Testimony of Eugene H. Rotberg
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I

I have four points to make this morning. First, the government securities business is not profitable for most dealer firms. There is, therefore, for all firms, a great incentive to find market aberrations, control supply, and/or find a way to finance positions well below the coupon on the debt. Second, the rules of the Treasury and the tender forms have not been promulgated in the ordinary fashion, and, in certain respects, are not clear and all-inclusive. Third, none of this excuses the activities of Salomon Brothers. Fourth, I will make some suggestions as to what we should and should not do.

First, fewer than ten dealers probably do 90% of the dealer business. The cost for personnel, computers, research and the servicing of clients is high. Moreover, it is not a business where one can rationally expect to profit at the expense of your clients. The financing of positions at costs below the yield of securities purchased is crucial in achieving profitability. The method employed is through "short squeezes." Profitability also depends on order flow and information. Dealers look to achieve a critical mass of information so that they can advise their clients and put in sensible bids for their own account.

The real competition occurs between the professionals in the market. Indeed, few were self-conscious about calling the Treasury and the Federal Reserve immediately after the May 22 "short squeeze." It is a game in which the winners are quite visible -- and the knowledge of the way winning is achieved, whether within the rules or outside, is immediately transparent.

For the major players who have chosen to be active, it is an elitist and a dangerous game where profitability may come from identifying or creating tiny aberrations, in an arcane way, which disappear quickly before competitors, or someone else's client, realizes what has happened. The tighter, more efficient, better the market, the greater the incentive and, indeed, the need to identify the aberration or, at the extreme, unhappily, to create it for a few brief moments. Otherwise, the prestige of being a primary market dealer will not make up for the overhead.

II

The Federal Reserve and Treasury need (though I am sure they would not put it this way) "shelf space." In the United States there are many other financial products with less volatility and risk to brokers and dealers competing for discretionary savings. The authorities require that a primary dealer be there not only in good times or in short maturities. They are also subject to a variety of competing pressures -- which are outlined in my written submission.

The Federal Reserve, understandably, tilts one direction or another, depending on which objective is paramount. They execute their responsibilities through informal dialogue and pressure -- sometimes a great deal -- and, of course, try to fine-tune competing objectives, in part through those famous Treasury rules we have heard so much about.

I am afraid the advantages of the informality has, as its flip side, vagueness and incompleteness. The rules have not been put out for public comment. For example, I doubt whether there has been careful dissemination of what is meant by a "single bidder" in competitive tenders; whether affiliates may or may not be combined, and what is the definition of an affiliate. I think reasonable people might question whether the tender form includes the refinancing positions held on a "when-issued" basis, or what is meant by a "net long" position where there might be a long position in one market, a short position in a second market, options in a third, and a stripped position in a fourth market, and how these are to be combined. Or, more important, how the aggregation can be meaningfully used to effect wise market policy. It also is relevant that anyone -- primary dealer or client -- can legally buy 100% of an issue on a "when-issued" basis before the auction or a few minutes thereafter.

All of this raises questions about the 35% rule. Reasonable people will shrug, call it a rinky-dink form. Others, more aggressive, will try to circumvent even those parts with clear intent. Indeed, I suspect that Salomon Brothers and two clients could probably have cornered the market -- legally, within the rules. That, in turn, undercuts the logical integrity of the 35% restriction. It does not, however, excuse its violation. The tender form, the authority for its use, and the penalties for its misuse, should be clarified, made explicit, and rationalized. Otherwise, the authorities may have to cope with further acts of uncivil disobedience. I must say that one of two most subtle questions involved on this whole matter is why would someone explicitly break a rule when it would be transparent (a) who did it, (b) how and why it was done, and (c) the result to be achieved could have been done legally.

III

Let me say that I do not have all the facts about the Salomon Brothers affair. Clearly, though, the participants wanted to control the supply, and, indeed, they knew they would be so identified. That, by the way, is part of the game. Their actions resulted in a short squeeze. As you can appreciate, if you can earn 3 or 4 percent on billions of dollars, even for a few days, it can result in a very high return on capital. The testimony of previous witnesses has described similar short squeezes. I am advised in this connection that in one of the situations a few years ago, the availability of collateral was so tight, the lenders paid interest -- so great was their need to obtain the underlying security. Indeed, some observers believe that managing the cost of financing through controlling supply, as here, or through other means, is the singlemost important factor in accounting for whatever profitability there is in the business.

If the Treasury is concerned about short squeezes, whatever their intent, they might issue more of the same security immediately into the market. This would, again, have to be done under

formal authority and publicized procedures where the pros and cons would be explored. I think that the resolution of this question involves the second illusive issue. Let me say generally though, it is ludicrous to believe that the U.S. Treasury, an institution which has an unlimited supply of the product, has to worry about price management.

I want to repeat that the fact that the "rules" were not subject to public comment or may not be logical or clear does not excuse their violation. It is the Treasury and Federal Reserve sandbox. It is their product, and if one wants to play in it, the dealers and clients must abide by the rules -- even if they are not elegantly enunciated. And if one does not like those rules and does not have the power to change them, then one should pack it up and take the accumulated earnings and wisdom to the Hamptons, or go into another line of business.

IV

I recommend the following:

1. The Federal Reserve and the Treasury (after public comment) should consider having a "TAP" to make securities available in a form and manner which would prevent short squeezes.

2. Publish rules and guidelines in the Federal Register for comment.

3. Clean up the tender form so that it is unambiguous and meaningful and asks the right questions about the positions of market participants in a disaggregated way.

4. Establish automated procedures so as to permit any customer of size to put in competitive bids electronically.

5. Disseminate price and volume information to the public on a real time basis.

6. Make illegal any communication among dealers for, say, the 15 minutes prior to the auction. I am not sure about this one. I would like to hear public comment.

7. Finally, I would urge a major inquiry -- not an adversarial investigation -- into the operations of the securities markets (including the government securities markets and those of derivative products and financing) similar to the Special Study of Securities Markets conducted in the early 1960s which reported directly to Congress. Periodic grand juries are not the most effective way to make wise public policy into what is going on in the securities markets.

It is particularly important that we not exaggerate the implications of what was done to the market or the extent to which the violations are widespread. I am concerned that we not

overreact and damage a very good market by using the events at Salomon Brothers to make changes which are irrelevant to addressing their actions.

I would not, for example, do away with primary market dealers. Whether the form of "primary market dealer" is retained in the sense of a selected body of designated firms, there is no doubt that some firms will choose to make markets, distribute more securities than other firms, make larger bids at auctions, and will be generally recognized to have better or more up-to-date research and information. These firms will attract the bulk of informed institutional business. But, without the cachet, they will assuredly perform that role more selectively -- particularly in bad times; they will quote wider markets and bid less because they will be aware that the Federal Reserve will no longer have the "right" to call them, and others, and question their lack of commitment. And, certainly, if the Federal Reserve no longer can conduct its open market activities only with such firms, that will assuredly, as a practical business matter, increase their uncertainty and risk and therefore their commitment to the market.

The implications of, say, not covering a Treasury auction are not acceptable. It is not the same thing as when markets disappear because specialists cannot take the pressure on a stock exchange, or the OTC market shuts down, or trading is stopped when limits are reached, or there is no market for hundreds of corporate bonds, except at wide spreads. Even a temporary hiatus of that sort is not acceptable in the U.S. government securities market -- and certainly not during an auction.

Similarly, the borrowing committee provides a window to the market. It lets the U.S. Treasury know what is happening. It is self-policing. The Treasury should not rely, alternatively, on ad hoc, one-on-one conversations with market players. The borrowing committee is continuous and provides a stable body of information, not just to the current Assistant Secretaries, but to the future ones when the current ones leave. It is not related to the events at Salomon Brothers. What happened at Salomon Brothers does not relate to the use of "inside information," or the <u>method</u> by which the U.S. Treasury and the Federal Reserve conduct auctions.

The dealers have also developed a distribution force, both retail and institutional, to finance our government's deficit. That should not be trivialized. Indeed, if I wanted to put great pressure to reduce the U.S. deficit, I could think of no better way to do it than by a few subtle changes in the structure of the U.S. government securities market, which would assuredly make it impossible to finance that deficit, except at excessive cost. As you can appreciate, a deficit which cannot be financed cannot exist.

Thank you.