# The Early Years of the Primary Dealer System

Kenneth Garbade
Research and Statistics Group
Federal Reserve Bank of New York

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The views expressed herein are those of the author and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.

Primary dealer:

A government securities dealer designated, by the Federal Reserve Bank of New York, as eligible to participate in open market operations undertaken by the Bank at the direction of the Federal Open Market Committee.

Order of presentation:

1. emergence of open market operations in the 1920s,
2. origins of the New York Bank's "recognized" dealer program,
3. replacement of that program with the FOMC's "qualified" dealer program in 1944, and
4. abandonment of the qualified dealer program following the Treasury-Federal Reserve Accord of March 1951

# Emergence of Open Market Operations

- no deep, liquid markets for U.S. Treasury securities when Congress passed the Federal Reserve Act in 1913

- situation changed during World War I

- U.S. participation financed primarily with:
  - four large bond issues – Liberty Loans – that traded on the NYSE and
  - certificates of indebtedness (interest-bearing securities that matured in not more than one year) that did not trade in a free market

# Emergence of Open Market Operations

- 18 months after the cessation of hostilities, Treasury officials consented to a free market in certificates
- over-the-counter trading blossomed
- one year later, in 1921, Treasury began issuing notes maturing in one to five years
  - like certificates, traded over-the-counter
- by mid-decade, bonds had also migrated to the OTC market

# Emergence of Open Market Operations

- post-war over-the-counter market for Treasury debt was national in scope
- most of the largest dealers had their main offices in New York
  - maintained close contact with branch offices and smaller regional dealers by telephone and telegraph
- transactions were executed in New York trading rooms, even if the ultimate buyers and sellers were elsewhere

# Emergence of Open Market Operations

- following the end of hostilities, New York Fed began to execute purchases of Treasury securities on behalf of, and at the direction of, the eleven other Reserve Banks
  - undertaken to satisfy the Banks' need for earnings, rather than for any policy purpose
- in the spring of 1922, the twelve Banks formed the Committee on Centralized Execution to coordinate their purchases

# Emergence of Open Market Operations

- March 1923, Federal Reserve Board ordered reorganization of the Committee on Centralized Execution as the Open Market Investment Committee
  - to bring the new policy instrument of open market operations under Board supervision

# Emergence of Open Market Operations

- Great Depression led to:
  - sharp expansion in marketable Treasury debt
    - from $14 billion in mid-1930 to $34 billion in mid-1939
  - comparable expansion of the dealer community
    - which, however, remained centered in New York
  - replacement of OMIC with FOMC

# The “Recognized” Dealer System

- New York Fed executed open market operations exclusively with dealers
  - even while the Treasury was selling bills and conducting buy-backs in public auctions

- why ?
  - 1952 Bank study stated that it was “in the public interest to have a strong dealer market and in the System’s interest to have a strong private market,” so “the System deals with, and does not attempt to step around, the [dealer] market”

# The “Recognized” Dealer System

- New York Fed dealt mostly with eight or nine “recognized” dealers

- chosen informally on the basis of
    1. reputation,
    2. capital,
    3. willingness to make markets and take positions, and
    4. large volume of business of national scope.

# The "Recognized" Dealer System

- July 1, 1939, Robert Rouse hired by New York Fed to replace Burgess
  - who had taken a job in the private sector

- Rouse had worked for twenty years in the government bond department of the Guaranty Trust Co.
  - most recently as one of the department's managers

# The “Recognized” Dealer System

- Rouse discovered that transactions with both recognized and responsible dealers had never been authorized by the Bank’s Board of Directors

- Board resolution formalizing the recognized dealer system followed on November 2, 1939

- same standards as informal system:
  - reputation, capital, willingness to make markets, national scope of business

- same fuzzy boundaries

# The “Recognized” Dealer System

- the nine formally recognized recognized dealers were required to:
  - submit daily activity reports, summarizing their transactions, positions, and financings
  - meet regularly with Bank officials to discuss market conditions
  - keep in touch with Trading Desk staff by phone during business hours

# Advent of the "Qualified" Dealer System

- following U.S. entry into World War II, Fed agreed to cap 3-month Treasury bill rates at ⅜ percent, long-term bond rates at 2½ percent, smooth curve between

- during the war, both Fed and Treasury had an interest in limiting speculative trading
  - Treasury wanted to finance the war with non-marketable bonds, but limiting trading was as close as it could get
  - Fed wanted to limit quantity of bonds it had to buy to maintain the interest rate caps

# Advent of the "Qualified" Dealer System

- mid-1943, Board Chairman Marriner Eccles began to advocate an aggressive regulatory program, including
  - regular examination of dealer books and records,
  - prohibition of predictions that prices were likely to rise or fall because of FOMC actions, and
  - prohibition of transactions effected for the purpose of inducing others to buy or sell

# Advent of the “Qualified” Dealer System

- Allan Sproul, president of the New York Fed, worried that Eccles’ agenda would lead to an expansive regulatory regime
  - because dealers were not the only speculators in the market

- Rouse thought the existing system was adequate and did not entail “responsibilities which the prescription of a definite rule might bring upon the System”

# Advent of the "Qualified" Dealer System

- nevertheless, Eccles' proposal led to the replacement of the Bank's recognized dealer system in February 1944

- the replacement, the FOMC's "qualified" dealer system, had similar standards, but also included requirements to
  - cooperate with the New York Bank and the FOMC in maintaining "orderly" markets and to
  - abstain from encouraging or stimulating "undue activity" in the government securities market

# Advent of the "Qualified" Dealer System

- 11 dealers qualified under the new system
  - 8 previously recognized by the New York Fed and
  - 3 "responsible" (but previously unrecognized) dealers

- 5 other "responsible" (but previously unrecognized) dealers did not qualify
  - largely for want of sufficient capital and/or restricted scope of business

# Expansion of FOMC Supervision

- Eccles subsequently suggested several modifications to and extensions of the qualified dealer system, including:
  - closer supervision of dealer positions,
  - introduction of a program for Federal Reserve Banks to report complaints of dealer violations of the terms and conditions for qualification,
  - limitation of open market operations to agency transactions with dealers, and
  - limitation of commissions to 1/64$^{th}$ of a percent of principal

# Expansion of FOMC Supervision

- June 1946, FOMC agreed to
  - limit open market operations to agency transactions with dealers
  - limit commissions to 1/64th of a percent
  - implement a program of closer supervision of (a) dealer positions and (b) violations of terms and conditions for qualification

# End of the Qualified Dealer Program

- Treasury-Federal Reserve Accord announced on Saturday, March 3, 1951
  - Fed no longer committed to keeping bond yields below 2½ percent
- FOMC began discussing how best to conduct monetary policy in the new era of a free market for Treasury debt

# End of the Qualified Dealer Program

- on matter of expanding the size of the primary dealer community:
  - New York study recognized the competitive disadvantages imposed on non-qualified dealers, but rejected idea of relaxing requirements
    - "no significant gain, and some possible risks"
  - ad hoc subcommittee study aggressively attacked privileged status of qualified dealers, stating that such privilege, if continued, had to be justified
    - wanted a more open system

# End of the Qualified Dealer Program

- additionally, the New York study acknowledged that,

  “there is inherent in the qualification process a limited element of supervisory responsibility”

- but warned against mission creep:

  “It would seem unwise for the Federal Reserve System to undertake an active supervisory influence over the [government secuties market]. The System would be involved in an operation quite apart from its statutory responsibility and it might create an unwholesome mixture of credit control and market administration.”

# End of the Qualified Dealer Program

- March 1953, FOMC approved recommendation that

  "the present system of rigid qualifications for dealers … be abandoned"

  and instructed the New York Fed that

  "henceforth transactions would be carried on with any persons or firms actually engaged in the business of dealing in Government securities"

# End of the Qualified Dealer Program

- within a year, seven new dealers joined the ten dealers then acting as primary dealers

- number of primary dealers remained at seventeen through the end of 1960

# Summing Up

- Federal Reserve officials generally sought to fashion a primary dealer system that was compatible with the existing structure of the government securities market

- took the market as they found it

- did not try to promote or suppress particular activities

- however, during World War II and continuing into the post-war period, System officials installed, in the absence of any statutory authority, an aggressive regulatory regime

END