higher interest rates if the repo rates on two to five year notes are lower. Just as a measure, if the \$300 billion of mortgage securities sold in 1992 had a higher yield by 8 basis points, that would be a cost to mortgage borrowers of \$240 million.

I agree with those who say the Treasury market is the basis for credit pricing for all other debt markets. Because of this, I believe we should follow the principle that "there is no free lunch". When hedging costs are affected in the cash or repo market, the cost will show up in the forward rates, mortgages, portfolio hedging, options and other places. I believe some regulatory agency must be empowered to gather data from large market participants on squeezes, large positions, and abusive practices; and make appropriate data available to the Treasury or take legal action when needed.

Sincerely yours,



Randy M. Strausberg



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LONGWOOD, FL 32779  
(407) 333-8500

MAR 25 '93 11:53

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THE CHAIRMAN

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

April 23, 1993

The Honorable Edward J. Markey  
Chairman  
Subcommittee on Telecommunications and Finance  
Committee on Energy and Commerce  
U.S. House of Representatives  
Washington, D.C. 20515

Dear Chairman Markey:

Thank you for your recent letters about the government securities market and the pending reform legislation.

In response to your letter of March 29, 1993, with follow-up questions from the Subcommittee's March 17, 1993 hearing on H.R. 618, a set of responses is enclosed. Also enclosed is a memorandum prepared by the staff in response to the questions raised in your letter of March 19, 1993, concerning the government securities trading activities of JFM Securities, Inc.

With respect to your letter of December 17, 1992, concerning the profitability of various activities of primary dealers of government securities, I understand that the Commission staff met with your staff on February 10, 1993 to discuss the information that is available from reports filed with the Commission and subsequently provided certain profitability data filed with the Federal Reserve Bank of New York.

Please do not hesitate to contact us if you have any additional questions.

Sincerely,

A handwritten signature in black ink that reads "Richard C. Breeden".

Richard C. Breeden  
Chairman

Enclosures

MEMORANDUM

April 26, 1993

TO: Chairman Breeden

FROM: Brandon Becker, Deputy Director *JB*  
Division of Market Regulation

RE: Account and Credit Approval Procedures of Government  
Securities Brokers and Dealers

In connection with Chairman Markey's letter to you of March 19, 1993 (attached), you have asked the staff to review existing rules and procedures relating to the approval of new accounts and credit approval procedures employed by government securities brokers and dealers. Chairman Markey's inquiry arises from reports of the government securities trading activities of Daniel O. Teyibo ("Teyibo") and JFM Government Securities, Inc. ("JFM").

Facts

A brief recitation of the facts concerning JFM may be helpful. Based on information received from dealers who had traded with JFM and the Commission's investigation to date, it appears that, beginning in approximately March 1991, and continuing up to the present, Teyibo and JFM (operating under various aliases) engaged in a "free riding" scheme whereby JFM accepted profits from government securities transactions conducted with government securities dealers and refused to pay for losses on settlement. In other cases, JFM attempted to effect such transactions but was unsuccessful. Overall, it appears that Teyibo and JFM accepted profits of approximately \$165,000 and reneged on losses of approximately \$550,000 in connection with trades involving a total of approximately \$1 billion of Treasury securities and approximately 25 dealers.

In furtherance of this scheme, Teyibo consistently misrepresented his status to the dealers with whom he traded or attempted to trade and provided false or fabricated financial statements and other documentation in support of these misrepresentations. In connection with these trading activities, he variously represented himself as a government securities dealer, an institutional money manager, or even an account executive in one of the firm's associated branch offices. He placed numerous calls to different traders within each firm, and if he was unsuccessful in effecting a trade in one office, called traders at other, including overseas, offices of the same firm.

The Commission filed a complaint against Teyibo and JFM for a permanent injunction and other relief on December 23, 1993. After receiving evidence that Teyibo had continued to engage in illicit trading activity under new aliases after the filing of

the complaint, the Commission sought and obtained a temporary restraining order and asset freeze on February 23, 1993, and on March 12, 1993, obtained a preliminary injunction enjoining Teyibo and JFM from violating the general antifraud provisions and the government securities dealer registration provisions of the Securities Exchange Act of 1934 ("Exchange Act"). Discovery in this matter is continuing.

In responding to the questions raised by Chairman Markey, we reviewed applicable regulatory requirements and also questioned four large, integrated broker-dealers that had effected government securities transactions with Teyibo or JFM with respect to internal procedures. The following responds directly to the specific questions raised by Chairman Markey in his letter.

Question 1. How do government securities brokers and dealers verify the identity and creditworthiness of the counterparties they trade with?

Response

Rules of the Commission and self-regulatory organizations ("SROs"), as well as internal firm guidelines, affect the process by which government securities brokers and dealers approve accounts with new customers. It appears that most of the firms that effected trades with Teyibo were members of the New York Stock Exchange ("NYSE"). NYSE Rule 405 requires that every member "specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer..." Accordingly, the rule permits documentation necessary to approve the account to be obtained after an initial trade is executed but before settlement. In addition, the rule requires each member to "use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over the account..."

In addition, Rule 17a-3(a)(9) under the Exchange Act requires broker-dealers registered under Section 15 of the Exchange Act to maintain a record for each cash and margin account showing, among other things, "the name and address of the beneficial owner of such account."

These rules are designed primarily to require that firms obtain and maintain adequate documentation in order to ensure that trades are legally authorized by the account holder and that the party or parties who are charged with liabilities and entitled to assets in the account are adequately identified. Concerns relating to customer creditworthiness are addressed

primarily by internal firm guidelines, including credit approval procedures.

In general, government securities and other broker-dealers have fairly specific internal procedures for accepting new customer accounts. The type of information required for institutional accounts varies among firms and includes financial information, investment experience, and corporate resolutions. Financial statements may or may not be required to be audited. Typically, firms provide the name of the customer to a compliance reporting service that maintains credit information derived from FOCUS and other reports in order to examine the credit history of the counterparty. In certain cases, a deposit may be required, and a personal meeting with the customer may be requested.

Generally, new accounts are approved in advance of a trade by a branch or sales manager, although this does not appear to be an absolute or consistent policy. One dealer indicated to us that requiring in all circumstances that all account information be verified prior to conducting an initial trade could pose an undue burden, although the circumstances in which such trades should be permitted would be rare. In addition, the manager may authorize a trade in advance of all new account information being provided and verified in some circumstances, depending on the circumstances and the size of the cash trade. This decision is seen primarily as a "judgment call" by the local manager.

The firms with whom we spoke indicated that, if or when a new customer names another trader or salesperson as his or her primary contact at the firm, the individual identified should be contacted before effecting the trade. One firm indicated that it had recently reiterated and strengthened its policy in this regard.

When trading for the first time with a party that identifies itself as another dealer or an investment adviser, the firm can identify the counterparty as a registered entity by consulting one of various lists of registered broker-dealers or advisers published by private corporations. The firms contacted indicated that their policy was to confirm that the counterparty was in fact registered.

The rules and procedures described are intended both to protect dealers from uncreditworthy or untrustworthy customers and to protect customers from misunderstandings or unauthorized trades. The risk to firm capital from free riding schemes or the poor credit of counterparties is more significantly limited by margin rules and internal credit approval procedures.

In general, credit approval is not required for cash transactions, although transactions of large size may involve

review by the credit department. In general, cash transactions are considered to consist of those with a settlement period of five days or less. Settlement of U.S. Treasuries occurs by next day payment versus delivery. The only credit exposure resulting from these trades, therefore, is the risk of an adverse one-day rate movement prior to settlement.

Accounts effecting "credit" transactions, including options, forwards, repurchase agreements, and derivatives, generally require approval by a credit department or committee within the firm in advance of any credit trade. The level of credit review depends on the type of customer and investment objectives, but generally will include a financial analysis based on a review of the financial statements and other information submitted, assurance that the preliminary credit checks described above have been conducted, contacting references, discussions with other firms with whom the customer has traded, and, in some cases, on-site interviews and other due diligence. Once this review has been completed, the firm assigns an internal credit rating and limit on aggregate exposure, as well as sublimits in terms of exposures to different categories of instruments. Depending on the size of the account and frequency of trading, the credit rating and limits will be reviewed periodically, e.g., annually or monthly. Although the procedures employed appear to be generally consistent among the firms we contacted, the size of and resources devoted to the credit department vary.

Each of the dealers we contacted maintain a "credit watch" or "no business" list of customers experiencing financial difficulty or with whom they have experienced credit problems, and this list is distributed to the various branch offices throughout the firm. One of the firms indicated that it had adopted this procedure recently in response to its experience with JFM.

**Question 2.** Are the policies and procedures employed by government securities brokers and dealers adequate to prevent or minimize the potential for con artists, unregistered broker-dealers or uncreditworthy broker-dealers from being allowed to trade?

**Response**

In general, we believe that the policies and procedures described are adequate to prevent a material risk to firm capital from trading with uncreditworthy parties or unregistered broker-dealers. Indeed, it appears that many of the trades effected by Teyibo and JFM succeeded not because of the inadequacy of procedures but because of the breach of established procedures by a few persons. In the great majority of cases, these were cash transactions that did not involve the potential for significant loss to the firm. The procedures certainly are not foolproof,

but we believe that the cost of constructing compliance systems that would avoid circumvention in all cases by the most skillful manipulators would outweigh the prospective benefits.

Question 3. Does the Commission see any need for improvement in the policies and procedures employed by government securities firms to prevent or minimize the potential for government securities firms from being victimized by a recurrence of the types of abuses described in the Post article?

Response

The most prudent compliance systems will not in all cases detect or prevent fraudulent practices, including free riding schemes, which derive from an intent not to pay for unprofitable trades rather than inadequate credit or account approval procedures. We believe that mandating by regulation the specific terms of account or credit approval procedures would be of doubtful utility. In terms of the risk to broker-dealer capital from the failure to pay for trades ordered by the customer, the primary regulatory safeguards are the Commission and SRO rules relating to net capital requirements, early warning procedures, and similar rules. Apart from these protections, broker-dealers have a strong incentive, from the standpoint of "business risk," to ensure that their counterparties are creditworthy. Accordingly, we do not at this time see a need for increased regulatory requirements in this area.

**Responses to Chairman Markey's Post-Hearing Questions on H.R. 618**

**Question 1.** The Public Securities Association recently submitted a statement for the record of the Subcommittee's hearing on H.R. 618 which asserts that Section 11 of the bill is "overly broad and may go beyond the stated objective" of making the use of false or misleading statements in connection with any bid or purchase of government securities an explicit violation of the federal securities laws. In your oral testimony, you indicated that you saw Section 11 as making explicit for this market area "that which we believe is already the law in 10b-5, [but] not to change the law itself." Please provide the Subcommittee with your analysis of and response to the assertions made in the PSA statement regarding Section 11.

**Response**

Section 11, which would add to the Exchange Act subsection 15(c)(7), would not alter the Commission's existing authority under Section 10(b) of the Exchange Act and Rule 10b-5 to prosecute fraud in government and other securities transactions. Instead, subsection 15(c)(7) provides strengthened antifraud protection with respect to the very narrow area that was the direct focus of the Commission's investigation of Salomon Brothers and the distributing dealers of government-sponsored enterprises. Accordingly, we believe that the PSA's concern that the legislation could "establish a new standard for securities fraud" is not justified outside the limited context to which the provision is addressed, and within that context, is overstated. Subsection 15(c)(7) is distinguishable from the Commission's authority under section 10(b) and Rule 10b-5 in the following specific ways.

**Scope**

Rule 10b-5 applies to false or misleading statements made by any person in connection with any securities transaction. Subsection 15(c)(7) would apply only to false or misleading statements by government securities broker-dealers, bidders, and purchasers in connection with a new offering of government securities by an issuer.

**Private Actions**

An implied private right of action under section 10(b) and Rule 10b-5 has long been recognized. Because subsection 15(c)(7) is intended to guard specifically against false statements to the issuers of government securities, not to other purchasers or sellers, a private right of action is unnecessary and should not be inferred.

Written Statements

Section 10(b) and Rule 10b-5 apply to oral as well as written statements. Subsection 15(c)(7) would apply only to written statements, which are specifically required of bidders in Treasury auctions and distributions of GSE securities.

Rulemaking

Section 10(b) provides authority to the Commission to define by rule acts and practices that are fraudulent. Subsection 15(c)(7) would not grant any additional rulemaking authority to the Commission.

Materiality

Rule 10b-5 expressly applies to false or misleading statements or omissions of material fact. Although we believe that the abuses uncovered in the Salomon and GSE cases were violative of Rule 10b-5, subsection 15(c)(7) does not contain an express materiality standard. Because of the narrow range of misstatements that would be covered, we believe that a materiality requirement is not necessary in this context. Minor violations are unlikely to be prosecuted, and bidders and dealers can easily avoid liability by ensuring the accuracy of written statements addressed to the Treasury or another issuer.

Knowledge Standard

Section 10(b) and Rule 10b-5 apply to statements made with scienter, which the Supreme Court has defined as "a mental state embracing an intent to deceive, manipulate, or defraud." 1/ Subsection 15(c)(7) would apply to written statements made "knowingly or willfully." 2/ Thus, although subsection 15(c)(7) would require proof that a person knowingly submitted a bid that was false, it does not require an intent to defraud as under Section 10(b).

Question 2. During your oral testimony, you mentioned that "there is a five-year Treasury issue that is on what in the lingo of the trade is called on special" and that it was possible for the existence of such specials could have an adverse impact on interest rates affecting seekers of home mortgages. Mr. McDonough stated that the issue in question "is on special in the repo market, not in the cash market, and it is the cash market

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1/ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-194 n.12 (1976).

2/ See generally 137 Cong. Rec. 13733, 13734 (statement of Sen. Dodd in support of S. 1699).

which affects this mortgage seeker that has been brought to our attention." The attached letter from Mr. Randy Strausberg suggests that tightness in the repo market also affects interest rates. Do you agree with Mr. Strausberg's or Mr. McDonough's analysis? Why?

Response

The Commission recognizes that the regular-way secondary market in Treasury securities ("Cash market") and the Repurchase Agreement market in Treasury securities ("Repo market") are separate markets, each with its own dynamics, but it does not appear that these two markets are totally unconnected. It is possible that price distortions due to a supply shortage or "squeeze" may develop independently in the Repo market. We believe, however, that it is an overstatement to say that squeezes that originate in the Repo market cannot have spillover effects on rates in the Cash market. Because Treasury securities act as benchmarks for a wide range of other rates in the national economy (including mortgage rates), any spillover that might occur in the Cash market can have widespread ramifications. Accordingly, in order to maintain a comprehensive overview of the Treasury securities markets, the surveillance staffs of the Commission and the Federal Reserve Bank of New York ("FRBNY") routinely review rates in both the Cash market and the Repo market.

The complex relationships between the Cash and Repo markets are illustrated by the rates evidenced in mid-March 1993 for the February 1998, 5 1/8 coupon five-year Treasury notes. During this period, our systems indicated that the five-year notes were trading in a range of 250-300 basis points below general collateral in the Repo market, a deviation that the staffs of the Commission and the FRBNY viewed as significant. In other words, the low rates in the five year notes were indicative of strong demand, constrictions of supply or some combination thereof in the Repo market.

During the same period, a yield curve regression analysis routinely conducted by the FRBNY staff indicated that the yield in the five year notes was running a few basis points lower in the Cash market than what was "predicted" by the yield curve. In other words, the lower rates indicated higher prices in the Cash market than might be indicated by a comparison with rates in Treasury securities with similar durations. In discussions among the agency staffs participating in the Working Group for Treasury Securities, however, there was a consensus that a deviation of only a few basis points in the Cash market did not appear, in itself, to be significant in the prevailing market environment. At that time, the FRBNY regression analyses were indicating that all of the current or "on-the-run" Treasury notes were trading at

rates that were a few basis points lower than predicted by the yield curve.

**Question 3.** In your response to a question from Representative Oxley regarding the need to modify the federal securities laws in order to address so-called "cherry-picking" abuses in the government securities markets, you stated that "I would be happy to look at and consult our enforcement and general counsel's divisions to see whether, in their view, a change in the law is necessary to whether perhaps we ought to sharpen up the rules in that area." Please inform the Subcommittee whether you believe there are any legislative changes affecting either the Government Securities Act of 1986 or the Investment Advisers Act of 1940 which would be advisable to respond to the problem of cherry picking abuses. In addition, please inform the Subcommittee of any SEC rule changes being contemplated for this area.

**Response**

"Cherry picking" by an investment adviser occurs when the adviser places an order for securities for a group of clients and, after prices have changed, allocates them among clients in a way that advantages certain clients at the expense of others. That practice violates the fiduciary duties of the adviser and is a violation of Section 206, the anti-fraud provision of the Advisers Act. The Commission currently has sufficient legislative authority to address these practices. Section 206(4) authorizes the Commission to adopt rules reasonably designed to prevent fraudulent acts and practices.

In addition, Section 204 permits the Commission to require advisers to keep records of all brokerage transactions, which permits Commission staff to identify such abusive practices. Under this authority, the Commission has adopted Rule 204-2(a)(3), which requires registered advisers to create and maintain a memorandum of each brokerage order and of any modification or cancellation of the order. The memorandum must identify the account for which the order is entered. This recordkeeping requirement is designed to create a paper trail to inform Commission examiners of abusive practices such as cherry-picking. Because, as a practice, investment advisers complete these memoranda contemporaneously with the order, cherry-picking can be discovered.

Because these rules appear adequate to deal with this relatively rare practice, no new rules are currently contemplated in this area.

**Question 4.** The Subcommittee recently received a letter from New York Fed President Corrigan which attributed several recent short squeezes in the market for Treasury securities to "natural market

forces." In general, how does the SEC determine whether a short squeeze in the Treasury market results from natural market forces or fraudulent and manipulative activity?

**Response**

Under the framework of the Working Group for Treasury Market Surveillance, the Federal Reserve Bank of New York gathers information with respect to Treasury securities markets (including the Cash and Repo markets). While there are no audit trails or other SEC surveillance systems in the government securities market, the SEC monitors, to the extent practicable, suspicious price/yield and volume movements and overall market conditions using our own automated systems.

Reports concerning dealer practices and market activity are analyzed to determine if there appear to be significant concentrations of positions at particular firms or by particular customers. If such concentrations are indicated, the parties are contacted by the FRBNY staff in order to obtain their explanations of trading strategies or other rationales for acquiring and maintaining such large positions. The explanations offered by these parties are scrutinized in order to determine if they are credible and consistent with market perspectives obtained from other market participants. At that point, if necessary, further inquiries are made to determine if one party has attempted to control or influence prices/yields artificially or if several parties may have colluded to accomplish the same results. In such cases, the SEC, as part of its responsibility as the primary enforcement agency for this market, would investigate and if appropriate prosecute for violations of the securities laws.

This framework was followed in each of the Treasury note "squeezes" mentioned in the letter from FRBNY President Corrigan. These situations and the preliminary findings of the FRBNY were discussed among the agency staffs participating in the Working Group. In each instance, the FRBNY believed that there appeared to be legitimate explanations, based upon prevailing market dynamics, to indicate that position concentrations were not sufficiently suspicious to warrant further investigation. While we have no reason to disagree with the FRBNY findings, the SEC is not, of course, bound by any such determination by the FRBNY, and the final decision concerning whether the SEC will seek to investigate possible violations of the federal securities laws remains that of the SEC alone.

**Question 5.** Press reports have referred to the short squeeze that occurred in the April 1991 2-year Treasury notes as the "forgotten squeeze." New York Fed President Corrigan recently wrote the Subcommittee that for a time, the April 2-year traded at "an even greater cash market premium than the May 2-year note"

that resulted in Salomon Brothers' troubles. Is there any information you can provide the Subcommittee for the record at this time regarding the SEC's inquiries into the causes of this particular squeeze and whether any manipulative activity may have occurred?

**Response**

At this time, we cannot provide any information for the record in response to the foregoing question concerning the April 2-year notes.

**Question 6.** Last year's Joint Report highlighted abuses associated with noncompetitive bidding for Treasury securities and indicated that the Commission was pursuing investigations in this area. Last year, Cantor-Fitzgerald publicly confirmed the existence of an SEC investigation into their noncompetitive bidding practices to the press, but vigorously denied any wrongdoing. More recently, press reports have indicated that the Discount Corporation disclosed to its shareholders that "the staff of the [SEC] has advised the registrant that they contemplate bringing an administrative proceeding against the registration" alleging violations of the federal securities laws in connection with submission of noncompetitive bids. Is there any information you can provide the Subcommittee for the record at this time regarding the SEC's findings and conclusions regarding potential wrongdoing in the noncompetitive bidding area?

**Response**

At this time, we cannot provide any information for the record in response to the foregoing question concerning noncompetitive bidding.

ONE HUNDRED THIRD CONGRESS

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**U.S. House of Representatives**  
**Committee on Energy and Commerce**

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

Washington, DC 20515-6119

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DAVID H. MOULTON  
 CHIEF COUNSEL AND STAFF DIRECTOR

March 29, 1993

The Honorable David W. Mullins  
 Board of Governors of the  
 Federal Reserve System  
 20th and C Streets, N.W.  
 Washington, D.C. 20551

Dear Mr. Mullins:

Thank you once again for your testimony at the Subcommittee's March 17, 1993 hearing on H.R. 618, the Government Securities Reform Act of 1993. Your appearance before the Subcommittee was extremely useful in informing our deliberations on this important legislation.

In order to address certain issues raised in connection with the Subcommittee's March 17, 1993 hearing, I would greatly appreciate your assistance and cooperation in responding to the attached follow-up questions.

Again, thank you for your assistance and cooperation in responding to the Subcommittee's request. It is requested that a response be provided within 10 working days, or no later than April 12, 1993. Should you have any questions regarding the Subcommittee's request, please have your staff contact Mr. Jeffrey S. Duncan of the Subcommittee staff at 226-2424.

Sincerely,

*Edward J. Markey*  
 Edward J. Markey  
 Chairman

Enclosure

**POST-HEARING QUESTIONS FOR MR. MULLINS  
IN CONNECTION WITH  
MARCH 17, 1993 SUBCOMMITTEE HEARING ON H.R. 618**

1. In a recent letter to the Subcommittee, Federal Reserve Board Chairman Greenspan stated that the Fed does "not lend for short sales," that it "limit[s] the amount of a security lent to a dealer at any time," and that when its holdings are small it sometimes rations in cases of heavy demand. Please provide the Subcommittee with responses to the following questions:

A.) What is the rationale for not lending for short sales, given the fact that counterparties who are not short would presumably be free to relend the securities to those who are?

B.) What limits does the Fed place on the amount of a security it lends to a dealer at any time, and what is the justification for these limits?

C.) How does the Fed go about rationing supply of a issue in cases of heavy demand?

2. In the aforementioned letter, Chairman Greenspan also indicated that the Fed does not offer a lending facility for its foreign and international accounts. Why is this? Are you at all concerned that the failure to provide such a lending facility may reduce market liquidity or efficiency?

3. The Greenspan letter also stated that the Fed does not "pre-screen collateral when accepting propositions" when it provides reserves through repurchase agreements, and that "many of these securities are considered to be 'lightly special' because their rates are not far from general collateral rates and because they are on and off special so quickly." Please provide responses to the following questions:

A.) Why doesn't the Fed pre-screen collateral when providing reserves through repurchase agreements?

B.) What criteria does the Fed use to define when a security is "lightly special"?

C.) What criteria does the Fed employ to determine when an issue is "on significant special"?

D.) When and how were these criteria adopted?

E.) If an issue were 25 basis points or more from general collateral, why wouldn't the Fed want to adopt a policy of generally not accepting such collateral in order to reduce the potential for a squeeze in the issue?

4. Chairman Greenspan's letter also indicated that since January 1, 1991 the Fed had accepted collateral that was on "significant special" -- which he defined as 50 percent of the general collateral rate -- a total of 8 times. Please provide a chart indicating how many times between January 1, 1991 and December 31, 1993 the Fed accepted collateral that was on special. In this chart, please provide a breakdown of how many times the security accepted was: 1) less than 25 basis points of general collateral; 2) between 25-50 basis points of general collateral; 3) between 50-75 basis points of general collateral; 75-100 basis points of general collateral; and, over 100 basis points of general collateral.

5. Chairman Greenspan's letter also indicated that the Fed preferred "not to take items for which there is a great demand in the repo market," and that "if we do get them, we review the surrounding circumstances and, as appropriate, contact the submitting dealer firm to advise it that we prefer not to be shown this type of collateral." From January 1, 1991 to December 31, 1993, how many times has the Fed rejected collateral on this basis? In each case, how many basis points from general collateral was the issue?

6. During the Subcommittee's hearing, Mr. Randy Strausberg, a former New York Fed official, testified that to effectuate a manipulative strategy "players attempt to tighten an issue in the financing market by taking them 'off the street' to a lender that will not recycle the securities." Does the Fed monitor all of the collateral it accepts when it provides reserves through repurchase agreements to assure that it is not being utilized by market participants seeking to take an issue off the street and put it on special?

7. Of the collateral the Fed accepted between January 1, 1991 and December 31, 1992, how many instances did the issue subsequently trade 25 basis points or more from general collateral?



BOARD OF GOVERNORS  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D. C. 20551

DAVID W. MULLINS, JR.  
VICE CHAIRMAN

June 3, 1993

The Honorable Edward J. Markey  
Chairman  
Subcommittee on Telecommunications  
and Finance  
Committee on Energy and Commerce  
House of Representatives  
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter of March 29 following up on my testimony of March 17 and correspondence from Chairman Greenspan. I hope that you find my specific responses to your questions, which are enclosed, helpful.

Sincerely,

A handwritten signature in cursive script, reading "David W. Mullins, Jr.", written in dark ink.

Enclosure

Q.1. In a recent letter to the Subcommittee, Federal Reserve Board Chairman Greenspan stated that the Fed does "not lend for short sales," that it "limit(s) the amount of a security lent to a dealer at any time," and that when its holdings are small it sometimes rations in cases of heavy demand. Please provide the Subcommittee with responses to the following questions:

A. What is the rationale for not lending for short sales, given the fact that counterparties who are not short would presumably be free to relend the securities to those who are?

Q.1.A. The Federal Reserve's securities lending facility was established solely to help avert clearance and settlement problems that could result in unnecessary disruptions in the smooth functioning of the market. The program is structured to minimize any effect--either positive or negative--on trading strategies or practices, such as selling securities short. The size of the securities lending program is necessarily constrained by the size of the Federal Reserve's holdings and is therefore small relative to the overall market. The size of the average loan in the past two years was about \$13 million, and the total amount of securities out on loan each day averaged \$236 million in 1991 and \$180 million in 1992. By contrast, dealers borrow or reverse in hundreds of billions of dollars in securities each day.

B. What limits does the Fed place on the amount of a security it lends to a dealer at any time, and what is the justification for those limits?

A.1.B. The lending limits are \$50 million for any one Treasury bill, \$10 million for any one Treasury note or bond, and a total of \$150 million of securities lent to any one dealer. These limits were chosen to reflect the typical market transaction size and, with our

holdings of some issues quite limited, to assure our ability to accommodate all the dealers with which we have a trading relationship in an equitable manner. Moreover, the lending program was not designed to compete with private market arrangements, but only to supplement them for the sake of the efficient functioning of the clearing mechanism.

C. How does the Fed go about rationing supply of an issue in cases of heavy demand?

A.1.C. Rationing of a specific issue is based on our holdings, the number of requests, and the amounts requested. The amounts rationed to dealers generally are set in the morning and may be increased later in the day if the volume of subsequent requests and the Federal Reserve's holdings permit.

Q.2. In the aforementioned letter, Chairman Greenspan also indicated that the Fed does not offer a lending facility for its foreign and international accounts. Why is this? Are you at all concerned that the failure to provide such a lending facility may reduce market liquidity or efficiency?

A.2. The foreign central banks and international organizations that hold a portion of their dollar denominated assets with the Federal Reserve retain full control over the disposition of those assets. They may lend those securities to other parties at their own initiative and discretion.

Q.3. The Greenspan letter also stated that the Fed does not "pre-screen collateral when accepting propositions" when it provides reserves through repurchase agreements, and that "many of these securities are considered to be 'lightly special' because their rates are not far from general collateral rates and because they are on and

off special so quickly." Please provide responses to the following questions:

A. Why doesn't the Fed pre-screen collateral when providing reserves through repurchase agreements?

A.3.A. The primary objective of Federal Reserve open market operations is to manage the supply of reserves available to depository institutions. Each morning as new data become available, Federal Reserve staff review the current reserve picture to determine whether adjustments need to be made. If we decide to enter the market to arrange a repo (which provides additional reserves to the banking system on a temporary basis), we contact the dealers at about 11:30 a.m. to request propositions. About 10 to 15 minutes later, we receive propositions, which are stated in terms of dollar amount and rate but which do not indicate the specific collateral. We then evaluate the propositions and accept those most advantageous to the Federal Reserve in terms of rate, up to the amount consistent with our reserve objectives. Since time is at a premium, we try to complete our operation as efficiently and quickly as possible, thus minimizing the period that dealers are exposed to possibly changing market conditions and meeting as promptly as possible the banking system's need for reserves. We notify the dealers around noon of our decisions to accept or to reject their offers. Only in the afternoon do dealers tell us which issue or issues they intend to use for the repo. Since a dealer is likely to provide a number of different securities, the process of assembling, recording, and pricing the issues takes considerable time. Thus, we are not in a position to know the specific collateral that is to be delivered until after our operation was announced and propositions were accepted. Hence, the agreement to do the transaction with a dealer is not contingent on the specific

security used as collateral. As a practical matter and as detailed below, we have made our preference not to receive securities that are deeply on special plain to the dealer community, effectively making it unnecessary to pre-screen collateral.

B. What criteria does the Fed use to define when a security is "lightly special"?

C. What criteria does the Fed employ to determine when an issue is "on significant special"?

D. When and how were these criteria adopted?

A.3.(B,C. and D) Phrases such as "lightly special", "on significant special", "deeply special", and "specialness" are terms used by market participants in a qualitative sense. Certainly, the Federal Reserve has not established any formal taxonomy in this area. In Chairman Greenspan's letter of February 1, 1993, the phrase "on significant special" was specified as "about 50 percent of the general collateral rate" in order to formulate a quantitative answer to your question.

E. If an issue were 25 basis points or more from general collateral, why wouldn't the Fed want to adopt a policy of generally not accepting such collateral in order to reduce the potential for a squeeze in the issue?

A.3.E. The Federal Reserve has a policy of not taking securities that are deeply on special that should be familiar to all primary dealers. We intend to remind them of our policy at the upcoming meeting of the Public Securities Association at which all the primary dealers will be represented.

With that said, I would note that the rate at which a given security trades or is quoted is updated continuously over the course of the day. As a result, a security that is deemed to be "on special" early in the morning might not be considered to be "special" later the

same morning or in the afternoon. Further, it is common for securities to trade 25 basis points away from the general collateral rate without concern or threat of a squeeze.

Q.4. Chairman Greenspan's letter also indicated that since January 1, 1991 the Fed has accepted collateral that was on "significant special"--which he defined as 50 percent of the general collateral rate--a total of 8 times. Please provide a chart indicating how many times between January 1, 1991 and December 31, 1992 the Fed accepted collateral that was on special. In this chart, please provide a breakdown of how many times the security accepted was: 1) less than 25 basis points of general collateral; 2) between 25-50 basis points of general collateral; 3) between 50-75 basis points of general collateral; 4) 75-100 basis points of general collateral; and, 5) over 100 basis points of general collateral.

A.4. The data requested are presented in the table below, although I would caution you not to draw strong conclusions from them. It is not unusual for repo rates to fluctuate considerably over the course of the day. The repo rates used to derive the data in the attached table pertain to morning repo rates, but dealers transfer the securities to the New York Reserve Bank in the afternoon, by which time repo rates on particular issues may have changed. Hence, one cannot necessarily conclude that the issues reflected in the table were trading below the general collateral rate and, therefore, that their use as collateral in Federal Reserve operations may have contributed to a shortage. The Reserve Bank began to maintain a formal database of repo rates in mid-September 1991. As a consequence, repo data for the first nine months of 1991 had to be reconstructed from other sources that are probably not as reliable; the repo data for the remainder of the period you

Securities Accepted as Repo Collateral  
That Were Quoted at Rates below the General Collateral Rate<sup>1</sup>

		<u>Basis points below the general collateral rate</u>				
		<u>Less</u>				<u>Greater</u>
		<u>than 25</u>	<u>25 to 50</u>	<u>51 to 75</u>	<u>76 to 100</u>	<u>than 100<sup>3</sup></u>
1991 <sup>2</sup>						
Total Desk Repo Collateral (\$ mil.)	508,650					
• Within each category (\$ mil.)	24,369	406	6,811	7,508	2,286	7,358
• Percent of total	4.8	0.1	1.3	1.5	0.4	1.4
• Number of items	151	3	85	27	15	21
1992						
Total Desk Repo Collateral (\$ mil.)	533,378					
• Within each category (\$ mil.)	7,854	50	3,417	1,503	659	2,225
• Percent of total	1.5	0.0	0.6	0.3	0.1	0.4
• Number of items	42	1	14	10	5	12

1. The repo rates used are taken from morning indications, while the collateral is submitted to the Federal Reserve in the afternoon.

2. Estimated from two different data sources on repo rates.

3. These include the 8 occasions cited in Chairman Greenspan's February letter in which the securities were quoted at less than one-half the general collateral rate.

requested are given to us by dealers as indications of where rates were over the course of the morning.

To put the figures in the table in some perspective, the Federal Reserve accepted collateral in the form of approximately 20,000 items totalling over a trillion dollars in 1991 and 1992. The average dollar amount of each item in the categories you requested was only \$167 million. Given the enormous volume of trading in the Treasury market, it is hard to envision how the acceptance of these securities could have had a discernible impact on their financing rates.

5. Chairman Greenspan's letter also indicated that the Fed preferred "not to take items for which there is a great demand in the repo market," and that "if we do get them, we review the surrounding circumstances and, as appropriate, contact the submitting dealer firm to advise it that we prefer not to be shown this type of collateral." From January 1, 1991 to December 31, 1992, how many times has the Fed rejected collateral on this basis? In each case, how many basis points from general collateral was the issue?

A.5. As discussed in the answer to question 3, we do not pre-screen the securities that are presented. Of course, we do evaluate the collateral that we receive after the fact. Because the repo market is very fluid, an item that was in great demand early in the day may be closer to or at the general collateral rate when it is shown to us later in the day. When we find that we have received a security that might have been significantly special either on the day of an operation or on prior days, we review the surrounding circumstances--such as the amounts shown in and the pattern of intraday trading. Only a handful of instances warranted a call to the dealer advising that we do not want to receive this type of security.

Q.6. During the Subcommittee's hearing, Mr. Randy Strausberg, a former New York Fed official, testified that to effectuate a manipulative strategy "players attempt to tighten an issue in the financing market by taking them 'off the street' to a lender that will not recycle the securities." Does the Fed monitor all of the collateral it accepts when it provides reserves through repurchase agreements to assure that it is not being utilized by market participants seeking to take an issue off the street and put it on special?

A.6. Yes, as described above, we review all the securities we take on repo.

Q.7. Of the collateral the Fed accepted between January 1, 1991 and December 31, 1992, how many instances did the issue subsequently trade 25 basis points or more from general collateral?

A.7. Most on-the-run issues trade, to some extent, on special in a manner that reflects the normal trading patterns of market participants and the Treasury's auction cycle. The degree of specialness will depend importantly on where an on-the-run issue is in its life cycle, as well as other factors including its usefulness as a hedging vehicle. Issues that are less actively traded and not heavily used in hedging strategies might trade only 15 to 20 basis points below general collateral. More actively traded issues, or issues that may be particularly useful in hedging risk, often trade 100 or more basis points below general collateral.

We do not have the data necessary to answer your question directly. However, in an attempt to shed some light on the matter, we reviewed repo market quotes for a sample of active issues traded over a two-month period in late 1992. The sample, which consists of approximately 500 sets of intraday repo quotes, indicates that only about one-tenth of the issues that were within 25 basis points of general collateral in the morning moved to more than 25 basis points away from general collateral at some point during the afternoon. Of these, a handful were held at the Fed as collateral (generally in very small amounts).

ONE HUNDRED THIRD CONGRESS

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DAVID H. MULLTON  
CHIEF COUNSEL AND STAFF DIRECTOR

**U.S. House of Representatives**  
**Committee on Energy and Commerce**

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

Washington, DC 20515-6119

March 29, 1993

Mr. William J. McDonough  
Executive Vice President  
Federal Reserve Bank  
of New York  
33 Liberty Street  
New York, NY 10045

Dear Mr. McDonough:

Thank you once again for your testimony at the Subcommittee's March 17, 1993 hearing on H.R. 618, the Government Securities Reform Act of 1993. Your appearance before the Subcommittee was extremely useful in informing our deliberations on this important legislation.

In order to address certain issues raised in connection with the Subcommittee's March 17, 1993 hearing, I request your assistance and cooperation in responding to the attached follow-up questions.

Again, thank you for your assistance and cooperation in responding to the Subcommittee's request. It is requested that a response be provided within 10 working days, or no later than April 12, 1993. Should you have any questions regarding the Subcommittee's request, please have your staff contact Mr. Jeffrey S. Duncan of the Subcommittee staff at 226-2424.

Sincerely,

*Edward J. Markey*  
Edward J. Markey  
Chairman

Enclosures

**POST-HEARING QUESTIONS FOR MR. MCDONOUGH  
IN CONNECTION WITH  
MARCH 17, 1993 HEARING ON H.R. 618**

1. During the hearing, SEC Chairman Breeden mentioned that "there is a five-year Treasury issue that is on what in the lingo of the trade is called on special" and that it was possible for such specials to have an adverse impact on interest rates affecting seekers of home mortgages. You stated that the issue in question "is on special in the repo market, not in the cash market, and it is the cash market which affects this mortgage seeker that has been brought to our attention." The attached letter suggests that tightness in the repo market also affects interest rates. Do you agree or disagree with this analysis, and if so, why?

2. In a recent letter to the Subcommittee, President Corrigan said that "a market participant alone or acting in concert with others, could attempt to corner or manipulate the market for a particular security with the intention of generating an artificial shortage." At the same time, both his letter and your testimony attribute recent episodes of Treasury securities trading "on special" to natural market forces. How do you distinguish a "natural squeeze" from a "manipulative squeeze"?

3. President Corrigan also stated in his letter to the Subcommittee that the New York Fed "remain[s] mindful that the manner in which...market participants pursue profit opportunities can raise concerns of whether some participants exert any undue influence on market prices and financing rates." At what point do you become concerned that a market participant was exerting "undue influence" on market prices or financing rates?

4. President Corrigan's letter also noted that a single, large non-dealer firm acquired a sizable position in the December 1991 5-year Treasury note in when-issued trading and the auction, and then "executed repurchase agreements with dealers when it was possible to ensure a sufficient profit after expenses." Aside from the issue of auction rule violations, how does this type of activity differ from what Mr. Mozer reportedly was trying to do in the financing market following the May auction?

5. President Corrigan's letter also said that following the auction of the August 1992 10-year note "a number of market participants attempted to profit from their perception of an imbalance between the level of...short positions and the availability of the 10-year note from holders willing to lend their securities. While this activity helped redistribute the note to market participants seeking to satisfy their delivery obligations, at times it also may have enhanced the temporary scarcity value of the 10-year note and contributed to maintaining large rate concessions in the financing market." Aside from the issue of auction rule violations, how does this behavior differ from what Mr. Mozer and others reportedly were doing with the

**April and May 1991 2-year notes?**

6. During the Subcommittee's hearing, one of the witnesses testified that when Treasury issues go on special, "the greatest cost to the Treasury results from the loss of hedging vehicles," because "when hedging securities are hard to borrow, when yield spreads to surrounding issues change unpredictably, when traders lose money simply by servicing their clients, the market will become less efficient; traders will bid lower and widen their bid-to-offer spread -- other things being equal, yields will be higher than they ought to be." Do you agree that these adverse consequences can result from a squeeze caused by "natural market forces." If so, shouldn't one objective of reopening policy be to minimize the potential for such inefficiencies?

7. President Corrigan's letter to the Subcommittee argued that "there is not, and perhaps will never be, a neat and precise definition of 'acute and protracted'" short squeezes. Corrigan also cautioned "against relying solely on simple statistical criteria, especially to the exclusion of judgment regarding the ability of the market's normal adjustment mechanism to work through temporary conditions." In contrast, one of the witnesses at the Subcommittee's hearing argued that frequent short squeezes result in losses in hedging vehicles and higher costs. To respond to this situation, the witness suggested that "the Treasury should adopt a clear cut policy for reopening tight issues regardless of the cause" and develop "a statistical measure of the market's difficulty with an issue." What is the New York Fed's justification for not relying primarily on statistical measures, appropriately supplemented with judgments about the state of the market, in order to determine when an issue trading on special should be reopened?

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FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N. Y. 10045-0001

AREA CODE 212 720-6180

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WILLIAM J. McDONOUGH  
EXECUTIVE VICE PRESIDENT

April 13, 1993

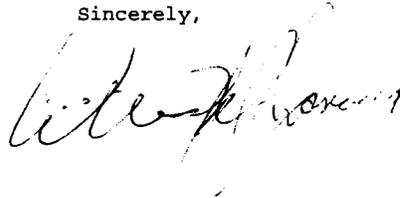
The Honorable Edward J. Markey  
Chairman  
Subcommittee on Telecommunications  
and Finance  
Committee on Energy and Commerce  
House of Representatives  
Washington, D.C. 20515

Dear Mr. Chairman:

Your letter of March 29, 1993 contained some follow-up questions arising from the March 17 hearing before the Subcommittee and from Mr. Corrigan's January 25, 1993 responses to your December 17, 1992 letter.

My responses to your recent questions are enclosed. If I can be of further assistance, please let me know.

Sincerely,



Enclosure

**FEDERAL RESERVE BANK OF NEW YORK****QUESTION 1**

During the hearing, SEC Chairman Breeden mentioned that "there is a five-year Treasury issue that is on what in the lingo of the trade is called on special" and that it was possible for such specials to have an adverse impact on interest rates affecting seekers of home mortgages. You stated that the issue in question "is on special in the repo market, not in the cash market, and it is the cash market which affects this mortgage seeker that has been brought to our attention." The attached letter suggests that tightness in the repo market also affects interest rates. Do you agree or disagree with this analysis, and if so, why?

The point of my remark was that the yield on this issue in the cash market, while possibly a bit lower than other surrounding issues, was about normal.

In my view, in a broad context, a mortgage seeker ultimately feels only very small--essentially negligible--effects from activity in the financing market for Treasury securities. Because homeowners repay their loan principal gradually throughout the life of their mortgage, these loans produce cash flows that differ fundamentally from their Treasury market counterparts. As a result, the Treasury market provides an imperfect hedge for the mortgage market. While this hedge is clearly valuable, it has its limits and, importantly, market participants have increasingly come to recognize and compensate for these limits.

In determining their benchmark lending rate, mortgage lenders sample rates for a number of different Treasury maturities over a few months' time. Thus, mortgage pricing relies on general stability in the overall yield curve and not at any one individual point in time. Our work over the past year has shown that the impact of "natural" shortages on yield-curve

relationships appears only small and temporary, thereby leaving critical relationships unaffected over a somewhat longer timeframe. After the mortgage lenders determine the appropriate benchmark rate, the actual rate they offer to the homeowner will also reflect the outlook for the broader conditions in the overall mortgage market, further weakening the linkage between mortgage loan rates and activity in the Treasury market.

A change in cash Treasury yields could affect certain adjustable-rate mortgages if they are tied to a particular Treasury security. Strong demand for Treasury issues and the resultant scarcities that may develop in particular issues act to push yields down, thereby perhaps generating a beneficial effect to borrowers in the mortgage market.

#### QUESTION 2

In a recent letter to the Subcommittee, President Corrigan said that "a market participant alone or acting in concert with others, could attempt to corner or manipulate the market for a particular security with the intention of generating an artificial shortage." At the same time, both his letter and your testimony attribute recent episodes of Treasury securities trading "on special" to natural market forces. How do you distinguish a "natural squeeze" from a "manipulative squeeze"?

In a broad sense, a natural shortage or so-called "squeeze" can occur when market participants make independent assessments of market factors with the result that demand for a security sharply escalates relative to its available supply.

A manipulative squeeze might occur as the result of a combination of factors that would not have developed naturally. The shortage could be by design and would be motivated by a desire to significantly influence the price of the security.

The resulting shortage would not have occurred if ordinary economic and market forces were at play. The shortage could develop because one participant had a decidedly controlling position - or if two or more market participants worked in concert to create a severe shortage.

Having said that, it is important to note there will always be elements of judgement necessary when attempting to answer the question of whether the anomalies that develop in the market-place are an outgrowth of natural market forces or of manipulative efforts. The Federal Reserve Bank of New York's efforts over the last year have been geared to developing and gathering the type of information necessary to provide the appropriate regulatory and/or legal authorities with an understanding of developments in the market. These efforts should assist them in making informed judgements and fulfilling their responsibilities. As we gather and review the considerable amount of information available to us, we are in constant contact with members of the inter-agency working group--the Treasury, the Federal Reserve Board, the SEC and the CFTC. Each and every inquiry into market behavior is discussed by the group and any questionable activity would be referred on to the appropriate regulatory or legal authority for further inquiry should we or any member of the group deem it necessary. I can assure you there would be no hesitation on our part, or the working group's, to make this referral--which in itself is a matter of judgement.

QUESTION 3

President Corrigan also stated in his letter to the Subcommittee that the New York Fed "remain[s] mindful that the manner in which...market participants pursue profit opportunities can raise concerns of whether some participants exert any undue influence on market prices and financing rates." At what point do you become concerned that a market participant was exerting "undue influence" on market prices or financing rates?

Our efforts are geared toward detecting incidents in which a participant or participants gain effective control over the availability of a specific Treasury issue, in either the cash market or the financing market. We have established procedures to identify conditions under which the market's normal adjustment mechanism breaks down--so that the market can no longer provide reasonable alternatives for investments, risk management or speculation. Aside from the clear need to distinguish between temporary and persistent conditions, the market's difficulties must also appear directly and largely attributable to the actions of an individual market participant or to a group acting in concert.

QUESTION 4

President Corrigan's letter also noted that a single, large non-dealer firm acquired a sizable position in the December 1991 5-year Treasury note in when-issued trading and the auction, and then "executed repurchase agreements with dealers when it was possible to ensure a sufficient profit after expenses." Aside from the issue of auction rule violations, how does this type of activity differ from what Mr. Moser reportedly was trying to do in the financing market following the May auction?

The non-dealer firm that was noted is an investor in Treasury securities. Investors in Treasury securities have no obligation to lend their securities. Indeed, an investor that provides securities to the market incurs certain risks that some

investors may want to avoid, particularly credit risk. Nevertheless, other investors choose to lend securities because they can enhance their investment return by providing their securities to dealers and others. However, an investor is unlikely to provide securities unless the incentive overcomes the risk and costs.

For example, investors typically provide Treasury securities to financing market participants through repurchase agreements. By executing a repurchase agreement an investor receives cash in return for the securities and pays a rate of interest. The provision of securities would create an economic loss for the investor unless the cash could be invested at a rate higher than the rate the investor is paying for the repurchase agreement. Under current rate relationships, if the investor executes the repurchase agreement at the general collateral rate and invests the cash at the Federal funds rate there is likely to be little if any profit since the rates are often very close and any spread that may be earned may not compensate for the administrative costs of employing traders, clerks, credit analysts and accountants. If the repurchase agreement can be arranged at a rate lower than the general collateral rate there may be sufficient incentive to entice the securities away from the investor. To be sure, a bank investor, other financial institutions, or institutional investors may have a particular need for cash or may be able to employ funds raised through repurchase agreements at rates higher than the Federal funds

rate, but there are not many overnight or very short-term investments that offer a rate much higher than the overnight repurchase rate for general Treasury collateral.

Because of continuing inquiries and legal proceedings regarding the events of the spring of 1991 it would be inappropriate to comment about what Mr. Mozer was trying to do.

QUESTION 5

President Corrigan's letter also said that following the auction of the August 1992 10-year note "a number of market participants attempted to profit from their perception of an imbalance between the level of...short positions and the availability of the 10-year note from holders willing to lend their securities. While this activity helped redistribute the note to market participants seeking to satisfy their delivery obligations, at times it also may have enhanced the temporary scarcity value of the 10-year note and contributed to maintaining large rate concessions in the financing market." Aside from the issue of auction rule violations, how does this behavior differ from what Mr. Mozer and others reportedly were doing with the April and May 1991 2-year notes?

It is important to keep in mind the market conditions that surrounded the August 10-year note throughout the third and fourth quarters of 1992. The corporate bond market underwent a dramatic period of increased underwriting activity during the third quarter in response to steadily declining interest rates. Underwriters were able to sell the new issues as long as investors remained interested in buying them; however, when investor interest began to decline in September, underwriters were left with a need to hedge large volumes of unsold corporate issues. Many of them chose to hedge their inventories by selling short the August 10-year note, which market participants widely acknowledged as the most popular hedging instrument for the new corporate issues.

When called upon to discuss the August 10-year note, market participants attributed the issue's scarcity value almost exclusively to the considerable level of demand created by hedge-related short selling. The comments made by market participants were consistent with position data gathered by the Market Surveillance unit, which indicated that the primary dealers maintained sizeable cash market short positions in this issue throughout the September - November period. Given the cash market conditions prevalent at that time, the issue almost certainly would have traded with a significant rate concession regardless of the strategies pursued by matched book traders.

Those who established matched book positions in the August 10-year note did so by executing repurchase and reverse repurchase agreements in the open market in anticipation that repo rates would either rise or fall, with no assurance that rates subsequently would move in their favor. Furthermore, the agreements they used to establish their positions were available to other market participants, including those who maintained cash market short positions in the issue despite the large and persistent rate concession with which it traded. Thus, it would appear that the profits, if any, made by these traders would have been available to other market participants who shared their convictions concerning the probable course of future financing rates.

In addition, not all of the firms that established matched-book positions in the August 10-year issue were poised to profit from an increase in the issue's scarcity value. In fact, the most active matched book traders of the August 10-year note

were firms with sizeable cash market short positions. These firms stood to lose money if the repo rate concession increased the cash market value of the 10-year note relative to other securities.

Another point worth noting is that those who traded specials positions in the 10-year issue had an incentive to locate and to draw into the market collateral that otherwise might not have been available to short sellers attempting to meet their delivery obligations. While their activities occasionally might have enhanced the scarcity value of the issue, the intermediary function performed by these traders on balance likely added to the liquidity with which the issue traded in the repo market during the September - November period.

In light of these considerations, it is evident that the factors at work in determining how the August 10-year note traded in the financing market differed greatly from those that had influenced the trading of the 2-year notes issued in April and May of 1991.

#### QUESTION 6

During the Subcommittee's hearing, one of the witnesses testified that when Treasury issues go on special, "the greatest cost to the Treasury results from the loss of hedging vehicles," because "when hedging securities are hard to borrow, when yield spreads to surrounding issues change unpredictably, when traders lose money simply by servicing their clients, the market will become less efficient; traders will bid lower and widen their bid-to-offer spread -- other things being equal, yields will be higher than they ought to be." Do you agree that these adverse consequences can result from a squeeze caused by "natural market forces." If so, shouldn't one objective of reopening policy be to minimize the potential for such inefficiencies?

Let me begin by addressing several of the points made in the statement above. First, when an issue becomes difficult

to borrow in the financing market, it does not necessarily mean that a hedger will move his hedge into a less efficient, more costly off-the-run issue, or that he would look to another financial market for a replacement hedging vehicle. We have observed that hedgers prefer to use on-the-run securities for their hedging activity and are not likely to move their hedges into an off-the-run security, even if the on-the-run issue is trading significantly on special in the financing market. This is true because the cost of an issue trading significantly on special in the financing market can be much less than the cost of the wide transaction spreads incurred by moving the hedge into a less liquid, off-the-run issue, where bid-to-offer spreads tend to be somewhat wider.

Second, there is always the possibility in the Treasury market that yield spreads to surrounding issues will change unpredictably -- this is part of the risk inherent in any financial market. Before entering the market, participants assess the factors that are likely to affect price/yield relationships over the course of their exposure to the market. Clearly, these participants benefit to the degree that these relationships remain stable over time. During the past year of our enhanced surveillance activities, we have found that, overall, the U.S. Treasury market has provided hedgers with an environment of stable yield relationships. Third, there has been no indication that traders have widened their bid-to-offer spreads in the cash market for actively traded issues.

The U.S. Treasury market continues to offer a level of efficiency and liquidity that is unmatched by any other financial market in the world. The high degree of competition and activity in the Treasury market, and the large number of outstanding issues, make Treasury securities a prime hedging tool. The activity of hedgers undoubtedly provides an even greater degree of efficiency to the U.S. Treasury market.

Based on the above discussion, we have found no evidence that hedging activity in the Treasury market has significantly decreased; therefore, there has been no indication that the Treasury's borrowing costs have increased as a result. We will continue to monitor the important role hedgers play in the Treasury market over time.

With respect to the second part of your question, I will restate that policies regarding the reopening of issues are left to the discretion of Treasury. However, we continue to feel that orderly Treasury debt management practices are essential to the continued efficient operation of the Treasury market.

**QUESTION 7**

President Corrigan's letter to the Subcommittee argued that "there is not, and perhaps will never be, a neat and precise definition of 'acute and protracted' short squeezes. Corrigan also cautioned "against relying solely on simple statistical criteria, especially to the exclusion of judgment regarding the ability of the market's normal adjustment mechanism to work through temporary conditions." In contrast, one of the witnesses at the Subcommittee's hearing argued that frequent short squeezes result in losses in hedging vehicles and higher costs. To respond to this situation, the witness suggested that "the Treasury should adopt a clear cut policy for reopening tight issues regardless of the cause" and develop "a statistical measure of the market's difficulty with an issue." What is the New York Fed's justification for not relying primarily on statistical measures, appropriately supplemented with judgements about the state of the market, in order to determine when an issue trading on special should be reopened?

The decision to reopen a Treasury security rests with the Treasury Department, not the Federal Reserve. The Federal Reserve Bank of New York, through its market monitoring activities, provides the Treasury with information relevant to making that decision and acts in an advisory capacity.

The Market Surveillance function of this Bank collects data on both the cash and financing markets, such as yield curve spreads, financing rates and transactions volume. These data form the foundation of our analyses and recommendations to the Treasury. However, no one statistic or combination of statistics is a perfect measure of the severity of a shortage. Market conditions are constantly changing, and there can be no substitute for flexibility and sound judgement. All of the data must be considered in the context of current and anticipated market conditions.

A single statistical rule might force the Treasury to reopen an issue when it is anticipated that natural market forces are likely to ease the shortage soon. A reopening, in this instance, may disrupt the market further and could impact future liquidity. Given the implications of a reopening to the marketplace and to its debt operations, the Treasury has determined that it should only issue additional securities when it is necessary to ensure the market's efficiency.

In addition, it is not clear that the number or severity of shortages would be reduced by establishing a mechanical measure. The relevant factor is how aggressively the Treasury implements its reopening policy, regardless of whether statistical or subjective criteria are used. In fact, by being

somewhat vague about if and when a security will be reopened, the Treasury may actually deter participants from creating an 'artificial' shortage, in that potential manipulators are uncertain about how much influence they can exert before triggering a reopening.

Incorporating a subjective understanding of market conditions into the reopening decision should not be confused, however, with giving consideration to the cause of a shortage. The Treasury stated in the Joint Report that it "will provide additional quantities of a security to the marketplace when an acute, protracted shortage develops, regardless of the reasons for the shortage." Indeed, when the Treasury reopened the ten-year note (6 3/8 % TN 8/15/02) in November of last year, it was made clear that there was no evidence of wrongdoing or manipulative behavior, but rather that the severity of the shortage warranted a reopening.



Telerate Systems Incorporated

Carl M. Valenti  
President

One World Financial Center  
200 Liberty Street  
New York, NY 10281

Telephone: 212 412-1058

April 5, 1993

The Honorable Edward J. Markey  
Chairman, Subcommittee on  
Telecommunications and Finance  
Committee on Energy and Commerce  
United States House of Representatives  
Washington, D.C. 20515

Dear Mr. Chairman:

On behalf of Telerate Systems, Inc. ("Telerate"), a wholly owned subsidiary of Dow Jones & Company, Inc., I appreciate the opportunity to submit this letter for the record of the hearing before the Telecommunications and Finance Subcommittee on March 17, 1993. As you know, we have previously communicated to you our concerns about the so-called transparency provisions of government securities reform legislation. We would like to reaffirm our position that standby authority to regulate transparency could adversely affect the secondary market for government securities, and assure you that the private sector, through new initiatives, continues to improve transparency.

**Creating transparency in markets is Telerate's core business.** We specialize in the delivery of financial data, decision support products and transaction services to financial markets where decision-making requires time-critical data. Telerate operates in 70 countries with a staff of 2,400 professionals worldwide. In 1969, Telerate pioneered the field of electronic financial information services with the delivery of real-time market rates for commercial paper. Telerate thereby transformed a fragmented market involving thousands of traders into a centralized source of information which can be accessed by market participants.

Today, our strength still lies in the collection and distribution of rates and quotes on financial instruments. The Telerate service provides real-time information covering foreign exchange, fixed income securities (including government securities), equities, energy, mortgage markets, metals, commentary and news -- including Dow Jones' newswires and Capital

The Honorable Edward J. Markey  
April 5, 1993  
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Markets Report<sup>SM</sup> -- displayed on 60,000 pages. The cost of subscribing to Telerate is as little as \$600 per month.

**Providing transparency in the secondary market for government securities is one of our principal services.** Using data obtained from Cantor Fitzgerald (and its related companies), we provide best bids and best offers for U.S. government securities, the size associated with the best bids and best offers, and the volume and price of executed transactions. Our system includes trading for every government security issue in which Cantor Fitzgerald displays a market, including every issue of U.S. Government Treasury securities, U.S. Treasury S.T.R.I.P.S. (zero-coupon securities) and non-guaranteed publicly traded government-sponsored enterprise issues (such as Federal National Mortgage Association debentures). This data can be manipulated in numerous ways with the use of value-added products offered by us. In addition, that segment of Telerate's customer base that has the means and desire to receive government securities market information through a digital feed is able to store, analyze and process the data supplied through the Telerate information service.

Although it is not uncommon for traders to subscribe to several financial information services, Telerate's information is available to, and relied on by, virtually every significant participant in the fixed income and foreign exchange markets worldwide. Our subscribers include brokers, dealers, the Federal Reserve System, foreign central banks, mutual funds, insurance companies, federal, state and local governmental units, pension funds and other sophisticated institutional and individual investors.

**In June of 1991 Telerate significantly broadened the distribution of government securities information by the introduction of its Treasury 500 product.** Treasury 500 provides live broker quotes (bids and offers and transaction sizes) and includes -- for the first time -- "off-the-run" Treasury securities (securities issues that have already been fully distributed), agency securities, zero coupon Treasuries and sophisticated cross-market derivative products. Users can store and organize this data to meet their own analytical needs.

**Telerate also has created a more transparent market by providing trading information on U.S. Government Sponsored Enterprises (GSEs) in response to requests from its customers.** While this innovation, like other improvements in transparency during recent years, is costly to develop and maintain, Telerate still has an economic incentive to develop such new products.

The Honorable Edward J. Markey  
April 5, 1993  
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Moreover, because of the limited brokerage commission revenue available in the GSE market, the broker providing Telerate the GSE information could become active in GSEs only because it could sell such information to Telerate. The enactment of Section 8 would change this analysis significantly. Indeed, Telerate might not have invested in the GSE product if Section 8 had been in effect when the product was being considered. Putting it another way: If this information were to become commoditized -- so to speak -- there might not be enough of an economic incentive to attract distributors for it.

Most recently, on February 1, 1993, Telerate began to provide trading information on "odd lots" of Treasury securities, which are amounts of less than \$1 million. Prior to the introduction of Telerate's new service, investors trading odd-lots frequently had to pay higher prices because dealers do not like to handle small denominations. In addition, many institutional investors who wanted to buy or sell odd lots had to solicit bid and offer prices on the telephone from multiple dealers and compare the quotes to find the best price. Telerate's new service offers a fundamental change in the way odd lots are traded, allowing customers instantaneous, real-time access to a market previously lacking transparency.

Telerate's competitors in the information industry continue to enhance transparency through improvements in their products. Last year, the Joint Report on the Government Securities Market ("Joint Report") acknowledged that GovPX was playing a role in its system improving transparency. We understand that GovPX, through its principal product PROPHECY, now provides information on the size associated with quotes and a digital feed which allows the use of analytical software. Furthermore, GovPX announced that it will offer trading data for GSE, federal agency and zero-coupon securities by mid-year. However, even before GovPX made these improvements, the secondary market for government securities was transparent because of Telerate and other information processors.

Last September, two of Telerate's market data vendor competitors, Bloomberg and Knight-Ridder, began to distribute "executable" odd lot prices on a range of U.S. government securities originating from a service operated by First Boston called GovTrade. The GovTrade service, which reportedly is targeted to small investors, allows qualified Bloomberg customers to route their orders from their terminals directly to First Boston's trading desk. Online order routing is not yet available to users of Knight-Ridder's information services; instead, the subscribers communicate by telephone with First Boston's traders.

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April 5, 1993  
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Industry publications report that a number of other primary dealers, including Kidder Peabody, Morgan Stanley and Fuji Securities, and the aspiring primary dealer Spear Leads Government Securities, all have plans to publish their own "live" prices over market data vendor networks. According to trade journals, a major equity quote vendor, ADP, is planning to join in the near future its principal rival, Quotron, in disseminating delayed U.S. Treasury prices from interdealer broker Garban Ltd.

This activity in the private sector demonstrates that the information services market is vibrant and increasingly competitive. Information processors continue to enhance the quality of products and services that, in turn, increase transparency. Moreover, more interdealer brokers are entering the information services market and are distributing their trading data to a wide range of customers.

With respect to Section 8 of H.R. 618, we are concerned that although it is well-intended and has facial appeal, the legislation could impair the gains in transparency that are already evident in the private sector and the continued increases in transparency in the future. For the reasons outlined below, we respectfully suggest that the Subcommittee delete Section 8 and agree to the language of S. 422, which provides for a comprehensive study of transparency in the government securities market.

The regulatory approach of Section 8 is not necessary. The Joint Report was prepared in response to allegations of improprieties in the primary market and should not be used to justify regulation in the secondary market. There is no evidence that even suggests that the secondary market for government securities is distorted because of a lack of information needed to participate fully in the market.

We think it is noteworthy that only one of the regulatory agencies contributing to the Joint Report -- the SEC -- supports a grant of additional regulatory authority over transparency. The Treasury Department has not revised its stance since the Joint Report. Moreover, the Federal Reserve System Board of Governors, in testimony before this Subcommittee on March 17, 1993, noted that private sector initiatives have enhanced transparency and, if allowed to continue unencumbered, will develop further gains for investors in this market.

More importantly, SEC Chairman Breeden has not disavowed his statement before the Senate Securities Subcommittee on January 23, 1992, in which he conceded that "immediate regulatory steps to

The Honorable Edward J. Markey  
April 5, 1993  
Page 5

mandate transparency in the government securities market at this time are not necessary."

Because Section 8 seeks to solve a problem that has not yet been identified, the language is inherently broad and is likely to result in unintended consequences. David W. Mullins, Jr., Vice Chairman of the Board of Governors of the Federal Reserve System, in testimony on March 17, 1993, emphasized that every single member of the Board of Governors was opposed to the regulatory approach of H.R. 618. Moreover, a major peril of excessively broad regulation of the secondary market for government securities is that it could increase the Federal government's cost of borrowing money in the primary market. According to the Joint Report, "An increase of financing costs of only one basis point -- one hundredth of one percentage point -- would cost taxpayers over \$300 million each year."

The private sector will necessarily perceive Section 8's grant of standby authority to be a grant of actual authority to regulate the price and content of trading data. Standby authority will have a chilling effect on the capital-intensive financial information service business. Telerate alone has spent hundreds of millions of dollars during the past several years to develop the state-of-the-art system that provides transparency in the government securities market (and other markets) today. We would be reluctant to continue to make such significant, long-term capital investments if the SEC were vested with regulatory authority that could completely change the nature of and demand for Telerate's services.

In summary, we at Telerate take great pride in our role as one of the pioneers in bringing real-time prices to the secondary market for government securities. We are confident that we and other information providers will continue to deliver the leading-edge technology that further enhances the level of transparency. We must continue to do so if we expect to survive in this highly competitive market place. We would welcome the opportunity to work with the regulators who may be responsible for assessing the private sector's efforts to increase transparency in the secondary market for government securities.

Very truly yours,

*Carl M. Valenti*

# GOVERNMENT SECURITIES REFORM

TUESDAY, MARCH 30, 1993

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON ENERGY AND COMMERCE,  
SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE,  
*Washington, DC.*

The subcommittee met, pursuant to notice, at 2:15 p.m., in room 2322, Rayburn House Office Building, Hon. Edward J. Markey (chairman) presiding.

Mr. MARKEY. So sorry to keep all of you waiting. Well, we have a very curious interaction of the procedural posture on the floor being such that the Republicans are using roll calls in order to make particular points with the Democrats, which is fine and all within their Constitutional and procedural rights, combined with other business which is pending before the House and unfortunately this issue has been caught in the middle of this scheduling confluence and we very much apologize to you for that.

Today the subcommittee is holding a hearing on H.R. 616, a bill to repeal section 11(a) of the Securities Exchange Act of 1934 in order to permit members of national securities exchanges to effect transactions for accounts for which they have investment discretion.

I have joined with Representatives Fields and Moorhead in sponsoring this legislation in order to eliminate an anachronistic provision of the law which prevents money managers who are members of the New York Stock Exchange and other national exchanges from using an affiliated broker to buy or sell stock for certain client accounts.

This restriction was adopted in the mid-1970's in response to concerns over institutional access to exchanges and the potential conflicts of interests resulting from allowing combinations of money management and brokerage functions.

As implemented by the SEC, the 11(a) managed accounts provision allow money managers to use affiliated brokers to do everything other than actually executing a buy and sell order on the exchange floor for their managed accounts. Instead, the current rules require money managers to use independent floor brokers known on Wall Street as "two dollar brokers" to execute trades for their managed accounts.

H.R. 616, in contrast, would allow money managers to use an affiliated broker to actually execute the buy or sell order provided that full disclosure of compensation arrangements is provided in order to alert investors to any potential conflicts of interest.

(189)

In the last Congress this subcommittee heard testimony indicating that elimination of the 11(a) managed account provisions would reduce unnecessary costs associated with the use of independent floor brokers, enhance the ability of money managers to assure quality of execution of trades for their managed accounts, reduce certain administrative and compliance burdens and eliminate incentives for transactions to be executed on foreign exchanges or in the over-the-counter market merely to avoid incurring the costs associated with the provision.

The witnesses before us today are testifying in support of the pending legislation and the SEC has also indicated its support. We look forward to receiving their testimony and would hope that they will work with us as we move this legislation forward through the process to the House floor and hopefully into law.

That concludes the opening statement of the Chair.

[The text of H.R. 616 follows:]

103D CONGRESS  
1ST SESSION

# H. R. 616

To amend the Securities Exchange Act of 1934 to permit members of national securities exchanges to effect certain transactions with respect to accounts for which such members exercise investment discretion.

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## IN THE HOUSE OF REPRESENTATIVES

JANUARY 26, 1993

Mr. MARKEY (for himself and Mr. FIELDS of Texas) introduced the following bill; which was referred to the Committee on Energy and Commerce

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## A BILL

To amend the Securities Exchange Act of 1934 to permit members of national securities exchanges to effect certain transactions with respect to accounts for which such members exercise investment discretion.

1 *Be it enacted by the Senate and House of Representa-*  
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. PROHIBITED TRANSACTIONS.**

4 Section 11(a)(1) of the Securities Exchange Act of  
5 1934 (15 U.S.C. 78k(a)(1)) is amended—

6 (1) in subparagraph (E), by striking “(other  
7 than an investment company)”;

1           (2) by striking “and” at the end of subpara-  
2 graph (G);

3           (3) by redesignating subparagraph (H) as sub-  
4 paragraph (I); and

5           (4) by inserting after subparagraph (G) the fol-  
6 lowing new paragraph:

7           “(H) any transaction for an account with re-  
8 spect to which such member or an associated person  
9 thereof exercises investment discretion if such  
10 member—

11           “(i) has obtained, from the person or per-  
12 sons authorized to transact business for the ac-  
13 count, express authorization for such member  
14 or associated person to effect such transactions  
15 prior to engaging in the practice of effecting  
16 such transactions;

17           “(ii) furnishes the person or persons au-  
18 thorized to transact business for the account  
19 with a statement at least annually disclosing  
20 the aggregate compensation received by the ex-  
21 change member in effecting such transactions;  
22 and

23           “(iii) complies with any rules the Commis-  
24 sion has prescribed with respect to the require-  
25 ments of clauses (i) and (ii); and”.

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•HR 616 BH

Mr. MARKEY. We now turn to recognize the ranking Republican member on the full Committee of Energy and Commerce, the gentleman from California, Mr. Moorhead.

Mr. MOORHEAD. Thank you, Mr. Chairman.

I want to commend you for calling this hearing on H.R. 616, a proposal to amend section 11(a) of the Securities and Exchange Act of 1934.

The prohibition against an exchange member firm effecting orders for managed accounts over which it has investment discretion is a holdover from the days of fixed commission rates. Since May 1st, 1975, the markets have changed dramatically and experience has shown that the restrictions of 11(a) are unnecessary, although this section of the law does not appear to increase investor protection. It does impose unnecessary administrative costs and market inefficiencies on money managers.

In considering amendments to the Securities Law of 1975, Congress was apprehensive about the possibility that broker dealers might churn managed accounts to generate commissions. It was also concerned that a firm might pressure managers of advised accounts to purchase a particular security to complete a block transaction or to close an underwriting of a new issue. Finally, there was also concern that brokers might give preference to managed accounts in the execution of their orders.

To resolve these problems section 11(a) was adopted as a part of the Securities Act Amendments of 1975. The practical effect of section 11(a) is to require institutions to channel their exchange business through unaffiliated broker dealers. It also forces exchange members to execute trades for their managed accounts through an unrelated firm. In the absence of demonstrated conflicts of interest occurring, the section introduced unnecessary inefficiency in the order execution process.

Mr. Chairman, I agree with the conclusion of the SEC that the elimination of the managed account provision of section 11(a) would reduce costs for affiliated brokers executing orders for managed accounts.

I know however that the testimony today of the Securities Industry Associations says that between \$200 and \$250 million a year of costs have been borne indirectly by holders of mutual funds and pension plan participants. That would seem to me to be an argument in favor of some portion of the savings to be realized by this legislation being passed back to the customers.

I look forward to hearing the testimony on this point and expect to be fully supportive of this legislation.

I yield back the balance of my time.

Mr. MARKEY. Great. The gentleman's time has expired and all other time has expired for opening statements from members. Without objection, the record will remain open for any other opening statements which members wish to insert in the record.

I'll turn to our panel, which consists of Paul Gottlieb, who is Associate General Counsel of Paine-Webber, and Lawrence Zicklin, Managing Partner of Neuberger & Berman.

We thank both of you for your willingness to participate here today and we apologize again for the delay. We don't anticipate a lengthy hearing but we must for each session assure that there is

a record that justifies the passage of the legislation, which is our full intention on an expeditious basis, so Mr. Gottlieb, whenever you feel comfortable, please begin—pull over the microphone.

**STATEMENT OF PAUL GOTTLIEB, CHAIRMAN, INVESTMENT ADVISER COMMITTEE, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY JONATHAN R. PARET, VICE PRESIDENT; AND LAWRENCE ZICKLIN, MANAGING PARTNER, NEUBERGER & BERMAN, NEW YORK CITY**

Mr. GOTTLIEB. Thank you, Chairman Markey.

Gentlemen, my name is Paul Gottlieb. I am the Chairman of the Securities Industry Association's Investment Adviser Committee. I am here to testify on behalf of the SIA in support of the repeal of the managed account prohibition in section 11(a) of the Securities Exchange Act of 1934. I appreciate the opportunity that you have accorded me and I ask that the SIA's written statement be included in the record.

Mr. MARKEY. Without objection, it will be included in the record.

Mr. GOTTLIEB. As you know, the managed account provisions in section 11(a) prohibit an exchange member from executing certain securities trades on the floor of any national securities exchange to which it belongs. These prohibitions cover transactions for the accounts of the brokerage firm itself, the accounts of its associated persons, any accounts over which member firms or its employees have investment discretion—the latter called "managed accounts."

The SIA strongly supports the legislative efforts to repeal the managed account prohibitions. Congress adopted these provisions in 1975 to address perceived problems then thought to be inherent in the combination of brokerage and money management functions.

We believe it is clear that section 11(a) no longer serves the purpose for which it was adopted and unnecessarily costs the securities industry millions of dollars each year. Beyond that, it has spawned an unnecessary layer of regulation and it has lessened the accountability of firms in their execution of transactions for managed accounts.

For all these reasons, we believe that the repeal of the prohibition is both in the interest of the securities industry as a whole and the investing public.

The managed account prohibitions are no longer relevant to the current structure of the securities markets because of the dramatic changes which have occurred in those markets since the mid-1970's. Fully negotiated commissions have replaced fixed fees. Exchanges are now open to all qualified persons and access to exchange floors has been expanded via various electronic means. These changes in the structure of the market obviate the need for the 11(a) prohibitions for managed accounts.

Moreover, it should be remembered that the managed account prohibitions only apply to a limited portion of securities transactions. Trades executed for institutional managed accounts on the over-the-counter markets or off exchange floors are not affected. Thus the prohibitions tend to distort order flow by artificially driving transactions to other markets.

The absence of the prohibitions for OTC securities has not led to abuses in that marketplace. At least in part we believe that is be-

cause the brokerage and money management firms are regulated and subject to the provisions of the '34 Act, the Company Act, the Investment Advisers Act, and ERISA. Whatever the reason, however, our experience suggests that the 11(a) prohibitions have outlived whatever usefulness they may have had.

In fact, the SEC as you know adopted Temporary Rule 11(a)2-2T to temper the consequences of 11(a) by permitting member firms to provide all securities services for a managed account except on the floor executions. This is a so-called effect versus execute rule and as you know it is still in force today.

As a result of the above, an exchange member must use independent floor brokers, the so-called two-dollar brokers, to execute trades for managed accounts.

One of the main reasons for the SIA's support for repeal is the cost to the industry of compliance with 11(a). Based on a survey conducted by the SIA in the late 1980's, the managed account prohibitions cost the industry annually between \$200 and \$250 million.

In addition to the substantial cost savings to the industry, SIA's survey found substantial administrative burdens associated with 11(a) compliance. These include within often a very tight time frame the need to determine the status of managed accounts, to indicate to trading desks whether a particular order or percentage of an order was for an account subject to 11(a) and to respond to floor broker questions regarding the status of orders.

In today's fast-paced marketplace, any delay in executing a particular trade may very well have significant consequences with regard to that transaction.

In addition to the costs and burdens which I have previously mentioned, the prohibitions in 11(a) can have a negative effect on the way brokered services are rendered to managed accounts—11(a) compels exchange members to delegate responsibility of their professional judgment as to how and when to achieve executions to independent floor brokers. Thus, 11(a) diminishes the ability of member firms to use their expertise in executing trades and it further reduces the ability of institutional clients to hold exchange members accountable for the quality of executions rendered.

In sum, SIA strongly supports the repeal of the managed account prohibition. The prohibition is no longer needed to enhance fair competition and compliance with the prohibition creates unnecessary costs to brokerage firms and inefficiencies in the order process. It diminishes the ability of members firms to use their expertise while reducing ultimate client accountability.

The demise of this provision will create a substantial benefit.

I thank you for inviting me to testify today and I would be pleased to answer any questions that you may have.

[Testimony resumes on p. 210.]

[The prepared statement of the Securities Industry Association follows:]

**STATEMENT OF  
SECURITIES INDUSTRY ASSOCIATION**

Chairman Markey, my name is Paul Gottlieb and I am an Associate General Counsel with PaineWebber Incorporated. I am here to testify today on behalf of the Securities Industry Association ("SIA") in my capacity as Chairman of SIA's Investment Adviser Committee. I would like to thank the Telecommunications and Finance Subcommittee ("Subcommittee") for the opportunity to participate in this hearing and provide the Subcommittee with SIA's views on the proposed repeal of the managed account prohibitions in Section 11(a) of the Securities Exchange Act of 1934 ("1934 Act").

SIA is the trade association representing over 700 securities firms headquartered throughout the United States and Canada. Its members are securities organizations of virtually all types -- including investment banks, brokers, dealers and mutual fund companies. SIA members are active in all exchange markets, in the over-the-counter ("OTC") market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America.

**I. Description of the Managed Account Prohibitions in Section 11(a)**

Section 11(a), adopted as part of the Securities Acts Amendments of 1975 ("1975 Amendments"), bars a national securities exchange member from executing certain securities trades on the floor of the exchange(s) to which it belongs. As discussed below, Section 11(a) was designed to address Congress' concerns about the conflict of interest then thought to be inherent with the combination of money management and brokerage.

Section 11(a)'s managed account prohibitions apply to exchange member firms' own accounts, their associated persons' accounts and institutional accounts over which the member or its associated persons have investment discretion ("managed accounts"). Section 11(a) does not prohibit investment managers from executing trades for managed accounts in the OTC market or on foreign securities exchanges.

Pursuant to a rule promulgated under Section 11(a) by the Securities and Exchange Commission ("SEC") in 1978 -- Rule 11(a)2-2T -- exchange member firms engaged in investment management, directly or through affiliates, are permitted to perform some brokerage functions with respect to managed accounts' trades. They must retain independent floor brokers, however, in order to execute those trades on behalf of their institutional managed accounts.

**II. General Discussion of the Reasons Why The Managed Account Prohibitions in Section 11(a) Should Be Repealed**

SIA strongly supports legislative efforts to repeal the managed account prohibitions in Section 11(a). While the prohibitions were thought necessary when implemented, SIA believes they are no longer appropriate or necessary.

The 1975 Amendments were the most comprehensive changes to federal securities regulation in over forty years. The legislation addressed perceived problems with institutional exchange membership and related issues through measures including the following:

- 1) the elimination of fixed commission rates (resulting in sharply reduced institutional rates);
- 2) the modification of exchange rules so that all qualified broker-dealers could join an exchange on a non-discriminatory basis; and
- 3) the creation of a national market system under the SEC's authority, resulting in expanded electronic access to exchange floors.

The changes in the 1934 Act resulting from the SEC's broad rulemaking authority it was granted in the 1975 Amendments led to major economic and structural changes in the markets in the mid- to late-1970's and after, largely reducing the potential for conflict between brokerage and money management functions and thus greatly diminishing the need for Section 11(a)'s trading restrictions. Some of these changes are discussed in the following paragraphs.

First, non-exchange members are no longer at a competitive disadvantage compared to exchange members with respect to management of institutional accounts because membership on all exchanges is now available to any qualified broker-dealer, including affiliates and subsidiaries of any institutional investor. Also, general availability of current last sale and quotation information, access to automated execution systems for small orders and electronic linkages between and among markets eliminated whatever unfairness existed for non-exchange members prior to the 1975 Amendments.

Second, because commission rates are relatively low in all markets for institutional investors, firms executing trades for institutional clients can seek the best execution of those trades within the national market system and no longer need to direct these transactions to alternate markets in order to recapture commissions.

Third, the ability to negotiate commission rates and the close monitoring of institutional trades has significantly reduced any potential conflicts of interest resulting from the combination of money management and exchange membership. As seen in the OTC market, broker-dealers cannot successfully charge high commission rates for trades for institutional accounts managed by them or their affiliates.

Finally, Section 11(a) does not restrict the execution of OTC trades by broker-dealers for their own or their affiliates' accounts or for advisory clients. Yet the absence of the managed account prohibitions has not led to abuses in the OTC market, as both broker-dealers and their affiliated investment managers are subject to a broad array of other fiduciary obligations. These fiduciary obligations also would apply to broker-dealers and their affiliated investment managers with respect to transactions in exchange-listed securities.

### III. History of Section 11(a)

#### **A. Market Operation Before 1975**

The "institutionalization" of the securities markets had begun in the late 1960's. Prior to 1975, exchange memberships and access to the exchange floor had been limited strictly in

order to prevent institutional investors from avoiding fixed commission rates by executing their own trades on exchanges. Congress and the SEC determined that, absent Section 11(a)'s restrictions, investment managers might have an incentive to manage accounts in order to generate brokerage commissions for their affiliates, given the structural climate at the time.

Both fixed commission rates and exchange membership restrictions created a distinct competitive edge to exchange members. Further, the NYSE and possibly other national exchanges permitted their existing members to engage in money management, creating even more of a competitive disadvantage for non-exchange-member money managers. An exchange member could increase the performance of its managed accounts by reducing its management fees, while continuing to profit from the fixed commissions charged for executing transactions for those accounts.

Before the 1975 Amendments, in order to carry out their fiduciary responsibilities as money managers -- including obtaining best execution on client transactions -- and to avoid the comparatively high fixed-commission cost, institutional money managers resorted to a number of practices to attempt to recapture a portion of the high fixed-rates, including:

- o Executing transactions in the OTC market (where commission rates were negotiable);

- o Attempting to join regional exchanges;
- o Attempting to obtain rebates on orders executed by other firms on the exchanges; and
- o Buying exchange-listed securities from non-member broker-dealers on a net price basis to avoid exchanges' fixed rate commissions (i.e., the "third market").

**B. Adoption and Repeal of Rule 19b-2 Under the 1934 Act**

The SEC tried to respond to the market distortions caused by limited access to some exchange memberships by restricting membership on all exchanges to those broker-dealers which conducted a principally public business. The SEC adopted Rule 19b-2 under the 1934 Act in 1973, which required each member of an exchange "to have as the principal purpose of its membership the conduct of a public securities business." A member was said to fulfill the "public purpose" requirement if at least 80% of its transactions were effected for persons other than "affiliated persons", or consisted of specified transactions.

Effectively, Rule 19b-2 allowed existing exchange members to continue conducting business for their managed accounts.

However, broker-dealer affiliates of institutions that had succeeded in joining certain regional exchanges, the principal exchange business of which consisted of transactions for affiliated institutions, were severely disadvantaged. Rule 19b-2 was criticized highly by both the House and Senate, which concluded that Section 11(a) should be amended. Rule 19b-2 was rescinded 18 months after the adoption of the 1975 Amendments.

#### C. Adoption of Section 11(a)

Congress adopted the managed account prohibitions in Section 11(a) in 1975 as part of a comprehensive package designed to ease the industry's transition away from fixed commissions and limited access to exchange membership. According to Senate Report 94-75 (April 14, 1975) and House Report 93-1476 (November 19, 1974), the Committees adopted the approach taken in the 11(a) amendment for the following reasons:

- o The Senate Banking Committee determined that competition between money managers had been harmed because the membership rules of the various stock exchanges were discriminating between firms in very similar businesses, and gave exchange members who wanted to enter the money management business a distinct advantage over managers unable to join exchanges;

- o The same Committee also regarded the practice of directing order flow to regional exchanges for the purpose of recapturing commission dollars inconsistent with the development of a national market system, as called for in the 1975 Amendments;
- o A House Committee decided that institutions had become the dominant investor force in the marketplace and that, by virtue of their size and ability to obtain services and preference to others, institutions were able to gain unfair advantages in the marketplace; and
- o Both House and Senate Committees decided that fixed-commission rates had created or aggravated conflict of interest problems stemming from the combination of money management and brokerage in entities under common control.

**D. Adoption of Rule 11a2-2(T)**

In 1977, the Commission adopted "temporary" Rule 11a2-2(T) under the 1934 Act ("Rule"). The Rule, still in effect today, permits exchange members to "effect" transactions otherwise prohibited by Section 11(a) if the trades are "executed" on an exchange floor through a member which is not an associated person of the initiating member, under certain conditions, including disclosure to clients regarding execution practices.

The SEC adopted the Rule because it was concerned that the 1975 Amendments were having and would have unintended and undesirable effects in light of the changes in the markets since their enactment. One of the Rule's main goals was to equalize the competition between exchange-member and non-exchange-member money managers. The SEC also was concerned that Section 11(a) might result in inefficiencies in the order process.

Under the Rule, the SEC construes the term "effect" to include all transaction services except on-the-floor execution. Exchange members are permitted to perform all brokerage functions in connection with exchange trades for institutional managed accounts other than the trades' execution. As a result, to comply with Section 11(a)'s managed account prohibitions, exchange members need to have an independent broker -- termed a "two-dollar broker" -- to execute transactions for such accounts on exchange floors.

**IV. Discussion of Compliance and Quality of Trade Execution Problems and Unnecessary Costs Results from the Managed Account Prohibitions' of Section 11(a)**

**A. Unnecessary Expenses**

In 1987, SIA conducted a survey to determine the costs of the managed account prohibitions in Section 11(a) to the securities industry. To estimate these costs, SIA surveyed ten NYSE members engaged in the investment management business, either directly or through affiliates. Of the ten firms, diverse in size, several are large broker-dealers, while others rank among the top 100 managers of tax-exempt assets or offer a complex of mutual funds.

The survey results showed that the managed account prohibitions in Section 11(a) cost the industry between \$200 and \$250 million in 1986 and 1987. The costs are primarily associated with the required use of independent brokers on exchange floors. These funds are paid directly by exchange members or their affiliates which provide investment management services. Indirectly, of course, the costs are borne by institutional managed accounts and, inevitably, the pension holders and mutual fund investors whose funds are being managed by investment management firms.

If Section 11(a)'s managed account prohibitions are eliminated, and exchange members are permitted to execute trades themselves for their own and their affiliates'

institutional managed accounts, there would be certain new additional expenses that these firms may incur, including the costs of additional floor brokers and/or leasing exchange seats. Nevertheless, SIA's study concluded that net savings in floor brokerage resulting from the repeal of the Section 11(a)'s managed accounts prohibitions would be substantial.

#### **B. Additional Compliance Requirements**

Exchange-member money managers incur administrative and compliance burdens resulting from Section 11(a)'s trading restrictions. Among other things, firms must determine, on an extremely short timeframe, the Section 11(a) status of their various managed accounts to indicate to their trading desks whether a particular order or percentage of an order is on behalf of an account subject to Section 11(a)'s prohibitions (and thus must be executed by an independent floor broker) and must respond minute-to-minute to their floor brokers' questions regarding the status of these orders. In today's fast-paced marketplace, any amount of time which unnecessarily delays a particular trade may very well negate the benefit of that trade for the particular investor.

#### **C. Negative Results on Quality of Trade Executions**

In addition to the monetary costs and administrative and compliance burdens resulting from Section 11(a), the managed

account prohibitions also have a negative effect on the way brokerage services are rendered to institutional accounts managed by exchange members or their affiliates. Section 11(a) prevents exchange members from exercising their independent professional judgment as to how and when to achieve executions of exchange transactions for their managed accounts or those of affiliates. Instead, such exchange members are forced to give that responsibility to independent floor brokers. Thus, Section 11(a) diminishes the ability of institutional clients to hold exchange members and their advisory affiliates accountable for the quality of the execution services provided to such clients.

Indeed, the required use of independent floor brokers for the trades of institutional managed accounts compels exchange members to take special steps to avoid competing with their own managed accounts for trade executions. This problem occurs because these investment managers are forced to execute trades through unrelated exchange members for institutional managed accounts, while the investment manager is free to execute trades through an affiliated exchange member for individual advisory accounts [not covered by the Section 11(a) managed account prohibition].

#### V. Conclusion

SIA believes Section 11(a) is no longer necessary to

enhance fair competition and that compliance with Section 11(a) creates unnecessary costs and inefficiencies in the order process. Further, Section 11(a) creates an incentive to trade off the exchanges because the provision does not apply to trades on the OTC market. We urge the Subcommittee to take a very important step toward market efficiency and repeal the managed account prohibitions in Section 11(a).

Again, I would like to thank you, Chairman Markey, for giving us the opportunity to share our views on this issue that is so important to our industry.

Mr. MARKEY. Thank you, sir, very much. Our second witness, Mr. Zicklin, Managing Partner from Neuberger & Berman. When you are ready, please begin.

**STATEMENT OF LAWRENCE ZICKLIN**

Mr. ZICKLIN. Thank you, Mr. Chairman. My name is Lawrence Zicklin and I am the Managing Partner of Neuberger & Berman in New York.

We have been making investment decisions for institutional accounts for more than 40 years and for individual accounts for over 50 years. Neuberger & Berman currently has under management investments valued in excess of \$25 billion.

I am pleased to be able to testify today in strong support of H.R. 616, a bill to repeal the managed account restrictions of section 11(a) of the Securities Exchange Act of 1934. The concerns for which 11(a) was originally enacted are now either obsolete or addressed by other statutory protections. Indeed, the managed account provisions of section 11(a) have become a significant and costly burden on the investment management industry without any compensating investor benefits.

Section 11(a) prohibits exchange members from effecting transactions for their managed institutional accounts on a national securities exchange. Effectively this prohibition requires us to channel our exchange business through unaffiliated broker dealers and to execute trades for our managed accounts through unrelated firms.

These section 11(a) constraints were enacted in 1975 primarily to prevent money managers from reaping the benefits of becoming exchange members, and secondarily to reduce potential conflicts of interest resulting from the combination of money management and brokerage functions. However, these section 11(a) constraints have been rendered obsolete by the regulatory market and statutory developments since 1975.

These statutory, regulatory, and market developments include:

In January, 1975, before enactment of the 1975 Amendments the Securities and Exchange Commission eliminated fixed commission rates, resulting in dramatically lower negotiated rates. Therefore there was no longer a need to direct orders to inferior markets in order to lower commission costs.

Shortly after enactment of the 1975 Amendments, the Commission opened exchange membership to all qualified broker dealers, thereby permitting membership by the affiliated broker dealers of institutional investors and eliminating their potential competitive disadvantage.

In March, 1978, Rule 11(a)2-2T permitted exchange members to effect transactions from managed accounts as long as independent brokers executed the trades on the exchange floor. By requiring the affiliated brokers to obtain written authorization for managed accounts and to disclose transaction related compensation, the rule addressed conflict of interest concerns behind section 11(a).

The Investment Company Act of 1940, the Employee Retirement Income Security Act—the ERISA Act—of 1975, and Federal and State banking and insurance laws and regulations all imposed fiduciary obligations on money management and brokerage professionals.

Technological advances including general availability of current, last sale, and quotation information, access to automated execution systems for small orders, and electronic linkages between and among markets have eliminated inequities that put non-exchange members at a disadvantage before 1975.

Unfortunately, section 11(a) managed account restrictions are not simply unnecessary. They are inefficient and costly to an industry whose hallmark is efficiency and for whom profits are often calculated in basis points.

Surveys conducted by the Securities Industry Association reveal that section 11(a) prohibitions cost the industry between \$200 million and \$250 million in 1986 and 1987. New York Stock Exchange figures for 1989 and 1990 put the section 11(a) costs at between \$335 million and \$409 million in 1989 and between \$233 million and \$285 million in 1990. Such costs can conceivably be justified if there was some benefit to the managed account constraints of section 11(a). There are none.

Indeed, the restrictions are anachronistic and costly. Fair competition among money managers and efficient execution of transactions for institutional accounts have been achieved by other statutory, regulatory, and market developments.

The restrictions of section 11(a) that target transactions executed for institutional accounts on national exchanges also result in market inefficiencies because these constraints do not apply to the over-the-counter markets or foreign securities exchanges or to the execution awarded for individual accounts.

Because of the section 11(a) restrictions for institutional accounts, many individual orders in the same security must be executed by third party independent brokers both for efficiency's sake and for fiduciary reasons. The regulatory treatment of all institutional transactions should be comparable, thereby avoiding distortions and inefficiencies.

We support provisions in the legislation that would require prior authorization for engaging in the practice of using an affiliated broker and that require disclosure of compensation provided to such affiliated brokers. This disclosure coupled with the sophistication of institutional clients and their consultants should provide adequate protections against potential conflicts of interest and should enable institutional investors to hold their investment managers accountable for the quality of their total performance, which includes execution services.

Finally, I would like to assure the members of the subcommittee of the breadth of support for this legislation. There are hundreds of investment management professionals and dozens of investment management firms that will experience regulatory relief when this measure is enacted. These fiduciaries operate out of all major American cities on behalf of thousands of institutional clients.

Thank you, Chairman Markey, for giving me the opportunity to express these opinions.

Mr. MARKEY. Thank you, sir, very much.

That concludes the opening statements of the witnesses.

Let me recognize the gentleman from California for any questions which he may have.

Mr. MOORHEAD. Thank you, Mr. Chairman.

Mr. Gottlieb, your testimony says the fees are currently being paid directly by the investment managers and then indirectly they are being paid by the public.

I support the elimination of unnecessary costs on business but I would like to see some of the savings your firms will realize passed on to the customers.

Do you think that is possible? How would you suggest that Congress express this particular desire that investors share the benefits of cost savings?

Mr. GOTTLIEB. I appreciate your concern, Congressman.

Let me respond in a couple of ways.

First, I think there is an inherent argument being that this regulation is unnecessary and superfluous. Our goal should be to maximize efficiency and I think even for no other reason other than that I would urge that the provision be repealed, but I think, more to the point of your question, history has demonstrated that given the competition in our industry, and I point to the dropping of fixed commissions in 1975, that competition has demonstrated the historical result that fees have dropped, that commissions have dropped, and it's my belief that with the repeal of this provision and the cost savings to the industry competition will naturally result in a lowering of fees to customers and will also provide a benefit for participants in pension plans as well as mutual funds that currently have to pay the load in connection with these provisions.

Mr. MOORHEAD. A lot of the reduction fees have been because of these folks that advertise that they will, their prices are 'way below everyone else, they can handle your stock transaction probably without advisory services that so many of the larger firms have but they can do it, if you know what you want to buy, for a much lower price. Don't you think that's basically it?

Mr. GOTTLIEB. Well, the wonderful thing about competition is that it has the effect in all services being provided given the number of firms that are offering advisory products at this point, and that number still continues to grow, I'm confident that the competitive urges will cover the full gamut of services being offered to the public.

Mr. MOORHEAD. If this legislation is passed, will investment managers still use floor brokers? Under what circumstances?

Mr. ZICKLIN. I can take that, if you like.

Mr. MOORHEAD. Yes.

Mr. ZICKLIN. The extent that the floor remains the marketplace, I don't know how long that is going to last. There will be floor brokers used. The question is whose floor broker will be used. It will either be the firm's or the traditional two-dollar broker.

I suspect in many cases the two-dollar broker will continue to be used or the two-dollar broker will be retained by the investment manager to act on behalf of the investment manager.

Mr. MOORHEAD. What's a \$2 broker?

Mr. ZICKLIN. It's a misnomer. A \$2 broker is a independent person who executes orders on the floor. Historically it was done for two dollars a hundred. It is far less than that now as the intense competition has brought it down to 60 or 70 cents a hundred or sometimes below that.

Mr. MOORHEAD. I'm sure that people are the most competent people in the world but if you just watch the action down there, it looks like a zoo. You wonder how they ever keep it up hour after hour. Tough job.

Mr. ZICKLIN. You have to watch them one at a time, rather than the mass.

Mr. MOORHEAD. How could a fiduciary justify paying additional fees to an outsider once he is permitted to do the trade with an affiliate?

Mr. ZICKLIN. This is a very competitive industry. The fiduciary will act in a manner that is both competitive in order to earn his fee and in a manner to justify the total return that he's promised the client.

Remember, every fiduciary that is acting as a money manager is judged ultimately by the results he secures for that client. If he secures the proper result, he is re-hired. If he doesn't, he's gone, and therefore you find the proper people to act in your behalf, whether they be your own executor's orders or independent executor's.

Mr. MOORHEAD. You know, I have no further questions but I want to say I really appreciate your both coming in today. It's obvious that there is no great disagreement about the need for this legislation, but as the chairman has said, it's very important that we do have a record that is established and other than just our own feeling that it is in the best interest of everyone involved. We get people like you that know the industry and know what is going on to come and help us fill the record. Thank you.

Mr. GOTTLIEB. Well, I thank you, and just let me add that it is an honor for me, I'm sure for both of us, to be here.

This is a crucial process. It's important to all of us and the honor is ours to be here and we thank you for listening.

Mr. MARKEY. The gentleman's time has expired.

I assure you that each and every one of us feels as though it is an honor to work on the Robert Pozen Memorial Securities Act of 1993, and if none of us ever see it again or hear of it again, it will be an honor we can all look at in the rear view mirror, you know—never to be reflected upon again.

Let me ask this, Mr. Zicklin, in your written testimony you note that section 11(a), managed account restrictions result in market inefficiencies because, quote, "these restrictions don't apply to over-the-counter markets to foreign securities exchanges."

Could you explain the market inefficiencies—

Mr. ZICKLIN. Sure.

Mr. MARKEY.—which are created and how the national market is hurt by it.

Mr. ZICKLIN. Let me give you just one example.

A money manager manages an institutional type account and what we call a "natural account." Let's assume he wanted to buy \$100,000 XYZ shares. He's first got to investigate how many shares are 11(a) and how many are non-11(a).

He then theoretically could enter the non-11(a) through our own process while the 11(a) would have to go through an independent broker. Well, you are not going to do that because you are not going to have two orders competing on the floor on the same side thereby creating more demand than ordinarily would be and com-

Again, thank you very much for enabling me to be a part of this effort. If you have any further questions, please do not hesitate to contact me.

Sincerely,

PAUL GOTTLIEB, *Chair, Investment Adviser Committee.*

Mr. MARKEY. Mr. Zicklin, as you note in your written testimony, the original rationale for 11(a) managed account provisions was Congressional concerns of breaches of fiduciary duties by money managers such as churning of their managed accounts for commission income.

How large a role has the demise of fixed commission rates played in eliminating the competitive distortions? Has it eliminated the distortions between exchange member and non-member money managers that gave rise to the managed account restrictions in the first place?

Mr. ZICKLIN. I think since any competitor has the ability to join a national securities exchange, I think you now really have an equal playing field. To the extent people don't want to join, it's because they have no economic reason to join and find no economic reason to do so. Otherwise, I think the playing field has been levelled.

Mr. MARKEY. Do you agree with that, Mr. Gottlieb? There's no real difference?

Mr. GOTTLIEB. I would basically concur.

Mr. ZICKLIN. I think the evidence is Fidelity. Years ago when this was first enacted by recollection is Fidelity was not a member. Fidelity deemed membership advisable and therefore joined.

Mr. MARKEY. How important was unfixing the rate?

Mr. ZICKLIN. I think it was critical. I think once commissions were "unfixed," to use your terminology and membership were permitted, everything else was superfluous. The game was over.

I think for 18 years we have had this anachronism going on artificiality. I think it's time it ended.

Mr. MARKEY. OK, and let me ask this finally to both of you.

Some academic experts have suggested that the existence of minimums of one-eighth of a dollar introduces inefficiencies that make possible certain controversial trading practices such as payments for order flow.

Does the same logic that made the managed account restrictions unnecessary also apply to that situation? In other words, if the fixed rate of one-eighth of a dollar were replaced with a decimal system, would that reduce the potential for conflicts of interest that money managers today may confront in accepting payments for order flow?

Mr. ZICKLIN. I don't know if it would reduce that conflict but I think that anything that makes the markets more efficient we would vote for and if we could get 12.5 cents down to 6.25 cents from the point of view of our clients, it would be a much more efficient system.

I think that's where you have seen the electronic systems handled now.

Mr. MARKEY. Mr. Gottlieb.

Mr. GOTTLIEB. I agree—

Mr. MARKEY. "I concur—"

Mr. GOTTLIEB. "Completely." My very words.

Mr. MARKEY. It takes all the fun out of it, know what I mean? There should be somebody completely disagreeing saying—we can't find anyone.

Mr. ZICKLIN. We could suggest other legislation if you like.

Mr. MARKEY. Well, I think that we might have a couple of other questions that we would submit to you for the record, if we could and would ask for there to be a rapid written response to the questions but I don't think there is any controversy between the majority and minority on the subcommittee on the subject, and I think as a result we can process this legislation very quickly, which is our intention.

We would like to work with you as we are moving along to flesh out the legislative record and ensure in fact that we are giving proper instructions to the SEC and to the marketplace.

With that, we thank you very much for your participation. We thank you for coming down to help us today.

Mr. GOTTLIEB. Thank you very much.

Mr. ZICKLIN. Thank you for having us.

Mr. MARKEY. The hearing is adjourned. Thank you.

[Whereupon, at 2:45 p.m., the hearing was adjourned.]



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