To The Members of the Federal Open Market Committee

I thought the Committee would be interested in this report on the current status of the Treasury's plans for marketing long-term bonds through competitive bidding.

Robert W. Stone, Manager,
System Open Market Account.

November 8, 1962

CONFIDENTIAL--(F.R.)

To Federal Open Market Committee

October 25, 1962

From Peter Keir and Spencer S. Marsh, Jr.

Subject: Report on Treasury plan to market long-term bonds through competitive bidding by syndicates.

This memorandum reports on developments to date in Treasury and market thinking about the plan to offer long-term Government bonds for competitive bidding by syndicates. Its major emphasis is on the syndicate groups which have been formed to bid for the new bond, the underwriting problems which syndicate members foresee, and the alternative underwriting approaches which they are planning in light of these problems. Questions relating to syndicate organization and approach are the major area of uncertainty about the auction still to be resolved. The memorandum begins with a chronology of steps already taken to implement the Treasury plan, and ends with a brief discussion of some of the technical questions relating to new issue terms.

The points of view described in the memorandum are those that were prevalent in market circles prior to President Kennedy's statement on the Cuban crisis. Since it is not clear how international developments will affect bond market prospects over the next few months, one cannot say at this point to what extent these earlier views may change.

Chronology of Events

On September 14, 1962, the Treasury first announced its plan to experiment with auctioning of a long-term bond. Few details of the proposal were revealed at the time--other than that the new bond would be offered for competitive bidding by syndicates, would total $250 million, and would be auctioned sometime within the next six months. The announcement also stated that Treasury officials would hold an open meeting at the Federal Reserve Bank of New York on October 17 to answer questions about the proposed auction and to receive suggestions.

On the strength of the September 14 announcement, a number of security dealers and large banks moved immediately to organize syndicates, and three such groups were quickly established. Early in October key members from these three groups met separately with Treasury representatives to express their initial reactions to the proposal and to raise questions. These informal meetings were intended mainly to give the syndicate leaders an opportunity to raise questions and express views privately, and also to brief the Treasury on what to expect at the public meeting on October 17.

The October 17 meeting served principally as a forum for Under Secretary Roosa to spell out more of the details of the Treasury plan. Although the audience totaled at least 400 people, questions from the floor were limited and none of the prospective underwriters who were present showed any inclination to air his own views publicly. Mr. Roosa, in addition to providing some further details on the nature of the new bond to be offered, laid down a tentative time schedule looking ahead to the first offering. He also indicated a number of questions on which final decisions have yet to be made, in particular the question of possible restrictions on syndicate organization and operation, and stressed that the Treasury was still greatly interested in receiving written views and suggestions from the market to assist in making such decisions.

The time-table of steps leading to the first auction was outlined by Mr. Roosa essentially as follows:

(1) After a brief further period for receipt and digestion of suggestions from the market, the Treasury will publish in the Federal Register around mid-November a set of tentative rules governing bond auctions of this type. This procedure will give interested parties 30 days to suggest changes in the proposed regulations.

(2) Around mid-December the regulations will be published in final form. Then as soon as market conditions are favorable, the Treasury will offer a specific new bond and invite bids, setting a date for the auction within 10 days to three weeks after the announcement, probably in early January.

During the period just before bidding, interested syndicate groups will be required to signify to the Federal Reserve Bank of New York (as fiscal agent of the Treasury) their intent to bid, in order to give the Treasury an opportunity to screen prospective bidders. This would not preclude a syndicate, or any syndicate members individually, from dropping out prior to the bidding.

Purpose of Experiment

In its September 14 announcement the Treasury stated that the purpose of its experiment is to test whether the syndicated underwriting is a practicable means for occasionally placing moderate amounts of marketable long-term Government bonds in the hands of the public, at the lowest possible interest cost to the taxpayers, and without adverse effects on markets for other long-term securities.

Mr. Roosa amplified this statement briefly at the October 17 meeting. He referred to the feeling that the past method of issuing long-term bonds through direct subscription had not been as successful in placing long-term debt as might have been hoped, and indicated that the Treasury is therefore turning to the investment market for assistance. In this way he hopes the marketing experience and customer contacts developed by underwriters of corporate and municipal bonds can be used to broaden the demand for Treasury bonds as well. The new technique, however, is to be tested as a possible supplement--not as a substitute--for existing methods of offering long-term bonds.

Market reaction: Prospective underwriters have expressed widely different judgments as to the efficacy of the Treasury proposal. These opinions range from the optimistic view that the experiment is well worth trying and has a good chance of success, to the pessimistic view that a syndicated underwriting is not a good way to sell Treasury bonds and will create more problems than it solves.

The optimists argue that past investor disinterest in long-term Treasury bonds has been partly due to the fact that such issues have never been actively promoted by professional underwriters. This group believes that once the new Treasury approach remedies this promotional defect, demand for long-term Government bonds will increase, and the supply of long-term Federal debt can be expanded at less additional cost to the Treasury than existing financing techniques would require.

The pessimists argue, on the other hand, that the main requisite for selling long-term Government securities is an attractive rate. They believe that investor interest in Treasury bonds has lagged in recent years not because of the absence of selling effort, but because the traditional investment advantages of Treasury issues have been generally downgraded. In an economy subject to only mild business recessions, they see investors ascribing almost as little risk of default to securities of many private firms as to United States Government obligations; and in financial markets characterized by increased cyclical rate volatility, they point out that market risk has been nearly as great for Treasury issues as for other high-grade securities. Finally, they believe that immunity from early call (more characteristic of Government than other types of bonds) is undervalued by the market. In these circumstances, many institutional investors are reportedly disinclined to accept lower yields on Treasury bonds--or for that matter on high-grade corporate securities--so long as more attractive yields are available on obligations of other credit worthy borrowers.

The pessimists conclude that when reoffering yields are the same, long-term bonds offered for subscription in the usual way can be more successful than those sold at auction. They believe that the competitive bidding method will generally cost the Treasury more, because syndicates will bid high to discount underwriting risks, and because final investor demand will be narrowed, not broadened. Narrowing of the market will reportedly result because underwriters will find it easier to concentrate secondary distribution among large investors, and this tends to squeeze out the medium- and small-sized investors (particularly small banks) which have typically subscribed to long-term Government bonds in the past.

The Syndicates and Their Problems

Notwithstanding the diversity of opinion about the Treasury plan that prevails among prospective underwriters, the majority view seems to be that the experiment should be given a try and may or may not prove successful--depending upon whether effective solutions can be found to the many problems involved. Most of the major institutions that generally serve as underwriters in Treasury and other types of security offerings have indicated a willingness to participate in one of the syndicate groups. Moreover, to the three groups organized shortly after the initial Treasury announcement, a fourth may be added.

This fourth syndicate is still only in the discussion stage but it is being tentatively organized by one of the medium-size dealers. It would reportedly include about 200 savings banks, savings and loan associations, retirement funds and small insurance companies, which would bid for bonds to add to their own portfolios, not for distribution purposes.

The other three syndicates all include Government security dealers, large commercial banks, and other types of firms with underwriting experience in municipal and corporate security markets. While syndicate #4 would operate essentially as a buying group and would contemplate no secondary market distribution of the new issue, all three of the other syndicates plan some secondary distribution.

One syndicate (denoted hereafter as #1) has been organized by C.J. Devine and Co., Salomon Brothers & Hutzler, and five of the largest banks in New York and

Chicago (greater detail on the make-up of syndicates will be found in the Appendix). From the standpoint of competence in the Government securities market and financial resources, this syndicate appears somewhat stronger than the others, the two leading firms being probably the most active traders of long-term Treasury issues. There are about 60 other participants including many banks and some of the less important general security underwriting houses throughout the country.

The second group (syndicate #2) is headed by Morgan Guaranty Trust Co., Aubrey G. Lanston & Co., Inc., Halsey Stuart and Co., Bank of America and Blyth and Co., Inc. This group includes about 50 other banks and miscellaneous investment dealers.

The third group is headed by First Boston Corporation, Discount Corporation, and Continental Illinois National Bank & Trust Co. of Chicago. It includes about 80 other banks and firms throughout the country, many of them large underwriting firms.

The Devine and Salomon group is strong financially and in Government securities market experience, while the First Boston group is especially strong in underwriting experience. The Morgan Guaranty Group has somewhat less experience in Government bond trading since only Lanston, Morgan Guaranty and Blyth are dealers and none of the three is nearly as active in long-term bonds as the leading dealer firms in the first and third groups. The First Boston group is also not quite as strong in this respect as the Devine-Salomon group. On the whole, however, the relative strength of the three groups appears to be sufficiently well balanced and broad to provide a fair test, at least for the first offering.

Despite this relative balance in financial capacity and know-how, the three prospective syndicates are planning rather different approaches to the bond underwriting. These alternative approaches are partly a reflection of different institutional backgrounds among the key firms acting as principals. To a considerable extent, however, they also seem to reflect differing judgments as to the importance of several types of underwriting risk which are peculiar to Treasury bond auctions. These special risks are (1) the general problem of new issue stabilization in the post-auction market; (2) the risk that competing groups will overbid for the first bond in an effort to win the prestige of being the underwriter of the United States Government; and (3) the risk that official actions by the Treasury or the Federal Reserve will cause unexpected and artificial price movements, both before the bidding and while the new issue is still in syndicate. A brief discussion of the nature of each of these risks follows.

Stabilization problems: In any bond underwriting the winning syndicate is always exposed to the risk of a general decline in bond prices before the new issue has been fully distributed. But the proposed Treasury underwriting is thought to be more vulnerable to short-run changes in market tone than other bond underwritings for two basic reasons; one, the fact that outstanding long-term Treasury bonds are close substitutes for new Treasury issues; and two, the fact that secondary trading in outstanding Treasury issues is relatively active. In corporate and municipal underwritings the new issue usually possesses special features which differentiate it from other current new offerings, and competition from secondary offerings of outstanding issues is nominal because of the limited trading of seasoned issues. For these reasons, underwriters of new corporate and municipal bonds have had some success in stabilizing reoffering prices, where this has seemed desirable.

Prospective underwriters of the new Treasury bonds, on the other hand, have no illusions about their ability to stabilize the reoffering price. They believe that any significant weakening of the bond market tone would quickly erode the relative attractiveness of the new issue,and that without sizable support operations throughout the long-term market they could not exert a stabilizing influence on the value of the new issue. A powerful syndicate might have the financial capacity to undertake support action, but considering the potential losses involved and the possibility that even large-scale buying would be ineffective in any significantly weaker atmosphere than prevailed at bidding time, the prospective underwriters think it highly unlikely that the members of any syndicate could be persuaded to adopt such a course.

Support action by the winning syndicate would be difficult in any event because major operators in the Government securities market who were key members of losing syndicates would not be a party to the support effort. For this reason the winning underwriters might conceivably be vulnerable to raiding operations by powerful outsiders. In view of the tradition of aggressive competition that has generally characterized trading in the Government securities market, certain of the prospective bidders believed that this risk of market raiding is more than an outside possibility. At the same time, however, it should be recognized that the risks of engaging in raiding could be very considerable, especially if such raiding involved not merely the liquidation of existing inventories but the making of short sales as well.

Risk of overbidding: Participation in the syndicate that becomes the first underwriter for the United States Government is reportedly highly desired by syndicate members for the prestige it would presumably give them. This special incentive to win could lead to an extremely aggressive auction. If these influences lead to overbidding, as many fear they may, the gross spread between bid and reoffering prices is likely to be exceedingly narrow--squeezed on the bid side by the prestige factor, and on the reoffering side by investor insistence on an attractive yield.

Some observers believe that the gross spread in the auction may be no more than $2.50 to $3.50 per bond (which compares with $7.70 in the most recent A.T. & T. offering). Although the costs of syndicate administration are likely to be less for Treasury bonds than for new corporate and municipal issues, the net spread available to cover profit and special promotional costs might be no more than $1.75 to $2.75 per bond. A net spread of only $1.75 would provide little margin for market risk. In these circumstances any significant deterioration of the new issue price in the post-auction market could wipe out syndicate profits and might lead to net losses.

Uncertainties about official action: Given their inability to stabilize the post-auction market should adverse circumstances develop, some prospective underwriters of the new bond would probably welcome some assurance of direct support from the Treasury or the Federal Reserve in the event of market deterioration. There appears, however, to be no real expectation that such support would in all circumstances be extended. Nevertheless, some of the prospective bidders believe they are at least entitled to some assurance that neither the Treasury nor the Federal Reserve will take actions during the underwriting period which might significantly affect market price relationships.

For the Treasury, this would mean chiefly no discussion of other new bond issues in other types of Treasury financing until the syndicate offering had been well distributed. For the Federal Reserve, it would mean no change in the discount rate, reserve requirements, or stock margin requirements during the underwriting period, and no major change in open market policy. Some underwriters believe, moreover, that official assurances should include a prohibition against any System and Treasury Trust Account operations in long-term securities for periods before and after the syndicate bidding.

Underwriters in other bond markets have not been appreciably handicapped by the absence of such Treasury and Federal Reserve assurances, but these other markets are presumed to be less affected by System and Treasury Trust Account operations and to be largely immune to all except outright policy changes. This contrasts with the Government securities market which is sensitive both to rumors of contemplated policy moves and to official participation directly in the market. Market risks stemming from official actions are thus thought to be considerably greater for the underwriting of a Treasury bond.

Alternative Approaches to Syndicate Underwriting

According to their present plans, the three major syndicate groups contemplate quite different underwriting approaches to the Treasury offering.

Syndicate #3, in which the key manager and a number of other members have been active in corporate security underwritings, plans to pattern its operations after corporate experience. Corporate underwritings are governed by S.E.C. rules which require the winning syndicate to make a bona fide effort to sell to the public at the syndicate reoffering price before bonds can be taken directly into member portfolios. This group seems to be prepared to make a bona fide effort to sell the new Treasury issue and apparently contemplates holding its members in syndicate for an extended period if necessary.

Syndicate #1, in which several of the managers are large banks that are active in municipal bond underwriting, plans to pattern its underwriting operations more along the lines of a municipal offering. In municipal underwritings, although the syndicate usually makes a post-auction effort to distribute to other investors, members can take some or all of their shares of the new issue directly into portfolio if they wish, without making a bona fide effort to sell to the public.

Syndicate #2 plans to confine its group selling efforts largely to the period between the announcement of terms and the auction. Any bonds not sold by the auction date or shortly thereafter would then be divided among the members of the group, the syndicate would terminate, and each member would be left free to do so as it wished with the unsold bonds, either taking them directly into position or selling at negotiated prices which could be different from the original reoffering price. There would be little group underwriting effort in the post-auction period.

Syndicate #4, as has been indicated, is really a joint buying group and does not plan an underwriting operation at all. Its participation in the auction would be designed simply to obtain bonds for the portfolios of its members directly from the Treasury at the wholesale price, rather than paying a retail price to the winning syndicate.

The different approaches contemplated by the three syndicates that do plan to do some underwriting seem to have been shaped by their different attitudes toward the likely success of the auction. Syndicate #2, for example, seems to be tailoring its approach to fit the conclusion that underwriting risks are too great to justify a sustained group selling effort in the post-auction market at a fixed reoffering price. This pessimistic view seems to be based mainly on the following reasoning:

(1) Since adverse market developments could create excessive risks which the winning syndicate could not deal with effectively through stabilizing the post-auction market, syndicate members must press to distribute the new issue as quickly as possible before market conditions have a chance to change.

(2) When a fixed reoffering price is maintained, rapid distribution is sometimes inhibited because larger institutional investors delay their buying, hoping for a break in the syndicate price. On the other hand, if syndicate members take down the bonds immediately, they will be able to negotiate prices with individual buyers, and can deal more effectively with large investors--adjusting the price for block sales and creating an impression that potential buyers who lag behind may soon find supplies of the new bond exhausted.

(3) In the initial Treasury auction the incentive to win for prestige purposes may severely limit the spread between bid and reoffering prices. This will place a special premium on quick distribution to avoid market losses and it

will also place a serious financial limitation on the amount of effort that can profitably be put into promotion. Both of these considerations will make it particularly desirable to sell in block quantities to large buyers.

(4) When the underwriter is required to maintain a fixed reoffering price and to make a bona fide effort to sell to the public in the immediate post-auction period, he is placed at a disadvantage. If the secondary market strengthens and prices rise, the bonds sell out quickly with ultimate investors receiving the resulting capital gain. If the post-auction market weakens, on the other hand, the underwriter must eventually cut his reoffering price in order to distribute the issue, and may realize a net loss on the operation. In view of the special risks involved in Treasury underwritings--particularly the risk of overbidding in the first operation--it is argued that syndicate members should be allowed to share in post-auction price advances, as well as to absorb losses arising from post-auction price declines.

Syndicate #1 has a similar reluctance to assume undue risks in the post-auction period through holding open a bona fide offering to the public. They would expect to distribute the issue to best advantage after the auction but would want to be free to sell where they choose, preferably to buyers who would take large blocks. In particular, they would want to be free to take down any amounts of bonds at any time for their own portfolios, either permanently or until market conditions improve.

Syndicate #3 is obviously more optimistic about the prospects for success of the corporate-type of underwriting approach. Its optimism seems to reflect a basic assumption that the reoffering yield on the new bond will be relatively high, narrowing the usual spread between Treasury and high-grade corporate bonds sufficiently to attract good investor demand. This viewpoint on yield seems to depend in turn on the further assumptions that the gross spread between bid and reoffering prices will not be seriously impaired by overbidding for prestige purposes, and that all bidders will be required to follow the corporate-type of underwriting approach, i.e., that it will be necessary to make a bona fide offering of the bonds to the public. (As regards the question of a bona fide offering, it should be noted that there is room for compromise. For example, the Treasury could require a bona fide offering to the public of a minimum of 75 per cent of the bonds for at least 48 or 72 hours; or it could request bids from the syndicates on alternative bases.)

Policy Considerations

At the October 17 meeting Under Secretary Roosa reported that the Treasury had not yet reached a decision as to the type of the syndicates that would be permitted to bid and was, in fact, actively interested in obtaining further advice from the market on this question. He indicated that the Treasury still had an open mind on such questions as the desirability of allowing buying groups to bid in the auction and the need for restrictions on syndicate operations. (This would seem to apply to a requirement for a bona fide public offering although he did not mention this.) Questions on syndicate organization and operation were thus the principal remaining area of uncertainty which still needs to be clarified.

If the major objective of the new auction technique is to broaden the market for long-term Government bonds, the Treasury would probably benefit most by requiring the winning syndicate to make a bona fide effort to distribute the new issue as widely as possible. A regulation of this type would require the winning syndicates to make an actual offering of all or a large part of the issue to the public at a fixed price for some minimum period of time. Such an offering might provide a truer measure of the breadth of investor interest in Treasury bonds and it would probably also add a note of caution to those planning to bid aggressively for prestige purposes. On the other hand, a requirement for a bona fide public offering would obviously eliminate syndicate #4 from the bidding and would probably force a sharp adjustment in the thinking of syndicates #1 and #2 (and possibly #3), because of the greater potential underwriting risks involved. These changes would undoubtedly add somewhat to Treasury interest costs.

Without a requirement for a bona fide public offering, the approach suggested by syndicates #1 and #2 would, in any given auction, probably result in somewhat lower financing costs to the Treasury, at least in periods when the outlook was for fairly steady to declining bond yields. But promotional advantages to the Treasury would be less, and attractive new issues marketed in periods of declining interest rates could be pre-empted by insiders, leaving other investors in the position of paying up in the secondary market or doing without. The political implications of this result are obvious.

At this point the Treasury quite naturally has a preference for limiting restrictions on the syndicates to the absolute minimum that is needed. In principle, the Treasury prefers to maintain as much flexibility for the prospective underwriters as possible in order to avoid the chance that official restrictions would make final judgment on the experiment ambiguous. In an untried undertaking of this type official restrictions might kill initial interest; in later operations, after the technique had been successfully tested, reasonable regulations growing out of experience might be readily accepted.

Other Policy Questions

In addition to questions of syndicate organization and approach, market discussion of the syndicated underwriting has posed a number of other problems of special significance to public policy, the most important of which have already been fairly well resolved. These other problems are listed briefly below, together with a brief indication of present official thinking as to their solution.

(1) Should official buying by the Federal Reserve or the Treasury be used to help stabilize the market during the underwriting period? At the October 17 meeting President Hayes answered this question for the System. He said: "The Federal Reserve always takes into account Treasury financing operations in determining policies and actions. We always have in the past and always will in the future. I would think we would treat this kind of financing in just the same way as we have treated Treasury financing in the past." Mr. Hayes did not actually use the term "even keel" in his response, but he did suggest that Government security dealers would understand what he was saying since they are thoroughly familiar with the way in which monetary policy has been conducted during past Treasury financings.

Speaking for the Treasury, Under Secretary Roosa reported at the October 17 meeting that there will be no direct purchases of the new bonds by Treasury Trust Accounts either on special allotment over and above the $250 million, or directly from the winning syndicate. He went on to say, however, that "this does not mean Government Trust Accounts should be considered to be excluded from the Government securities market for any set period". Generally, Trust Accounts can be expected to stay out of the market from the date of announcement on the new issue until a reasonable period after the bidding date--say a week--but it should not be assumed that they will forego "an opportunity, in the event unusual bargains begin to appear, to take advantage of such bargains in the market".

(2) Should the Federal Reserve and Treasury Trust Accounts refrain from ANY action in the long bond market during the underwriting period? The prospective underwriters have expressed a belief that they are entitled to some official assurance that the Treasury and the Federal Reserve will refrain from any operations in the long-term bond market for a period both before and after the new bond auction. Neither the Treasury nor the Federal Reserve has made any direct response to this

point, but Mr. Roosa's statement on Treasury Trust Account action quoted above can be interpreted to mean that the Treasury would stay out of the market unless conditions deteriorated to a point where securities were offered at bargain prices. It would seem unwise to narrow the Treasury's flexibility too much, for it may wish to reserve its Trust Account ammunition to take action both against possible market rigging by prospective underwriters before the auction, and against market raiding by losing bidders after the auction. Any attempt by the Treasury to control market raiding directly by means of trading restrictions would seem to be of highly questionable feasibility.

(3) Should the Treasury make any commitment restricting its offerings of long-term bonds in other types of debt operations? In his opening remarks at the October 17 meeting Mr. Roosa stated that the syndicated underwriting technique is being tested as a possible supplement to--not a substitute for--existing methods of offering long-term bonds. Privately, however, Treasury officials have acknowledged that it is legitimate for underwriters to expect the Treasury to refrain from other new offerings of long-term bonds for at least a month on either side of the auction date in a syndicated underwriting.

If the initial Treasury bond auction occurs early in January, as seems likely under the present time table, discussion of new issue possibilities in the February refunding will begin to occur sooner than one month after the auction date. Moreover, the Treasury will probably also be engaging in other cash financing in January.

This close coincidence of the bond auction with other types of financings will undoubtedly be characteristic of bond auctions in the future as well. In short, the underwriters will simply have to rely upon the good judgment of the Treasury debt management team not to offer a new long-term bond in other types of financings while a substantial share of a recently auctioned bond is still in position. Reliance on Treasury judgment would apply to the frequency with which long bonds are sold through the auction technique.

(4) Can the small investor be accommodated? All three of the underwriting groups have indicated that they plan to market their awards of new bonds in large blocks and cannot afford to accommodate small investors interested in odd-lot buying. This would effectively exclude from participation in the new issue a type of investor that has traditionally depended upon Treasury offerings as an assured source of sound investments. Again the political implications are obvious.

One possible answer to this question is that small investors will still be accommodated by offerings of long-term bonds in other types of financings. The syndicated underwriting can be described, in other words, as simply another technique of long-term financing which seeks to capitalize on a particular type of investment demand. This answer will obviously fail to satisfy a small investor who is effectively excluded from a long-bond auction if he then sees the new issue move to a substantial premium and remain tightly held in the portfolios of large investors.

It has been suggested that this problem could be solved by allowing small investors to place noncompetitive bids for the new issue in lots up to $10,000. If, however, a relatively large amount of bonds were placed on a noncompetitive basis, the underwriters could complain that the availability of those bonds to the market would tend to undermine their position in the issue. Also, if noncompetitive bids were allotted at the winning underwriter's bid price, some investors might try to get sizable amounts of bonds at that price (and below the underwriter's reoffering price) by submitting many noncompetitive bids under a number of different names or in different places. Moreover, the underwriters would probably object in principle to Treasury undercutting of their price.

If, on the other hand, noncompetitive bids were allotted at the syndicate reoffering price, it is difficult to see how the underwriters could complain, since they do not plan to accommodate small orders anyway. In this case the small investor might still object to paying the underwriter's price, since he was actually buying the bond directly from the Treasury. But the Treasury could clearly argue that the underwriter was granted the bond at a lower price in payment for services rendered to the Treasury as a borrower.

(5) Would syndicate underwriting pose an anti-trust problem? This question, which appears to be of considerable concern to the syndicates, has two aspects. First: Is the fact that competing Government security dealer firms will be participating in the same underwriting syndicate cause for worry that they may become less competitive in their other Government securities business? It seems clear that if Treasury underwritings were only a small and occasional thing, there would be no cause for worry. On the other hand, if syndicated underwritings became a regular practice--as the Treasury apparently intends if they are successful--some feel that there might be a danger that the long bond sector of the Government securities market would tend to become stratified around the major underwriting groups, with understandings and knowledge of one another's operations obtained in dealer firms within each underwriting group carried over to affect competition in other sectors of the market.

A more tangible anti-trust question is whether dealers who exchange short position data under a syndicate agreement of an underwriting group will make themselves liable to subsequent anti-trust prosecution.

The Treasury is studying this matter, but it appears that there is little possibility of obtaining any advance ruling settling the question. Final determination whether joint actions are in violation of the anti-trust laws cannot be made until it is ascertained whether the practices actually followed at any given time and the results they produce can be construed to be in restraint of trade.

All that can be said on this issue at this point is that corporate and municipal bond syndicates have successfully avoided anti-trust litigation for many years.

(6) Would commercial bank underwriting be inhibited by inability to sell to their own trust accounts due to conflict of interest? Conflict of interest considerations prevent commercial banks from selling securities directly from the bank's own investment portfolio to trust accounts managed within the bank's trust department. When the bank is a member of an underwriting syndicate, some bankers believe that it is legitimate for the trust department to buy securities held by the full syndicate, as long as the syndicate reoffering price is still in force and the bank involved is not a syndicate manager. Others argue that even purchases from the syndicate can be made only if special authorization for such a purchase is first obtained from individual trust account beneficiaries. This process is probably administratively feasible only for the largest accounts.

The conflict of interest problem is not a new one for banks, since similar questions have had to be resolved with respect to municipal bond underwritings. It seems likely that solutions applicable to municipal underwritings can also be applied to the Treasury case.

(7) Will the 4 1/4 per cent interest rate ceiling on Treasury bonds act as a barrier to effective bidding? Unless bond market conditions change over the next few weeks, bidding in the initial Treasury bond auction will undoubtedly occur in a range well below the interest rate ceiling. This was the position taken by Mr. Roosa at the October 17 meeting in dismissing any concern about the interest rate ceiling. In some subsequent auction, however, the Treasury may have to announce in advance whether it will accept bids at prices that would make the effective interest cost more than 4 1/4 per cent.

Technical Questions on Bond Offering

At the October 17 meeting Mr. Roosa revealed a number of the specifics of Treasury planning on the new bond, including the fact that it will be a new issue (not a reopened issue); will have a long-term maturity possibly of 20-25, or 30, years; will require a 3 per cent cash deposit at the time of bidding; will be payable in Federal funds and will not be payable in credit to tax and loan accounts. Important questions on pricing, call provisions (if any), and estate taxes were left open, however, for further comment from the market.

Coupon and pricing: On October 17 the Treasury had not yet decided whether to set the coupon on the new issue and ask for bids on price alone, or to request bids on both coupon and price. In any case, Mr. Roosa indicated, coupons would be graduated in 1/8's of a percentage point, not in decimals.

Likewise, as of October 17, the question whether to set limits on allowable bid prices had yet to be decided, although Mr. Roosa did state that the Treasury will reserve the right to reject both prices that are too low and prices that are too high. Having indicated the possibility of rejecting a high bid, Mr. Roosa commented that he hoped his statement by itself would kill any remaining enthusiasm for overbidding. In practice, however, it might be rather difficult for any Treasury official to rationalize, to the satisfaction of critics, rejection of a high bid. An equally difficult but related question concerning both high and low bids is whether the Treasury should seek to exercise any control over the spread between syndicate bid and reoffering prices.

Call provisions: On the question of call provisions, Mr. Roosa indicated that he is inclined to favor a call date on the new issue--at some point short of maturity but somewhat longer than usual corporate practice. He stated, however, that he would like to hear further reactions to a call feature from the market. In particular, he would like to get a more precise market estimate of the difference in rate which the

Treasury would have to pay on, say, a 20-25-year bond, callable in 10-15 years, as compared with a bond of equivalent maturity with no call provision.

Estate taxes: Another question still open for Treasury decision is whether holders of the new bond should be granted the privilege of redeeming it at par in payment of estate taxes. Since the bond would probably be reoffered at a rate fairly close to current market rates and at a price not too much below par, and since there are already outstanding large amounts of relatively low coupon bonds that carry this privilege, there might be very little advantage in adding this feature to the new bond. Moreover, as a general principle, the Treasury is opposed to issuing securities which have any features of tax exemption. On the other hand, this is one way in which a long-term Treasury issue can be made slightly more attractive, particularly in the secondary market.

Regular vs. Syndicated auction: One final technical question raised at the October 17 meeting was why the Treasury plans to use a form of auction in which bidding is restricted to syndicates, instead of an open auction of the type used for Treasury bills. Mr. Roosa replied that the Treasury had judged, on the basis of an informal canvass of the market, that dealers and other potential bidders apparently would not be willing individually to back up their price judgment with a bid of any size in an open auction, unless the bid were as much as 1/4 of one per cent off the prevailing market.

The implication of this answer is that an open bond auction would require substantial underwriting by professionals. Although Mr. Roosa did not develop this point, many have argued that except for small investors placing noncompetitive tenders, bidding in such an auction would in fact be limited chiefly to a few knowledgeable professionals. It is alleged that portfolio managers of institutions that generally invest in Government securities would be reluctant to bid in this type of auction because they would believe they were not close enough to the market to make an informed bid and would fear being placed in a bad light with their superiors if they bid too high.

APPENDIX

SYNDICATES

I MANAGERS

Bankers Trust Co.
The Chase Manhattan Bank
The First National City Bank of New York
C. J. Devine & Co.
Salomon Bros. & Hutzler
Chemical Bank New York Trust Co.
First National Bank of Chicago

Manufacturers Hanover Trust Co.
Merrill Lynch, Pierce, Fenner & Smith, Inc.
61 others including
Second District Securities Co., Inc.
Briggs, Schaedle & Co., Inc.

II MANAGERS

Morgan Guaranty Trust Co. of New York
Aubrey G. Lanston & Co. Inc.
Halsey Stuart & Co.
Bank of America
Blyth & Co. Inc.

MAJORS

The Atlantic National Bank of Jacksonville, Florida
Crocker-Anglo National Bank, San Francisco
First National Bank in Dallas
Ladenburg Thalmann & Co., N.Y.C.
John Nuveen & Co.
Wertheim & Co.

About 44 others

III MANAGERS

First Boston Corp.
Discount Corp. of New York
Continental Illinois National Bank & Trust Co. of Chicago

45 MAJORS INCLUDE

New York Hanseatic Corp.
Wm. E. Pollock & Co., Inc.
Security-First National Bank, Los Angeles
Mellon National Bank & Trust Co., Pittsburgh
National Bank of Detroit
The Northern Trust Co., Chicago
Wells Fargo Bank American Trust Co., San Francisco
The Philadelphia National Bank

The First Pennsylvania Banking & Trust Co.
The National City Bank of Cleveland
The First National Bank of Oregon, Portland
Seattle-First National Bank
The First National Bank of St. Paul
Northwestern National Bank of Minneapolis
First City National Bank of Houston
The National Bank of Commerce in New Orleans
American Securities Corp.
Harriman Ripley & Co. Inc.
Paine, Webber, Jackson & Curtis
Stone & Webster Securities Corp.
Drexel & Co.
Francis I. du Pont & Co.
Bear, Stearns & Co.
Hallgarten & Co.
Hemphill, Noyes & Co.
Shearson, Hammill & Co.
W. C. Langley & Co.
Tucker, Anthony & R. L. Day

About 37 other nonmajors