Treasury-Federal Reserve Study of the
U.S. Government Securities Market

VIEWS OF THE U.S. GOVERNMENT SECURITIES DEALERS

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I. Introduction

This paper summarizes the views of primary dealers in U.S. Government securities concerning various aspects of the markets for Treasury and Federal agency securities. These views were solicited in the spring and early summer of 1966. All of the 20 dealer firms that were authorized to transact business with the Trading Desk of the Federal Reserve Bank of New York (as of the date of the study) submitted written replies to a questionnaire and participated in individual meetings with officials of the Treasury and the Federal Reserve.

The principal topics that were covered included the major factors affecting the performance of the U.S. Government securities market in recent years, major developments in the Federal agency securities market, the extent of participation in both markets by individual dealer firms, Treasury debt management techniques, Federal Reserve and Treasury trust fund operations in the secondary market for longer-term Treasury obligations, and operating techniques of the Trading Desk at the Federal Reserve Bank of New York. Dealers were also asked about their views concerning possible problem areas, specific market practices, trading facilities, and market organization. The dealers made numerous proposals for improving the functioning of the markets for U.S. Government and Federal agency securities.

The dealer firms that replied to the questionnaire and that also participated in individual consultations with Treasury and Federal Reserve officials were the following:

Bank dealers

Bankers Trust Company, New York
Chemical Bank New York Trust Company
Continental Illinois National Bank and Trust Company of Chicago
The First National Bank of Chicago
First National City Bank, New York
Harris Trust and Savings Bank, Chicago
Morgan Guaranty Trust Company of New York
United California Bank, Los Angeles

Nonbank dealers

Blyth & Co., Inc.
Briggs, Schaedle & Co., Inc.
Discount Corporation of New York
The First Boston Corporation
Aubrey G. Lanston & Co., Inc.
Merrill Lynch, Pierce, Fenner & Smith, Inc.
New York Hanseatic Corporation
Wm. E. Pollock & Co., Inc.,
Chas E. Quincey & Co.
D. W. Rich and Company, Incorporated
Salomon Brothers & Hutzler
Second District Securities Co., Inc.

II. Dealer Views Concerning the Performance of the U.S. Government and Federal Agency Securities Markets in the 1960's

A. Major factors affecting the Treasury bond market

Most dealers believed that the secondary market for intermediate- and long-term Treasury securities had deteriorated in the 1960's as compared with the 1950's. The two reasons most often cited for this worsening in market performance were (1) the abandonment of the Federal Reserve's "bills usually" policy in favor of transactions in all maturity areas of the market and (2) the Treasury's introduction of the new debt management technique of advance refundings.

Many dealers suggested that Federal Reserve operations in longer-term Treasury obligations were destabilizing and that these operations led to the formation of "artificial" prices in the market.

Such operations were not compatible with the functioning of a "free" market, because they inhibited or precluded dealer initiative in forming independent judgments about market trends based upon underlying economic forces. In particular, several dealers noted that Federal Reserve transactions in Treasury bonds could have policy implications and were of such potential size that even when actual operations turned out to be small, they tended to dominate market psychology and to create uncertainty in the minds of market participants. Some dealers made similar allegations with respect to Desk operations for Treasury trust accounts, or at least did not distinguish between transactions for the System and for the Treasury trust funds.

Advance refundings, dealers generally conceded, were an excellent debt management device, but the Treasury's utilization of this technique since 1960 had been too frequent and on too massive a scale. As a result many investors had been able to circumvent the secondary market in achieving their portfolio objectives. This had proved detrimental to the functioning of the secondary market. Many dealers also indicated that trading had tended to be concentrated during periods of financings and that between such periods market activity in longer-term securities had been greatly reduced.

The dealers were especially critical of what became known as "operation twist." This policy sought to maintain upward pressure on short-term interest rates for international balance of payments reasons. Many market participants felt that the policy also was designed to put downward pressure on long-term interest rates or at least to prevent such rates from rising. In practice, "operation twist" often meant that intermediate and long-term Treasury bonds were purchased by the Desk instead of Treasury bills--which have maturities of 1 year or less--in order to avoid placing direct downward pressure on bill rates when large purchases had to be made in the market. Other techniques, mainly in the area of Treasury debt management, were also used to maintain upward pressure on short-term rates.

While sympathetic to the objectives of this policy, many dealers believed that implementation of the policy had involved too much intervention in the U.S. Government securities market by both monetary and debt management officials. Several dealers said that private investors had tended to withdraw from the market as a result of this intervention. Moreover, "operation twist" in conjunction with Treasury advance refundings had contributed to a dampening of fluctuations in bond prices, since purchases of longer-term issues for official accounts tended to maintain a floor under bond prices, while advance refundings imposed a ceiling on prices through periodic additions to market supply. In this respect many dealers commented that, although the authorities had not actually "pegged" bond prices, there often seemed to be an officially approved range of price fluctuations. Under these circumstances, dealers felt that it had been very difficult to achieve profitable operations, since the major source of dealer profits--the correct anticipation of fluctuations in market prices from which alert dealers could benefit by timely additions to or liquidations of their inventories--had been denied them.

A number of dealers conceded that the objectives of Treasury and Federal Reserve officials were of overriding importance. Nevertheless, most of these dealers also felt that the officials needed to give more attention to the impact of official account transactions and of debt management techniques on the functioning of the secondary market for U.S. Government bonds.

Several dealers stressed the fact that the market's belief in some officially approved range of market fluctuations had been abruptly shattered during the late summer and fall of 1965 when interest rates rose sharply. Many dealers suffered sizable losses in this period. At the same time, the dealers spoke approvingly of an apparent return to "freer" markets since the fall of 1965. While the System and Treasury trust accounts had continued to operate in the intermediate and long-term maturity sectors of the Treasury bond market, such operations had been relatively small and, most important, did not appear to have any interest rate objectives. Several dealers indicated that the performance of the market was much improved as a consequence, although the rising trend of interest rates continued to make the market a difficult one in which to operate.

B. <u>Other developments affecting the Treasury bond market</u>

Several other reasons were given to explain what many dealers regarded as a deterioration in their ability to make satisfactory secondary markets for longer-term Treasury obligations during the 1961-65 period. Prominent among these was the over-all performance of the economy which in conjunction with debt management and monetary policies had fostered relatively narrow fluctuations in prices over most of the period and a gradual uptrend in yields. Indeed, some dealers gave more weight to economic developments than to official policies for the general market stability which made it difficult for dealers to stimulate investor activity and to realize profits from swings in market prices.

Several dealers pointed out that the relative stability of prices and yields during most of the 1961-65 period had been accentuated by increased competition among the dealers. This competition had contributed to the narrowing of spreads between dealers' bid and asked quotations to amounts that many dealers felt were incompatible with the market risks they assumed. A related development had been the assumption of what many dealers regarded as undue inventory risks. With trading spreads narrow and fears of sizable declines in bond prices stilled by official policy actions, many dealers sought to maintain profits through larger positions and a larger volume of trading. As a consequence, many dealer firms sustained substantial losses on their portfolios when Treasury bond prices fell in the late summer and fall of 1965. A number of dealers remarked that, as a result of this experience, the dealer fraternity had become more realistic about assuming market risks. Moreover, some of the temptation to assume such risks had been removed with the return of more freely fluctuating market prices and a widening of quotation spreads.

Another development that had tended to damp market fluctuations and to narrow spreads between dealer bid and asked quotations in the 1961-65 period was the intensified competition from many so-called "quasi" dealers, mainly large commercial banks. Dealer views differed widely as to the contribution that quasi dealers made to the functioning of the market. It was alleged that quasi dealers were willing to trade actively in the market and to take speculative positions during Treasury financings, but only so long as market risks were deemed to be minimal. When market yields began to rise sharply after mid-1965, for example, quasi dealers were said to have substantially reduced their trading activities.

A few dealers complained that the number of true primary dealers had declined in the period under review, especially since mid-1965. It was alleged that under difficult market circumstances very few dealer firms stood ready to make realistic markets and to assume significant risks in intermediate- and long-term bonds. The result was poorer over-all market performance than should be expected of firms that advertised themselves as primary dealers. At least one dealer firm questioned this view, however. It suggested that historically very few firms had been willing to make active markets in all maturity areas under all market circumstances; moreover, only a few firms were needed to fulfill this function and investors or or other dealers could secure realistic execution of their transactions by addressing themselves to these primary dealers. A number of dealers also thought that the market benefitted from a larger number of dealers, even though many of them might specialize only in certain maturity areas of the market; among the advantages cited were the availability of an increased amount of capital to the dealers as a group, a wider dispersion of market risks, and a broader range of contacts with investors.

C. Structural and institutional changes in the market

Several dealers suggested that with the growth in types and amounts of competing market instruments and the broadening of investment authorizations for many institutional investors, U.S. Government securities had declined in relative importance in many investment portfolios during the 1960's. Some dealers concluded that the broadening of market options had tended to impair the performance of the Government securities market, but other dealers were more neutral on this subject, and a few emphasized the greater trading opportunities generated by more flexible management of portfolios by institutional investors.

A related development that was more universally viewed as detrimental to market performance was the reduction or immobilization of the Government securities holdings of some of the most active participants in the market, especially commercial banks. In recent years many commercial banks had drawn down their investments in Government securities to minimal levels consistent with liquidity and growing collateral requirements. As a result, commercial banks, who were considered to be the mainstay of the secondary market, had tended to curtail their in-and-out trading activity in the market. Concomitantly, many traditionally less active market participants --such as pension funds and official accounts-- had acquired large blocks of securities. The resulting decline in institutional trading activity was felt to have affected mainly the intermediate- and long-term maturity areas of the U.S. Government securities market where the problem was compounded by reduced trading because of Treasury advance refundings, by lessened opportunities for switching because of relative market stability, and by reluctance to sell securities and realize book losses on issues acquired in earlier years when interest rates were much lower.

Several dealers indicated that the reduction or immobilization (for use as collateral) of Government securities in commercial bank portfolios had also tended to make it more difficult for dealers to borrow such securities for use in executing short sales. It was noted that other types of institutional investors tended to be less willing, or were not authorized, to lend securities for the purpose of facilitating short sales. With their operational flexibility impaired by the growing difficulty of borrowing securities, many dealers felt that the functioning of the market had been harmed. Some dealers viewed the problem as having become quite serious and only a few dealers said they had encountered little or no difficulty in borrowing securities.

Another problem that drew considerable comment from dealers was the extent to which funds were available to finance positions. Most dealers indicated that their sources of financing had not changed significantly with respect to institutional composition in recent years, although the number of individual sources had tended to increase. However, the cost of funds to finance inventories had been a growing burden, especially in the period of rapidly rising yields since mid-1965. Dealers had increasingly been faced with a negative carry on their inventories, and on occasions when the money market had come under particularly severe pressure some dealers had feared that necessary financing might not be available even at penalty rates. Large New York City banks, it was said, had tended to shy away in periods of very tight money from their traditional role as residual lenders to the dealers. Financing difficulties, many dealers suggested, had contributed in 1965 and 1966 to a reduction in their willingness to take positions and to make markets--thereby impairing market performance.

There were many comments about the changing composition of the firms in the dealer industry. Several dealers decried the decline in the number of specialized, nonbank dealer firms and saw a long-run threat to the market in the relatively fast growth of bank dealers. Since 1960 three major banks had initiated operations as primary dealers and a fourth very large bank was actively moving in that direction. Three specialized, nonbank dealer firms had disappeared from the ranks, including one that was absorbed by a large and diversified nonbank securities firm. Two other nonbank firms, which were already active in other sectors of the securities business, had formed new dealer departments since 1960. Over all, the number of primary dealers reporting to the Federal Reserve Bank of New York and authorized to transact business with the Trading Desk of that Bank had increased from 17 to 20 in this period.

While some dealers intimated that new firms were not needed in an industry already characterized by a high degree of competition for the available business, others welcomed the added competition and indicated that it fostered better markets and more service to customers. Moreover, a larger and more heavily capitalized dealer community was in a better position to underwrite Treasury financings and to accommodate sizable secondary market operations by the Federal Reserve and the Treasury trust funds.

With varying degrees of emphasis, several nonbank dealers and two or three bank dealers expressed concern over the recent growth, and the prospects for continued growth, in the number of bank dealers. The long-range danger seen for the market in this development was not so much a matter of increased competition *per se*, but the potential displacement of nonbank dealers as a result of uneven competition. Concern was felt especially for the narrowly specialized firms that did not have a broad securities business to fall back upon. Dealers expressing these fears thought that bank dealers tended to avoid making good markets in periods of tight money when bank management was tempted to force a retrenchment in the amount of funds used by the dealer department. As several dealers saw the matter, optimal performance by dealers under difficult market circumstances could be secured only from dealers who looked primarily to the Treasury and other closely related markets for their profits in bad years as well as good.

The competitive advantages that bank dealers were said to enjoy over nonbank dealers included readier access to sources of financing. Most bank dealer departments received a large part of their funds from the bank itself, which in turn could borrow on relatively favorable terms from the day-to-day Federal funds market or even perhaps from the discount window of the Federal Reserve Bank. Another reason for the uneven competition by bank dealers stemmed from the alleged fact that large banks tended to use the operations of their dealer departments as "loss leaders" designed to enhance the prestige of the bank and to secure a variety of collateral advantages through enlarged market contacts and services performed for customers. It was also asserted that bank dealers had a competitive edge in some Treasury cash financings, because banks were allowed to pay for certain new issues through credits to so-called Treasury tax-and-loan accounts at the banks. This form of deferred payment used by the Treasury to help underwrite large new cash issues was available to other banks but not to nonbank dealer firms.

Several bank dealers disputed--some hotly--the contention that they enjoyed any, or any significant, competitive advantage over other dealers. In particular, they stressed the fact that their dealer departments were expected to operate at a profit and were not to be subsidized by the rest of the bank for any lengthy period of time. Moreover, bank dealers had to assume the burden of a sizable and unprofitable odd-lot business which they executed for correspondent banks and other bank customers. This burden was shared by the large and diversified nonbank dealer firms, especially those with a stock exchange business, but the specialized Government securities dealers could avoid it for the most part. The bank dealers also pointed out that any benefits deriving from tax-and-loan account privileges in Treasury cash financings accrued to the investment department of a bank rather than to the dealer department, which normally was not allocated the new issues. Finally, with respect to the availability of funds to finance their positions, bank dealers pointed out that they were not granted access to Federal Reserve repurchase agreements,[1/] which were of considerable benefit to nonbank dealers, especially in periods of tight money.

D. Accommodation of investors in the U.S. Treasury bond market

Even though a number of dealers felt the functioning of the Treasury bond market had deteriorated in the 1960's, they emphasized their belief that the market had performed quite well

1/ A repurchase agreement involves a sale of securities and a simultaneous agreement to repurchase the same securities at a later date. Differences in prices, or rates of discount in the case of Treasury bills, provide a specific rate of return to the buyer for the period of time between the sale and repurchase dates. Repurchase agreements furnish dealers, in effect, with a means of financing their inventories.

in view of the many obstacles it had to overcome. It was even suggested that dealer willingness to make highly competitive markets and to accommodate customers had been "too good" in this period, as evidenced by narrowed trading spreads, increased volume, and greater position risks. The Treasury bond market, the dealers noted, was still in a class by itself when compared with secondary markets for seasoned corporate and State and local government bonds or for outstanding mortgages.

There had been times in recent years when the market for U.S. Government bonds was very active, especially around periods of Treasury financings, and in those circumstances investors had been able to move sizable blocks of longer-term securities. Even under less propitious market circumstances, the dealers observed, investors had been able to execute transactions of $1 million in bonds quite readily at prevailing market prices; more sizable blocks of longer-term securities could also be handled by the market, but these larger transactions occasionally required more time to be worked out.

Some dealers indicated that from an investor standpoint the Treasury bond market became "thinner" after mid-1965 than it had been earlier. Investors found it more difficult to make sizable portfolio adjustments. However, this development was viewed as normal in a period of rising yields, and most dealers still felt--given prevailing market circumstances--that the functioning of the market had tended to improve after mid-1965. The reason offered for this improvement, as noted earlier, was that the market became freer to respond to basic supply and demand forces and to changes in the outlook for over-all economic activity. At any given time, dealers believed, optimal performance of the bond market was achieved when official controls or manipulations were minimal.

E. Performance of the Treasury bill market

Most of the dealers reported that the market for Treasury bills had continued to function exceptionally well in recent years. The market had been highly competitive, and investors were continuously able to execute a large volume of business at, or very close to, prevailing market quotations.

Dealer views differed concerning the impact of a general broadening in investment authorizations and the growth in alternative short-term investment media during the 1960's. Some dealers believed that these developments had had little effect on the performance of the Treasury bill market as such, although the over-all increase in short-term debt instruments had tended to raise the general level of short-term interest rates. A few dealers thought the Treasury bill market had lost some of its relative attractiveness for investors, although they also thought that the performance of the bill market had been adversely affected only to a minor extent.

There was considerable emphasis, however, on the fact that profitable dealer operations in bills had been most difficult to achieve in recent years. The difficulty was attributed mainly to the general stability of bill rates over most of the 1961-65 period and to the related development of very narrow trading spreads stemming from intense competition among an increased number of dealers and quasi dealers. With differing degrees of emphasis, dealers blamed part of the stability in bill rates on direct policy actions of debt management and monetary officials. In this connection, the dealers were not opposed to secondary market operations in the bill market by the Federal Reserve. Indeed, most of the dealers were in favor of having the System confine its operations to the bill market under most circumstances. The dealers objected, however, to market maneuvers or debt management techniques whose aim might be to control the level of, or fluctuations in, Treasury bill rates.

F. Performance of the market for Federal agency securities

The dealers who commented on the market for Federal agency securities were agreed that this market had grown significantly during the 1960's. This growth had been a concomitant of the large increase in agency debt outstanding, which in turn had stimulated increased dealer and investor participation in the market. The dealers noted that they and other securities firms had done much to help broaden the market in recent years by educating investors to the merits of investment in Federal agency obligations. All of the primary dealers in U.S. Government securities now operated in the secondary market for agency issues, whereas before 1960 very few dealer firms had regular traders assigned to these securities.

A sharp distinction was drawn between the functioning of the secondary market for the seasoned issues of the old-line Federal agencies and the market for the less familiar securities of agencies with little previous market exposure. The better known agency names included the issues of three farm agencies (banks for cooperatives, Federal intermediate credit banks, and Federal land banks) and seasoned obligations of two agencies in the housing field (Federal home loan banks and Federal National Mortgage Association, the latter better known as "Fannie Mae"). Issues of these agencies, some dealers felt, currently enjoyed a better secondary market in the shorter maturities than did Treasury coupon obligations of comparable maturity. However, no secondary market--that for Federal agency securities included--even approached the depth and breadth of the market for Treasury bills.

The newer agency issues, the dealers added, did not share in this active secondary market for the more familiar agency obligations. Notable among the newer types of Federal agency obligations were the participation certificates (PC's) that were marketed by (or through) the Federal National Mortgage Association and the Export-Import Bank of Washington. The secondary market for PC's had been hampered not only by the relative newness of the instruments but also by various technical considerations. For example, their original availability only in registered form, as opposed to bearer form, had inhibited their tradeability.

In addition, their sale in serial form, with relatively small individual maturities, had also impaired their marketability, as smaller individual issues were harder to trade than fewer but more sizable "term" obligations. In short, these drawbacks, as well as others, had precluded the development of any real secondary market for participation certificates.1/

Some dealers expressed objections to the basic idea of issuing relatively expensive Federal agency debt in the place of direct Treasury obligations. A few dealers also asserted that the proliferation of new types of agency securities represented at least a long-run threat to the U.S. Government securities market. Several dealers thought that the record amount of new issues sold by Federal agencies during the first half of 1966 had contributed importantly to the upward escalation of interest rates in that period. It was strongly urged that in the future new issues be better timed and coordinated, so as to avoid the disruptive impact on markets that the "bunching" of new issues tended to produce.

III. Performance of Individual Dealer Firms

A. Trading activity

All of the dealers reported that they were active participants in the markets for shorter-term Treasury and Federal agency securities. Many indicated their trading in such securities had increased in recent years, especially in the case of Federal

1/ PC's were made available in bearer form and were sold as term obligations beginning with a FNMA offering on January 5, 1967.

agency obligations. On the other hand, relatively few dealers said they conducted any significant amount of business in intermediate- and long-term Treasury bonds. Some dealers mentioned that they had curtailed their trading in longer-term issues in the period of rising yields after mid-1965.

A number of dealers pointed out that from time to time they shifted the emphasis of their operations to those sectors of the market that appeared to promise the greatest potential for profits under prevailing market circumstances. The market for Federal agency securities had been a case in point during recent years and several dealers commented that they had looked increasingly to this market for their profits. Moreover, as it became more difficult to make profits in the Government securities market, the more specialized dealer firms had shown a tendency to diversify in recent years.

B. Relationships to Treasury and Federal Reserve

The dealers generally felt that the nature of their business obligated them to help underwrite Treasury financings, and several dealers considered that the dealers as a group had performed very well in this respect. Some dealers believed that they should not be expected to participate in Treasury financings when they thought their capital would be unduly jeopardized. In particular, some dealer firms held that their underwriting responsibilities were lessened when the Treasury offered new issues on terms which differed significantly from those that the dealer firm had recommended. Some dealers made it a practice to inform Treasury officials whenever they intended to reduce their participation in a given Treasury refunding operation.

The dealers recognized a responsibility to make competitive bids or offers when the Federal Reserve or the Treasury trust funds wanted to buy or sell U.S. Government securities. Some dealers said they felt obligated to extend themselves at times to accommodate official accounts under difficult market circumstances.

It was also their duty, the dealers said, to keep Treasury and Federal Reserve officials fully informed of market developments and to advise the Treasury concerning its financing operations. Some dealers suggested that the Treasury and the Federal Reserve should make fuller use of the dealers' expertise and that contacts between officials and the dealers should be improved. Several dealers complained that they received too little information from monetary and debt management officials, although the dealers generally recognized that the flow of information had to be a one-way affair for the most part.

C. Profitability of dealer operations

Most of the dealers indicated that their profit experience had been poor in the 1961-65 period, particularly toward the end of the period. Several dealers reported losses in one or more of these years and in some cases these losses had been substantial. The profitability of dealer operations had tended to improve for most firms in the first half of 1966, however. Most of the firms that had been in operation for a decade or more said they had realized substantially better profits in 1955-60 than in 1961-65.

The dealers stressed that the general stability of interest rates over most of the 1961-65 period had greatly limited the potential for profits on dealer inventories. Over time, position profits were the major source of net dealer income. Moreover, the narrow trading spreads associated with generally stable market yields and the intensified competition among dealers and quasi dealers in the 1961-65 period had further restricted dealer profits.

Many dealers also emphasized the rising cost of financing their inventories in this period. They drew attention to the "negative carry" that they increasingly encountered in this period when interest rates on dealer loans were higher than the interest return on the securities being financed. Finally, some dealers pointed up the fact that a generally rising trend of interest rates in the 1961-65 period had further curtailed the potential for profitable operations, especially since this trend was associated with relatively narrow short-run market fluctuations.

Several dealers indicated that unprofitable operations were compelling a reassessment of their continued functioning as primary dealers. Only a few firms had reduced their dealer operations substantially as of mid-1966, but some others had curtailed operations in the relatively risk-laden intermediate- and long-term sectors of the market. The necessity of profits for continued operations over the longer run was highlighted, and even those firms whose dealer operations were only a part of a diversified securities business or a department of a large commercial bank stressed that the firm or the bank could not be expected to subsidize unprofitable dealer operations over long periods of time.

It must be observed that many dealer firms remained quite optimistic about the long-run prospects for profitable operations in the market for U.S. Government securities. This was true especially of the firms that had been in this market for a long period of time.

IV. Comments on Specific Policy Issues and Suggestions for Improving the Market

A. Treasury debt management techniques

Advance refundings. Virtually without exception, the dealers believed that advance refundings as conducted in the 1960-65 period had been too massive and too frequent and had proved detrimental to the secondary market for intermediate- and long-term Treasury bonds. The dealers conceded that advance refundings were an excellent debt management technique, but they argued that more weight needed to be given to secondary market performance. Accordingly, future advance refundings should be made smaller, less complicated, and less frequent. At least one dealer recommended that advance refundings be abandoned altogether. In the long run, the dealers intimated, a strong secondary market would be of greater advantage to the Treasury than an optimal debt structure. Moreover, the Treasury could and should offer more long-term bonds in regular Treasury refundings.

Treasury bill auctions. A number of dealers suggested that the issues of 1-year bills were too small in size (at the time $1.0 billion) to be effectively traded in the secondary market.

Some dealers advised that the Treasury replace the current monthly auctions of such bills with larger quarterly auctions--reverting to the practice it had followed until the summer of 1963. Other dealers suggested retaining the monthly auctions and either enlarging them or reopening already outstanding issues of 1-year bills to investors some time after their initial issue.1/

Several dealers recommended that, as a matter of general debt management policy, the Treasury should aim to enclose all of the debt within fewer but more tradeable issues. This objective could be implemented by reopening more outstanding issues at times of Treasury financings instead of offering new issues. A larger floating supply of a given issue, dealers said, gave that issue a more competitive trading market and in particular made dealers more willing to assume a short position in the issue in order to execute a sale.

Dealer views varied with respect to the Treasury policy of limiting individual dealer allotments to roughly 25 per cent of any single bill issue. Some dealers saw no likelihood that individual dealers, who received as much as one-fourth of a bill issue, might exert an undue influence on the market, especially since new issues had to compete with outstanding issues of comparable maturity. Other dealers thought that when two or three dealers got large awards in the same auction, they tended to influence secondary market trading.

1/ In September 1966 the Treasury introduced a new cycle of monthly auctions of 9-month bills involving additions to 1-year bills that were already outstanding.

Thus, while no abuses might be found, the dealers recommended that the Treasury review its policy on allotments to individual dealers.

Some dealers believed the Treasury should abandon its infrequent practice of auctioning so-called "bill strips." These auctions involved bidding for several bill issues of varying maturities at a single price, with the successful bidders being awarded the "strip" of bills rather than a single issue. Some dealers contended that such auctions were awkward and tended to destabilize the entire bill market.

Tax-and-loan account credit in cash financings. Several dealers, especially the nonbank firms, commented that the privilege of paying for certain new Treasury cash issues by crediting Treasury tax-and-loan accounts--a privilege allowed only to banks--resulted in an unfair advantage to bank dealers. It was suggested that nonbank dealers be accorded some comparable advantage in these financings, possibly through some form of deferred payment for the new issues.

Several dealers conceded that the tax-and-loan account privilege was necessary to secure the underwriting support of banks around the country in Treasury bill financings where a large amount of new cash was being raised. However, they saw no need to extend this privilege to cash financings or refundings involving Treasury notes and bonds ("coupon issues"), especially if the amount of new money being raised, if any, was relatively small. Alternatively, a few dealers suggested that nonbank dealers be given some equalizing advantage only in cash financings involving coupon issues.

"Cash" or "rights" exchanges. Dealer views differed on this topic, but there was a tendency to favor rights exchanges. Some dealers thought that cash refundings were more difficult to underwrite than refundings in which holders of the maturing issues ("rights") were given the option to exchange these issues into one or more new issues. Cash refinancings always entailed more or less uncertainty as to the percentage allotment that would be received on cash subscriptions, and since 100 per cent allotments were rare, subscriptions had to be "padded" in line with estimates of the allotment percentage. A few dealers played down the difficulty of padding subscriptions, however, and one argued that from a dealer's standpoint a cash financing was preferable in periods of tight money when a "negative carry" might be involved in financing positions in maturing rights.

Some dealers contended that the several cash refundings undertaken by the Treasury in recent years had reduced the attractiveness of short-term coupon issues. Holders of these maturing obligations could no longer be sure that they would be offered a chance to exchange them at maturity. At the same time, such holders--particularly the smaller banks and other institutions that were the backbone of this sector of the market--were often wary of padding their subscriptions in cash financings. Moreover, investors and dealers who wanted to speculate on the potential appreciation of the value of rights, if and when the Treasury offered attractive new issues in a rights exchange, now tended to shy away from the short-term coupon sector of the market.

From the Treasury's standpoint, a cash exchange might be desirable, if it was deemed necessary to avoid attrition from unexchanged holdings of maturing rights or if it was considered expedient to raise net cash by making the new issue(s) larger than the maturing obligations(s). Dealers favoring rights exchanges concluded that only if these considerations were overriding should the Treasury use the cash refunding technique.

A few dealers commented on the practice of setting subscription ceilings for individual dealer firms in Treasury cash financings involving coupon issues. Some of the smaller dealers complained that the subscription limits tended to favor the large, diversified dealer firms whose capital might be greater but who were not necessarily more active in the market. It was also pointed out that there were no limits on subscriptions in Treasury bill auctions apart from the limitation that only about one-fourth of any issue might be awarded to a single dealer firm. The dealers argued that the amount of subscriptions and risk-taking in cash financings should be left to the judgment of the individual dealer firms.

Competitive sale of long-term Treasury bonds through underwriting syndicates. The few dealers who commented on this Treasury debt management technique urged that it be abandoned. In their view it was a cumbersome and costly device that had proved unprofitable for the dealers. Moreover, the amount of long-term debt that could be marketed through this means was relatively small.

B. Secondary market operations by official accounts

Federal Reserve transactions in U.S. Government securities. Most dealers were opposed to Federal Reserve operations in coupon issues if the objective was to control long-term yields. They objected, for example, to the policy that came to be known as "operation twist." At the extreme, some dealers argued that the Federal Reserve should intervene in the coupon market only to avoid or to correct a "disorderly" market situation. A "disorderly" market might follow a declaration of war or some other highly unsettling event. However, most of the dealers did not voice objections to Federal Reserve operations in very short-term Treasury coupon issues.

A less extreme view, shared by many dealers, was that relatively moderate operations in longer-term Treasury securities were acceptable, so long as these operations did not have any interest rate objectives. Accordingly, many dealers had no real quarrel with the type and scope of transactions in coupon issues that the Federal Reserve had carried out between the fall of 1965 and the summer of 1966. A number of dealers went a step further and actually recommended such operations with limited objectives. On the other hand, some dealers questioned the need for such marginal operations.

If the Federal Reserve decided that it should operate in all maturity areas of the market, then several dealers thought the

System should consider selling as well as buying longer-term Treasury obligations. This idea gave rise to several demurrers, but those subscribing to it pointed to possible advantages of System sales such as increased flexibility of Federal Reserve operations and the provision of scarce issues to the market which would enhance the tradeability of such issues. In this connection, some dealers also recommended that the official accounts engage in "swap" transactions with the dealers. The aim would be to provide the market with relatively scarce issues whose prices were higher and yields lower than other issues of comparable maturity. In return, the official accounts would enhance their earnings by acquiring less scarce and higher yielding issues. Some dealers indicated objections to this proposal, partly on the grounds that any sizable amount of swapping activity would prove unsettling to the market.

Treasury trust fund transactions in U.S. Government securities. Dealer views were divided concerning the proper role of Treasury trust fund operations in the secondary market for coupon issues. At one extreme, some dealers expressed a preference for having all Treasury trust fund investments limited to nonmarketable "special" issues and none in marketable Treasury obligations. A more moderate view held that investments in marketable issues were desirable when the earnings of the trust funds could be enhanced thereby. According to this group, management of the trust funds on a "professional" basis was the criterion that should be followed. However, these dealers did not approve of using the trust funds to "dress up the market" during periods of Treasury financings. In particular, they believed attempts at rate validation or the encouragement of close pricing of new issues by the Treasury should be avoided.

At the other extreme, a few dealers believed that the trust funds could properly be used to stabilize the market during Treasury financings, although one dealer felt that such market intervention should be undertaken only rarely. In general, the dealers deemed the avoidance or correction of disorderly market conditions to be a function of the Federal Reserve rather than of the Treasury trust funds.

It would be helpful, some dealers thought, if the Federal Reserve were to issue some "ground rules" spelling out its philosophy of operations in coupon issues and the conditions under which it intended to enter the market. The Treasury trust funds might also issue "ground rules" governing their operations. Another useful procedure, one dealer suggested, would be for the official accounts to give some notice to the market when operations in coupon issues were contemplated. This notification might indicate the general purpose of the operations, but the official accounts would not be expected to reveal their plans in any detail.

Official account operations in Federal agency securities. The dealers were sharply divided on the issue of official account operations in Federal agency issues. Their views ranged from strong support of such operations to equally ardent opposition. There was also a difference of views among senior spokesmen for several individual dealer firms. It might be added, however, that none of the dealers expressed opposition to Federal Reserve repurchase agreements made against Federal agency securities as distinguished from outright purchases or sales of such securities.

A major argument used by dealers who advised against such outright transactions was the probability of strong political pressures on the Federal Reserve to support particular agency issues or financings. It was felt that if such support were given, Congress might be encouraged to proliferate new agencies to finance pet projects and might even require Federal Reserve support of issues by such agencies.

Another major argument against official operations in agency issues stressed the disturbing impact on the secondary market of relatively large, and by nature discontinuous, Federal Reserve operations. The result would tend to be a market dominated by official transactions rather than one responsive to the basic forces of supply and demand. In essence, this was the same argument used by dealers opposed to Federal Reserve operations in longer-term Treasury obligations. In this instance, however, not all of the dealers who favored the "bills usually" policy were opposed to Federal Reserve operations in agency issues.

A majority of the dealers were convinced that the short-term sector of the market for Federal agency securities was sufficiently developed to accommodate more than token Federal Reserve transactions. Even a few of the dealers who opposed such operations conceded this point. Several of the dealers thought the Federal Reserve could and should conduct operations on both the buying and selling sides of the market. Such operations, some indicated, would enhance the prestige of the Federal agency securities market, would tend to bring rates on agency issues into closer alignment with yields on direct U.S. Government debt, and would stimulate investor activity in Federal agency obligations.

C. Techniques of the Trading Desk at the Federal Reserve Bank of New York

Identifying accounts and amounts involved in Desk operations. The dealers' most common and insistent recommendations concerning Trading Desk techniques centered on a desire to obtain as much information as possible about the nature and scope of the Desk's operations. Accordingly, a large majority of the dealers urged that the Desk identify the account for which it was conducting a given transaction. This meant indicating whether the transaction was for Federal Open Market Account, for Treasury trust funds, or for other "customer" accounts such as foreign central banks and official international institutions. The dealers alleged that this identification was important to them because the psychological impact of operations for the Federal Open Market Committee could differ markedly from the market effects of similar transactions for "customer" accounts. The dealers were always interested, of course, in trying to determine whether monetary policy was a consideration when the Desk was conducting operations. A small minority among the dealers felt that the Desk could not properly undertake to inform the dealers about the source of given market transactions, but even these dealers conceded they would find such identification useful.

A few dealers recommended that the Desk give some indication of the total amount of each operation that was spread among several dealers. The Desk would not obligate itself for the total specified if bids or offers to the Desk were not in line with current market quotations. It was argued that this technique would assure better execution for the Desk and would obviate a good deal of market uncertainty and dealer criticism. One dealer recommended that the size of operations be indicated only in the case of "customer" accounts; for operations for the Federal Open Market Committee, he suggested that only the general maturity area of the transactions be divulged.

Use of "go-around" technique for executing Desk transactions. Some dealers thought the Desk should utilize the "go-around" technique in all of its transactions instead of limiting use of the technique to operations for the System Open Market Account and occasional large transactions for "customer" accounts. A "go-around" involves the soliciting of bids or offers from all of the dealers when a given operation is conducted. An alternative, often used when relatively small transactions are being carried out, is to fill orders from bids or offers that individual dealers have spontaneously made to the Desk. This method means rechecking the quotations of a small number of dealers when the transaction is about to be executed and completing the transaction on the basis of the best price. This "best price" has to be in line with general market quotations at a given time.

A few dealers indicated that failure to use the "go-around" technique in all operations subjected the Desk to allegations of favoritism, especially from the smaller or less active dealers and tended to create some confusion and ill-feeling among market participants. Poorer execution of orders could also result, these dealers said. Other dealers argued that the Desk could secure optimal execution of its orders, if it limited its contacts to those dealers who were active in the sector of the market involved in the transaction. For example, only a relatively few dealers had made active and competitive markets in intermediate- and long-term bonds after mid-1965. These were therefore the only dealers who would be furnishing the Desk with competitive quotations on such issues and who were in a position to execute Desk transactions on a realistic basis in that sector of the market.

Frequency of Desk operations. A small number of dealers expressed a general preference for limiting the frequency of System operations and allowing the market to make more of its own short-run adjustments. In this connection, one dealer suggested longer reserve settlement periods for banks than the then current 1-week period for reserve city banks and 2-week period for country banks. A 4-week reserve settlement period was recommended for all member banks with actual settlement on a staggered basis among the banks.

Timing of Desk operations: "cash" vs. "regular" trading. Several dealers advised that Desk operations be undertaken as early in the business day as possible, preferably well before noon. Early operations greatly facilitated the delivery of securities sold to the Desk for "cash" (same-day payment and delivery) and gave dealers more flexibility in trading or financing securities purchased from the Desk on a given day. Moreover, when the Desk was buying, there tended to be a better availability of securities early in the day, that is, before the dealers had made commitments to trade or to finance their holdings.

A number of dealers also urged that the Desk engage in more trading for "regular" delivery (next-business-day payment and delivery) rather than for "cash" delivery. As in the case made for early operations during the day, the dealers felt that the greater lead-time afforded by trades for"regular" delivery gave them more flexibility in their own trading, financing, and delivery of securities.

Repurchase agreements vs. outright transactions. A number of dealers recommended that the Federal Reserve undertake relatively more outright transactions in U.S. Government securities and rely less on repurchase agreements. This suggestion was in line with a general preference on the part of most dealers to execute outright sales rather than merely to enter into a form of financing arrangement. However, a qualifying view was expressed in reference to periods of tight money when dealer financing costs were high. At such times, repurchase agreements with the System helped the dealers to finance their positions at something less than penalty rates, since the Desk usually made repurchase agreements at the discount rate. Another advantage seen for repurchase agreements was the possible use of such agreements to minimize the impact of Federal Reserve operations under difficult market circumstances.

Technical features of System repurchase agreements. A number of dealers recommended the permanent removal of the maturity restriction which made only securities due within 24 months eligible for System repurchase agreements. This restriction had already been lifted during periods of Treasury financings. During the summer of 1966 the Federal Open Market Committee decided to remove all maturity restrictions on U.S. Government securities eligible for System repurchase agreements.

The dealers also recommended that they be allowed in effect to substitute collateral on repurchase agreements made with the Desk. Under current regulations, dealers are permitted to terminate a repurchase agreement before maturity, but if they do so, they may not initiate a new repurchase agreement for the unexpired term of the old contract. Thus, when dealers sell securities that have been placed with the System under repurchase agreements and terminate the agreements by withdrawing the securities, the latter may not be replaced with other collateral, and unless the Desk decides to make an equal amount of new agreements on the same day, total repurchase agreements are reduced. Permission to (in effect) substitute collateral, the dealers argued, would add flexibility to their operations. Moreover, System repurchase agreements would become more attractive to dealers--thereby increasing the potential amount of such contracts that the Desk would be able to make at any given time.

Review of minimum dealer standards for trading with the Desk. A few dealers intimated that not all of the firms allowed to conduct transactions with the Desk functioned as true primary dealers in U.S. Government securities. It was alleged that a number of firms that formerly were active participants in the market had tended to reduce their activity in recent years. And since trading access to the Desk carried with it a number of privileges and advantages, the assumption of certain responsibilities should be a *quid pro quo*. It was therefore recommended that the Federal Reserve undertake a review of standards for firms wishing to trade with the Desk.

D. Problem of dealer financing

The problem of dealer financing elicited comments and suggestions from virtually all of the dealers. Several dealers, especially among the nonbank firms, saw an urgent need for a "lender of last resort" in periods of very tight money such as was being experienced at the time of the dealer meetings (June and July 1966). Several proposals were made to provide the desired lending facilities.

A number of dealers recommended that banks making loans to nonbank dealers or financing their own bank dealer departments be granted freer access to the Federal Reserve discount window, especially in periods of market stress. Such access should be without prejudice to the bank's over-all borrowing record from the Federal Reserve.

Another suggestion was to permit direct access to the discount window by nonbank dealers under a "line of credit." Other dealers urged that repurchase agreements with the System be at dealer initiative, also under a line of credit. Some bank dealers felt that they should be extended the privilege of entering into repurchase agreements with the Federal Reserve, a facility that only nonbank dealers currently enjoyed.

One dealer envisioned a more elaborate financing arrangement and argued for the establishment of a bank-credit pool which would have access in case of need to the discount window. Participation by individual dealers in this pool would be determined by formula.

A major problem seen in the extension of Federal Reserve credit to dealers at their own initiative was the possible conflict with prevailing System policy that such a release of reserves would tend to create. The problem would arise even if the Federal Reserve retained control over the total line of credit being granted. Moreover, if the System sold securities to offset an undesired release of reserves to dealers exercising their option to borrow, the ultimate financing needs of the dealers would not be changed, because the dealers would then have to finance the securities newly acquired from the System. The distribution of this need among the dealers might, of course, be altered somewhat.

To obviate this sort of difficulty, some nonbank dealers recommended an extension of Federal Reserve credit--say, through repurchase agreements--that would be fully used by the dealers for a specified period. Thus, a participating dealer withdrawing securities from a System repurchase agreement would agree to replace this security with other collateral to maintain his total commitment at a given level. Under such an arrangement, the Federal Reserve would retain control over the total amount and timing of bank reserves being injected and absorbed. Even this approach was seen to incorporate a basic drawback for the dealers, because a fully used line of credit, however welcome it might be in periods of tight money, would still leave the dealers with the necessity of having to finance peak needs.

While conceding that unresolved problems and new precedents were involved, the dealers felt that the availability of extra financing in tight money periods would encourage them to position more securities, thereby significantly improving the functioning of the market in such periods.

E. The market for Federal agency securities

Methods of marketing new issues. In the opinion of all the dealers who commented on methods of marketing new issues, the fiscal agents' method of marketing new Federal agency securities through selling groups has proved very effective and economical. This marketing approach was utilized to sell the well-known securities issued by three farm credit agencies (banks for cooperatives, Federal intermediate credit banks, and Federal land banks) and two housing credit agencies (Federal home loan banks and Federal National Mortgage Association). Three fiscal agents were involved, including one for the three farm credit agencies and one each for the housing agencies.

The obligations of these agencies were well seasoned, and the securities firms that constituted the selling groups had widespread contacts around the country with a large number of institutional investors.

Virtually the only complaint expressed concerning this marketing technique was a conviction on the part of a number of dealers that the selling groups were too large and included too many small securities firms that did not have enough retail contacts to sell all of their allotments. Concomitantly, many larger members of the selling groups felt that their allotments were too limited to meet the demands of all of their own customers. The consequence, it was alleged, was that the smaller members of the selling groups tended to sell their allotments to the larger firms who often lost the underwriting spread in the process. Thus, it was intimated, many of the smaller firms were "free riders" who performed no true service of retail distribution. Moreover, since the selling of allotments by these firms might tend to be unsettling under some market circumstances and consequently might inhibit the effective distribution of new issues, many dealers recommended that "free rider" members of the selling groups be weeded out.

Dealer views were less uniform, but on the whole commendatory, concerning the method employed to sell the relatively unseasoned participation certificates issued by the Federal National Mortgage Association and the Export-Import Bank of Washington. These securities have been marketed in negotiated sales through a group of underwriters. Unlike the members of the fiscal agents' selling groups, who are not compelled to participate in every new offering, the members of the underwriter group assume responsibility for selling an entire issue of PC's.

Among the reasons adduced in support of this selling approach was the need for underwriting support in a sale where a large amount of new money was being raised and where intermediate- and long-term issues were involved. It was also claimed that much selling effort, necessitating the services of many salesmen, was required to distribute successfully this relatively new market instrument, especially in periods when capital markets were weak. For these reasons, among others, possible alternative methods of selling participation certificates were deemed inadequate, save perhaps under very favorable capital market conditions.

For example, the fiscal agents' selling groups were alleged to work best where relatively short-term issues and/or little or no new money were involved. Competitive underwriting groups did not appear practicable, since two or more syndicates probably could not be put together to bid on an offering as large as $500 million or $750 million. Finally, the direct sale to investors method used by the Treasury did not appear feasible, because of the continuing selling effort and the frequent underwriting support required to market new participation certificates.

Among the drawbacks seen by some dealers in the negotiated syndicate underwriting method was the wider underwriting spread than the one paid by the fiscal agents to their selling groups. In addition, it was felt that negotiations prior to each sale were too protracted and that intra-group trading rules were too restrictive, since all such trading had to be channeled through the group managers.

Improving the marketability of Federal agency issues. Most of the dealer comments on the question of improving the marketability of Federal agency issues were addressed to participation certificates. On the technical level, it was urged that these securities be made available in bearer form as well as in registered form and that larger and more tradeable "term" issues be offered instead of relatively small serial issues. Both of these features were incorporated in the participation certificates sold in 1967.

The dealers also recommended that transfers of Federal agency issues be permitted over Federal Reserve wires and that new issues be delivered at all Federal Reserve Banks rather than at the New York Bank only. Since early 1967, wire transfers of participation certificates have been authorized between the Federal Reserve Banks of New York, Chicago, and San Francisco and new issues may be delivered at any of these Banks. Federal Reserve facilities outside New York may not be used for other agency securities.

Another suggestion made by many dealers was for better scheduling of new issues. It was felt that new agency offerings should avoid conflicts with each other and with offerings of direct U.S. Government debt. The "bunching" of new issues in the spring of 1966, it was believed, had contributed importantly to the escalation of interest rates in that period. In particular, it was deemed desirable to accommodate the timing and amounts of new participation certificates to market conditions rather than to fiscal year constraints.

F. Organization of the market, trading facilities, and market practices

Dealer association. Dealer views on the question of a dealer association varied from outright opposition to enthusiastic endorsement. Dealers expressing disapproval believed that an association of dealers could lead to restrictive trading rules, and one dealer suggested that it might tend to reduce competition and limit the entry of new firms. It was also stated that a dealer association could not be made to function effectively.

Several dealers adopted an intermediate position on the issue and indicated at least a qualified interest in an informal association. These dealers regarded self-regulation as preferable to SEC control, and some suggested that a formal association was not needed because of the small number of dealers.

The dealers who saw merit in the idea of a dealer association, whether formal or informal, stressed that it might help to resolve a variety of problems common to dealers. Examples cited were in the areas of trading hours, odd lot charges, clearing of securities, trading spreads, brokers' market, and definition and recognition of dealers. It was noted that fear of possible anti-trust prosecution had inhibited the development of a dealer association and that sponsorship by the Treasury and the Federal Reserve might be necessary to overcome this obstacle.

Brokers market. As on many other questions, dealer views concerning the brokers' market were sharply divided. Perhaps the only area of general agreement was that dealers used brokers mainly for the purpose of trading relatively small amounts of Treasury coupon issues. The brokers, who were not themselves dealers and had no positions, took a small "spread" for their services.

A number of dealers asserted that the brokers performed a very helpful function. Brokers provided a useful quotation service for coupon issues, and they permitted dealers to execute small transactions in these securities on an impersonal basis--that is, without revealing the identity of the parties involved in the transaction. The brokers could also be used to sound out market interest in particular issues.

Several other dealers were equally convinced that the brokers' market was more disruptive than constructive. Brokers could be used by individual dealers to manipulate the market to their advantage. As a result, the use of brokers tended to conceal the true condition of the market. In addition, it was alleged that the brokers' market injected much unnecessary activity into the market and that brokers could not be used to execute sizable transactions.

Some tempering assessments, used with varying degrees of emphasis by both defenders and opponents of the brokers' market, suggested that brokers could not be used to move the market in any substantial way against the basic forces of supply and demand. Any induced movement in quotations, therefore, tended to be of short duration. One dealer pointed out that other means of market manipulation were available to a dealer, if he were inclined to attempt to influence the market. Another dealer emphasized that the onus of any dubious legerdemain in this market rested with the dealers rather than with the brokers.

There were few specific recommendations for dealing with the brokers' market beyond an implicit plea for continued exercise of dealer responsibility. One dealer suggested that the Federal Reserve respond periodically to bids or offers in the brokers' market. He suspected that such intervention would create uncertainty but that it would also be a constructive influence on the market.

Problem of odd lots. Most of the dealers, especially the diversified firms and bank dealers, viewed odd lots as a costly and growing problem. Several of these dealers had instituted schedules of odd-lot charges or had established price differentials that were the equivalent of such charges. However, it was felt that customer relationships precluded setting odd-lot charges or their equivalents sufficiently high to compensate for the expenses of handling small transactions. Dealers pointed out that it costs as much to handle a small order as one running to several million dollars.

A number of proposals were advanced to help remedy this problem. Some dealers recommended higher minimum denominations for marketable Treasury obligations. It was suggested, for example, that these be set at $10,000 or even $25,000 as compared with the current $500 standard for most Treasury bonds and $1,000 for Treasury bills, certificates, and notes. Several dealers also regarded as promising the idea of having a central odd-lot house for handling

U.S. Government securities, possibly under the auspices of the U.S. Treasury. However, a few dealers were not enthusiastic about this proposal. They indicated that the dealers would still need to handle the initial odd-lot requests, and they were not certain that any savings would be involved. But regardless of the approach eventually adopted, a number of dealers pointed up the need for more effective handling of odd lots through such means as the bunching of orders and the use of computers. It was also recommended that the Federal Reserve expedite its denominational exchanges of U.S. Government securities.

Mechanism for clearing securities. A number of dealers urged that progress toward a fully automated system for clearing securities be accelerated. Some dealers also mentioned that faster transfers of securities over Federal Reserve wires would be most helpful. Another suggestion was aimed at liberalizing Federal Reserve and commercial bank time schedules for delivery of securities.

Facilities for borrowing securities. Several dealers mentioned that borrowing securities to execute short sales or to avoid delivery failures had become an increasing problem in recent years. Some dealers described the problem as already serious. Only a minority of the dealers indicated that their trading activity had not been inhibited by difficulties in borrowing securities, although they conceded that a few individual issues had posed problems in this respect.

Many dealers recommended, some in quite urgent terms, that a study of the feasibility of lending officially held securities be undertaken. Loans of securities might be made from the Federal Reserve portfolio, from the holdings of the Treasury trust funds, and perhaps also from other "customer" accounts in the custody of the Federal Reserve. Most of the dealers suggested that such loans be made on standard commercial terms--including the provision of satisfactory collateral, payment of interest on the securities borrowed, and payment of a loan fee of 1/2 per cent per annum. These loans might be made for the purposes of avoiding delivery failures and to enable the dealers to sell securities "short" for relatively limited periods of time. The dealers concluded that an increase in the volume of securities that could be borrowed would considerably enhance the tradeability of many issues and would augment the over-all flexibility of the market.

Margin requirements on dealer loans. Very few dealers commented on the subject of margin requirements on dealer loans, and only one suggested that some loose practices had developed in this area. He recommended that standard margins be established on repurchase agreements and on bank loans made to nonbank dealers. A few dealers noted that dealers who are members of the New York Stock Exchange are automatically subject to margin requirements on borrowings to finance security holdings.

Settlement of transactions in "Federal" or "clearing-house" funds. The dealers indicated that the current practice was to settle in Federal funds any transactions involving issues due within 1 year and in clearing-house funds any transactions involving longer-term obligations. All transactions executed over Federal Reserve wires were settled in Federal funds.

Several dealers recommended that all transactions be settled in Federal funds. They argued that in periods of tight money, especially, too many purchases for settlement in Federal funds (i.e. immediately available funds) and too many sales for settlement in clearing-house funds (available the next business day) could be very costly because the dealers had to finance the securities in the interim at relatively high interest rates.

The 4-1/4 per cent interest rate ceiling. Several dealers believed that removal of the 4-1/4 per cent interest rate ceiling would be desirable from the standpoint of the market as well as from the standpoint of debt management. They indicated that the absence of the Treasury from the long-term market for considerable periods of time when interest rates were high tended to decrease investor interest in U.S. Government bonds. Moreover, many investors had strong preferences for "current" coupons and were reluctant to purchase issues bearing lower coupon rates of return, even though yields on such issues might be equally high due to their sizable discounts.