Official Surveillance and Oversight of the Government Securities Market

by 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 Securities and Exchange Commission, 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

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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, I should also stress 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 that 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 Securities and Exchange Commission, the Federal Reserve Board, and the Commodities Futures Trading Commission. The entire working group holds a biweekly 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 with 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 participants' 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 that 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