Chairman Fauntroy and Members of the Subcommittee:

Permit me to compliment you for calling these timely hearings, and for the leadership this Subcommittee has provided over the years in addressing problems in the government securities market.

In response to the questions raised in Chairman Fauntroy's letter of June 27th, I would like to begin by summarizing the conclusions of the SEC's June 20th Report on the government securities market, which has been previously submitted to this Subcommittee. It is requested that the Report be included in the record.

Following the ESM and Bevill, Bresler & Schulman ("BBS") failures, the SEC undertook a study, in consultation with the Federal Reserve Board and the Department of the Treasury, to determine whether additional regulations were needed - and if so, the most cost-effective approach.

As this Subcommittee is well aware, the government securities market is by far the world's largest, most liquid and efficient securities market. The dollar volume of trading is about 15 times that of all transactions in corporate securities on all exchanges and in the over-the-counter market. The spreads between bid and asked prices and transaction execution costs are a fraction of those in corporate securities. This highly liquid, keenly competitive, very efficient market is essential to the effective execution of the nation's monetary and fiscal policies.

Also, as Chairman Fauntroy has pointed out, "If regulations were to increase interest rates on Treasury securities by as little as one-tenth of a percentage point, federal net interest expenditures would rise by $2 billion a year" - which is a multiple of the recent alleged losses of less than $600 million - and such losses are before taxes, insurance and civil suit recoveries, if any.

While no regulatory scheme can be expected to eradicate fraud - which the SEC already has the authority to expose and prosecute - better disciplines should deter fraudulent activities.
In conjunction with its study, the Commission obtained extensive written and oral comments from market participants and others. Acting Secretary of the Treasury Niehenke testified at the Commission's open forum that the ESM/BBS failures have not had a perceptible adverse impact on the cost of financing the national debt. Chairman Volcker testified this morning that, "the recent problems have not substantially effected the core of the government securities market" and that, "the market has continued to function with a high degree of efficiency and liquidity."

An area not as yet addressed in these hearings is the prompt and extensive reaction of investors, government securities dealers, federal, state and municipal authorities, the accounting profession and others, to the widely publicized ESM/BBS failures - which have been chronicled on the front pages of the nation's press.

Market participants have a "pocketbook" interest in immediately reducing their exposure to such abuses, at minimum cost to themselves.

The Commission's report states that many investors are:

- Perfecting their security interests in repos;
- Not providing excess margin in reverse repo transactions;
- And are checking the credit of dealers with whom they do business.

And that:

- The Federal Financial Institution Examination Council - which consists of the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Federal Home Loan Bank Board and the National Credit Union Administration - has proposed and the Federal Reserve Board and the Federal Deposit Insurance Corporation have adopted, guidelines which require adequate collateralization.
- The Federal Home Loan Bank Board has re-articulated its investment guidelines for savings and loan associations and is considering additional collateralization, mark-to-market and other requirements.
- The New York State Comptroller, the State of New Jersey and a number of municipalities have issued or are considering collateralization and other requirements.
- The Federal Reserve Board has issued voluntary capital adequacy guidelines, stepped-up its visits to dealers and issued educational materials to investors.
Individual federal reserve banks are holding educational seminars around the country for government securities investors.

The Government Accounting Standards Board and the American Institute of Certified Public Accountants are reviewing repo auditing and disclosure issues.

And the Securities and Exchange Commission has:

- Directed investment companies to perfect their security interests in repos;
- Released for public comment, rules which would require registrants to make greater disclosures of repo transactions and risks;
- Brought actions against ESM, BBS and others, and is investigating several other firms.

Other state and federal law enforcement authorities are also pursuing such cases.

Thus, federal, state and municipal authorities and others have and are responding to the problems posed by the recent failures.

In the light of such responses, the Federal Reserve Board, the Treasury and the SEC differed somewhat in their views concerning the need for federal legislation. The three bodies concluded that if Congress decides that additional legislation should be enacted, they would find the approach summarized on page 3 of the SEC Report acceptable.

As summarized on page 4 of the Report, the Commission indicated that, while it has not conducted a formal cost-benefit analysis, if legislation is to be enacted, the Commission would recommend the following approach.

Briefly:

- Registering with the SEC all unregulated government and agency securities dealers;
- Granting the SEC and the bank regulators authority to sanction or bar those who violate either the securities or the banking laws;
- 4 -

- Granting the Treasury, in consultation with the Federal Reserve Board, authority to adopt capital, independent audit and recordkeeping requirements, as necessary, for the presently unregulate dealers;

- All other dealers, would continue to be subject to the SEC's or the bank regulators' capital and recordkeeping requirements;

- Non-bank dealers would be subject to inspection and rule enforcement by existing self-regulatory organizations, under SEC oversight, and bank dealers by bank regulators.

- Primary dealers would continue to be subject to Federal Reserve Board surveillance.

The Commission favors the foregoing approach over others that would require collateralization of repo transactions; creation of a new self-regulatory organization; or expansion of the Municipal Securities Rulemaking Board ("MSRB") to include the government securities market.

Collateralization is being mandated or encouraged by federal, state and municipal regulators and others, to address the specific needs and interests of those who deal in government and agency securities. An overlay of additional federal regulations would not be cost-effective.

Also, the Commission does not recommend:

- Formation of a new self-regulatory organization because the limited rulemaking required, does not warrant creation of a new regulatory body;

- Nor expanding the MSRB to include government securities because the government and municipal securities markets have very little in common.

If Congress concludes that legislation is necessary, the Commission favors the approach I have just outlined, rather than H.R. 2521, H.R. 1896 or others, because:

- It includes dealer registration and authority to sanction or bar those who violate the banking or the securities laws.

- Additional collateralization, margin and when-issued rulemaking authority is not needed. To the extent that market participants do not adequately address any of these areas, existing agencies have ample authority to do so.
An advisory council seems unnecessary, in view of the daily contacts of the Federal Reserve Board, the Treasury and the SEC with the participants in these market.

After considering alternatives, the Federal Reserve Board, the Treasury and the SEC concluded that Treasury rulemaking, in consultation with the Federal Reserve Board, was an acceptable approach.

And since the dealers that account for the bulk of the transactions in government securities are already, and will continue to be, subject to inspection and enforcement by the SEC and the bank regulators, subjecting them to the Federal Reserve Board's authority as well, seems unnecessarily duplicative.

The Commission has not addressed the need for a Federal Reserve Board study of access to broker screens or of certain other business issues.

Thank you. I would be pleased to respond to your questions.