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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

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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. Indeed, you and your colleagues have played a leading and very valuable role through the years in exploring the difficulties that have arisen in these markets and the efforts of the Federal Reserve and others to deal with them.

Recently, in testimony before another Subcommittee of the House, I set forth the basic position of the Federal Reserve on the need for regulation of the market for Treasury securities. We have concluded that legislation providing for registration, inspection and limited regulation of government security dealers would be desirable.

In arriving at this conclusion, we have noted the recent problems have not substantially affected the core of the government securities market -- that is, dealers accounting for the bulk of trading activity and market-making and participating regularly in the distribution of new Treasury securities. The market has continued to function with a high degree of efficiency and liquidity.

We also recognize that any regulation inevitably involves additional costs for at least some of the participants in the market. However, we believe that legislation can and should be framed in a manner to avoid unnecessary detailed and costly regulation and supervision -- that the mandate given to the regulatory body or bodies should provide only limited powers directly related to protecting the integrity of transactions in the market.

Moreover, as depositors and taxpayers in Ohio and Maryland can attest, there have been considerable costs growing out of recent market weaknesses, extending even beyond losses to the parties directly involved in government securities transactions. While regulation will not and can not avoid all potential losses from fraud or otherwise, we do believe registration, inspection, and some regulation could help reduce the risks to third parties.

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 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 adequacy 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 market. Obvious cases in point are guidelines with respect to capital and such practices as the collateralization of RPs. 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.

Let me underline this last point. The potential costs of highly detailed and expansive regulations are real. Preserving the extraordinary liquidity and resiliency of this market is essential to the conduct of monetary policy and the management of the public debt. Official intrusion into this market beyond that considered absolutely essential to promote its safety and soundness -- for example, imposing on this market the degree of regulation characteristic of other securities markets -- is unnecessary and could impair its basic efficiency and liquidity. Within the limited framework we would propose, costs of regulation would be quite modest relative to the size of the market, and regulation could reinforce the performance of, and confidence in, the market.

The framework we have in mind for regulation could be implemented through a number of different administrative structures to deploy effectively the expertise of the relevant regulatory bodies in the process of registration, supervision, and regulation. One such approach is embodied in the joint proposal developed by the Treasury, Securities and Exchange Commission, and Federal Reserve. That proposal, as you know, provides for registration with the Treasury (or with the SEC, if the preference of that agency were to be adopted), basic rulemaking authority by the Treasury in consultation with the Federal Reserve, and enforcement by banking agencies or by existing self-regulatory organizations (SRO) under SEC supervision, depending on whether the dealer firm is a bank or nonbank. That proposal encompasses all the elements we consider necessary, including limitation on the scope of regulation. Properly implemented, with ample consultation between the Federal Reserve and the Treasury, we would find this approach acceptable.

The two bills under specific consideration by this Subcommittee -- H.R. 2521 and H.R. 1896 -- embody other approaches. Although there are large differences between the two bills in the scope of regulation, both would center the responsibility for registration and regulation in the Federal Reserve.

The Federal Reserve does have a strong interest in seeing that the job of overseeing the government securities market is done well, that the integrity of the marketplace is reinforced, and that regulation not be unduly burdensome. Reflecting those interests, we expect to continue to play a key role in surveillance of the primary dealers with whom we trade. We would also want to work closely with those responsible for registration and rule-making authority generally. We have not felt it necessary or sought, however, to have these latter responsibilities directly under our authority. Alternative arrangements would be consistent with the requirements as we see them.

For instance, an alternative arrangement to the "joint proposal" with some appeal would fit regulation and oversight within a framework of a new SRO for dealers in Treasury and federally sponsored agency issues. The SRO approach would involve directly in the rule-making process those with the fullest knowledge of market practices and the most intense interest in minimizing the burden of regulation. The mandate for rule-writing provided such an SRO should be carefully prescribed and limited. The SRO would, of course, need to report to, and be subject to the jurisdiction of, a federal agency or some combination of agencies. We believe we should participate in that oversight process.

Your bill, Mr. Chairman, H.R. 2521, captures some of the advantages of this approach by creating an advisory council to work with the Federal Reserve, although the council would have no legal responsibility for rulemaking. If rulemaking were in any event narrowly circumscribed by law, an advisory council might serve as an alternative to an SRO.

The bill introduced by Congressmen Dingell and Wirth simply transformed an existing SRO, the Municipal Securities Rulemaking Board (MSRB), by providing it authority over the entire government market. We have opposed this proposal because the two markets -- for federal and municipal securities -- are so different. The authority of the MSRB is considerably broader in scope than we view as necessary, growing out of the regulatory needs of a market with a large number of small issuers, a multiplicity of issues and financing techniques, and small investors. At the same time, the MSRB has no, or little, experience with one of the principal problems in the Treasury market, collateralization of repurchase agreements, since that instrument is not so widely employed in the municipal market. In addition, we question whether the SEC, acting alone, as provided for in the Dingell-Wirth bill, is the most suitable agency for exercising ultimate oversight for the Treasury and sponsored agency market.

With respect to the specific provisions of H.R. 1896 and H.R. 2521, we can see problems with each. The former is too sweeping; it simply grants the Federal Reserve Board authority to regulate government securities dealers without specifying the nature of that regulation or its purpose. As I stated before, in our view any regulatory authority over this market given to any agency should be strictly limited to those market practices that threaten the integrity of the market.

Your bill, Mr. Chairman, is in some respects too narrow. For one, regulation of trading practices appears to be limited to segregation of customer securities and delivery of collateral.

These may be the most obvious issues now facing the market, but I would hesitate to rule out the possibility of problems emerging in other areas. It is for this reason that I would include authority to regulate when-issued trading, and to set margin requirements, with the clear understanding that such authority would not be used unless needed to deal with practices that posed clear threats to the integrity and efficient functioning of the market.

In addition, rules promulgated by the Federal Reserve under your structure would apply only to nonbank, nonregistered nonprimary dealers. Apparently depository institutions and dealers registered with other agencies would be subject to rules of those agencies. But we think the basic rules governing dealer behavior should be applicable, in their essentials, to all dealers. It would seem to us most practical in that context to vest the basic rule-making authority for the dealer market in one federal authority (whether a single agency or some combination).

H.R. 2521 seems to rely on the Federal Reserve to inspect the nonbank secondary dealers, rather than an existing SRO. No matter which authority registers these dealers or writes the rules for their trading practices, I believe routine enforcement could more efficiently be conducted through existing channels. That could be accomplished by having nonbank dealers who are not otherwise registered be inspected by the National Association of Securities Dealers.

In any event, as I have mentioned, we feel it necessary and appropriate to continue our surveillance of all primary dealers through the Federal Reserve Bank of New York. 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. For the reasons indicated, I do not believe the provisions of either H.R. 2521 or H.R. 1896, as drafted, provide a wholly appropriate framework for such regulation.

We do find the joint Treasury-SEC-Federal Reserve plan acceptable for these purposes. At the same time, we do not exclude the possibility that other regulatory structures 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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