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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Telecommunications, Consumer Protection and Finance

of the

Committee on Energy and Commerce

House of Representatives

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I appreciate this opportunity to present the views of the Federal Reserve on regulation of the market for Treasury and Federally sponsored agency securities. My remarks will be relatively brief, Mr. Chairman, because your Subcommittee is already well informed about the developments that have prompted consideration of the need for formal regulation of these markets. By way of background, however, I should emphasize two points.

First, the problems that have arisen recently have not substantially affected the core of the government securities market -- that is, the dealers accounting for the bulk of trading activities, engaging more or less continuously in market-making, and participating regularly in the distribution of new Treasury securities. Consequently, the market has continued to function with a high degree of efficiency and liquidity.

Second, the failure of some dealers operating at the periphery of the market, both in recent months and in earlier

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incidents, did have severe adverse repercussions for some customers. The insolvency of a number of thrift institutions was precipitated, while other institutions involved in financing or servicing the fringe dealers were placed in some jeopardy. In our highly interrelated and interdependent financial markets, these developments carried at least the seeds of more widespread systemic problems.

In reviewing these circumstances, we have concluded that legislative authority providing for registration, appropriate record-keeping, and inspection of those representing to deal in government and federally sponsored agency securities is desirable, and certain minimal regulatory authority should be provided with respect to certain trading practices. We also believe, however, that the legislation should be framed in a manner to avoid unnecessarily detailed and costly regulation and supervision--that the mandate given to the regulatory body or bodies should provide only limited powers directly related to the integrity of trading practices.

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As you know, the Federal Reserve already exercises a degree of surveillance over the government securities markets as an integral part of our responsibilities for conducting open market operations, for monetary policy, and for acting as fiscal agent in the sale and transfer of Treasury and certain sponsored-agency debt. That surveillance activity has centered particularly on the so-called primary dealers--those with whom we have (or are contemplating) a business relationship. It is aimed in the first instance at informing ourselves of the financial condition of our counterparties in transactions. That surveillance also encourages the maintenance of liquid markets for our open market operations and the Treasury's sales of securities.

Rather close surveillance of those with whom we deal--the 36 so-called primary dealers--is a natural outgrowth of our business relationship. It has appeared to work effectively, and is not dependent on legislation. In all our considerations of the need for legislation, we, the Treasury, and the SEC, have assumed this surveillance of the primary dealers by the

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Federal Reserve will be maintained in essentially the current mode.

While the primary dealers account for the bulk of dealer participation in the government and "agency" markets, activities of others have apparently been expanding. In response, the Federal Reserve began to gather data, on a voluntary basis, from dealers with which we do not trade. We have taken other steps, such as suggesting capital adequacy guidelines and educating investors and lenders in appropriate techniques, to protect the integrity of the marketplace.

However, developments also suggest the inherent limitations of such a voluntary approach. The Federal Reserve has no authority over the "fringe" dealers, cannot examine them, and does not have a business relationship with them. Under those conditions, a dealer wishing to avoid official scrutiny or surveillance can do so. Consequently, our present approach, for other than primary dealers, cannot be counted on to minimize fraudulent behavior or excessive risk-taking at the expense of third parties. Indeed, a purely voluntary surveillance

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program runs the risk of seeming to offer more assurance to customers of these dealers than in fact it can deliver -- a position in which we do not wish to find ourselves.

The SEC has reviewed with you steps taken by other regulatory and advisory bodies and investors to help further assure the integrity of the marketplace. These steps are constructive, and if maintained, will certainly help greatly to guard against a repetition of recent problems. We support those efforts.

At the same time, we recognize that, contrary to our own earlier expectations, this kind of market and regulatory response after previous problems materialized did not prove fully adequate. Nor can new legislative authorities or regulatory approaches provide assurance against all fraud, excessive risk, or new weaknesses in trading practices. Nonetheless, we now believe the balance of consideration does point to a more formal process of registration, inspection, and regulation for all government securities dealers, provided such official intrusion is limited only to areas at the core of our concerns.

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The potential costs of highly detailed and expansive regulations are real. We want to preserve the extraordinary liquidity and resiliency of the largest financial market in the world. Those characteristics help make Treasury securities a unique investment vehicle for both domestic and foreign holders, and an efficient market is essential both to the Treasury in selling its securities and to the Federal Reserve in conducting monetary policy. We want to preserve free entry and to avoid imposing heavy operating costs. Registration and rule-making need not deal with the complexities of other markets involving many different issuers and less standard financing instruments.

In our view, any structure of regulation for the Treasury market should embody--and be confined to--three principal elements.

First, it should provide for registration of dealers and for authority to bar or limit the participation of those who, through violations of securities laws or otherwise, have clearly demonstrated that they should not be allowed to occupy a position

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of trust in the government securities markets. While a registration requirement can raise difficult issues, including the necessity to define a dealer, it is important that those who have been disciplined in other markets not be allowed to find refuge in trading government securities--the very securities investors turn to for assurance of relative safety and liquidity.

Second, registration implies the need for certain minimum guidelines for record-keeping and auditing so that continued adherence to the standards established for registered dealers can be monitored. To assure the accuracy of these reports and conformance to standards, legislation should include the authority to inspect registered dealers on a regular basis and when problems are suspected.

Finally, there should be some mechanism for writing and enforcing rules to foster the financial soundness of government securities dealers and to encourage, in a limited area, market practices consistent with the safety and efficiency of the

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market. Obvious cases in point are guidelines with respect to capital and such practices as the collateralization of RP's. Legislation might permit regulation of certain other practices--such as appropriate margins or when-issued trading--if needed, but authority should be confined to areas that involve a direct threat to the integrity of the marketplace.

Inevitably, even such limited regulation as we would contemplate would entail some costs. There would be expenses arising directly out of the process of writing, enforcing, and complying with the regulations. These would be borne by dealers and their customers in a manner that is not easily identified. But these administrative costs would appear to be quite modest, relative to the size of the market. Provided the basic efficiency and liquidity of the market is not impaired, interest costs should not be affected. It is concern over the latter possibility that militates against the degree of regulation characteristic of other securities markets. Within the limited framework proposed, regulation could reinforce the performance of, and confidence in, the market.

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Failure to regulate may itself have costs. Savers and taxpayers in Ohio and Maryland can testify that difficulties in the Government securities market can have costly repercussions beyond the parties directly involved in the securities transactions themselves. More generally, loss of confidence as a result of failures in sectors of the market could affect other soundly operated, capitalized, and financed dealers, and potentially affect trading conditions generally.

With respect to the specific structure of rulemaking and oversight, we believe that the approach of HR 2032 would point to overly detailed regulation. We have sympathy for the concept of using a self-regulatory organization to write rules and of employing existing regulatory bodies or SROs to enforce them. However, we do not believe the Municipal Securities Rulemaking Board (MSRB) provides an appropriate base for such an entity. Its traditions and methods of approach are inappropriate to the government securities market, and the grant of authority provided by HR 2032 is

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overly broad. We also question whether the SEC, acting alone, is the most suitable agency to exercise ultimate oversight authority over the market for Treasury and sponsored-agency securities.

There are large differences between the tax-exempt and taxable government markets. The former deals with a multitude of issuers of varying credit quality, underwriting is usually done by syndicates of dealers with securities frequently awarded on a negotiated rather than competitive bid basis, and a much higher proportion of final sales are to relatively small individual investors. Those circumstances may well warrant a comprehensive set of regulations governing many aspects of dealer behavior, as the MSRB has issued. But those regulations, by and large, do not provide an appropriate starting point for regulating the government securities market, and would, in fact, impose unnecessary and excessive burdens. For example, in the context of the limited number of issuers and issues and the sophistication of customers in the Treasury and agency markets, detailed rules in such areas of MSRB concern as

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customer suitability, competitive practices and dealer education do not appear necessary. On the other hand, the MSRB has no experience in regulating RP's--a first priority of rulemaking in the Treasury market--since this form of financing is not so commonly used in the municipal market.

If an SRO were to be established as the appropriate rule-making body for the government and agency securities markets, we believe its responsibilities should be limited to those unique markets. Moreover, the Federal Reserve has a body of expertise and substantive concerns that, in our view, suggests more than a consultative role in overseeing an SRO. The interests of the Treasury and SEC would also need to be taken into account.

Last week, Chairman Shad described to you a proposed regulatory structure emerging from discussions among the Federal Reserve, Treasury, and SEC. That approach provides an acceptable alternative framework to an SRO. The elements we consider essential for legislation are included: registration; inspection; and provision for limited regulation of financial

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standards and key market practices. Properly implemented, the principal benefits of regulation could be captured at low cost.

Some legislative proposals would empower the Federal Reserve to inspect and enforce regulations for primary dealers. We will in any event need to continue our surveillance of all primary dealers through the Federal Reserve Bank of New York, and I do not believe we need any new or special legislative base for that effort. We will continue to insist that primary dealers play an active role in Treasury financing operations and will continue to collect data from them that we need on a regular and frequent basis. And we would anticipate that they will continue to meet high financial standards, even beyond those required of other dealers.

In conclusion, Mr. Chairman, the Federal Reserve supports legislation providing for registration, inspection, and limited regulation of dealers in government and sponsored-agency securities. However, we share the concerns expressed by

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others that HR 2032, as drafted, does not provide an appropriate framework for such regulation.

We do find the joint Treasury-SEC-Federal Reserve plan acceptable for these purposes. We do not exclude the possibility that other regulatory structures--including a SRO rule-making body--could work as well, or even better.

We would, of course, be glad to work further with the Subcommittee in developing these concepts into appropriate legislation.

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