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Abstract

This paper presents a history of the primary dealer system from the late 1930s to the early 1950s. The paper focuses on two formal programs: the "recognized" dealer program adopted by the Federal Reserve Bank of New York in 1939 and the "qualified" dealer program adopted by the Federal Open Market Committee (FOMC) in 1944 and abandoned in 1953. Following his selection as Manager of the System Open Market Account (SOMA) in 1939, Robert Rouse formalized the New York Fed's system of "recognized" dealer counterparties. Although the Bank typically dealt with recognized dealers, it also did business from time to time with other dealers; neither the original informal system nor the successor formal system made a sharp distinction between the two. The focus of monetary policy changed from managing reserves to keeping interest rates low following the entry of the United States into World War II. To support the new focus, the FOMC replaced the New York Fed's recognized dealer program with its own program of "qualified" dealers. The new format limited transactions for the SOMA to qualified dealers and imposed a variety of restrictions on those dealers. Following the Treasury-Federal Reserve Accord of March 1951, the FOMC returned stewardship of the primary dealer system to the New York Fed, with instructions to develop a more open system that contemplated transactions with anyone "actually engaged in the business of dealing in Government securities."

Key words: primary dealer, open market operations, System Open Market Account

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A primary dealer is a government securities dealer designated, by the Federal Reserve Bank of New York, as eligible to participate in open market operations undertaken by the Bank at the direction of the Federal Open Market Committee. The primary dealer *system* is the nexus of designation criteria and performance requirements that stem from the decision to execute open market operations through primary dealers.

This paper presents a history of the primary dealer system from the late 1930s to the early 1950s. The paper focuses on two formal programs: the "recognized" dealer program adopted by the Federal Reserve Bank of New York in 1939 and the "qualified" dealer program adopted by the Federal Open Market Committee in 1944 and abandoned in 1953, but addresses as well the more informal predecessor and successor systems. Section 1 reviews the emergence of open market operations as a principal instrument of monetary policy in the 1920s. Section 2 describes how Robert Rouse formalized the New York Bank's informal system of "recognized" dealer counterparties following his selection as Manager of the System Open Market Account in 1939. Although the Bank typically dealt with recognized dealers, it also did business from time to time with other dealers; neither the original informal system nor the successor formal system made a sharp distinction between the two.

The focus of monetary policy changed from managing reserves to keeping interest rates low following U.S. entry into World War II. To support the new focus, the FOMC replaced the New York Bank's recognized dealer program with its own program of "qualified" dealers. As discussed in sections 3 and 4, the new format limited transactions for the Open Market Account to qualified dealers and imposed a variety of restrictions on those dealers.

Following the Treasury-Federal Reserve Accord of March 1951, the Federal Reserve System undertook an extensive examination of how best to conduct monetary policy in the new era of a free market for Treasury debt. As discussed in section 5, the FOMC returned stewardship of the primary dealer system to the New York Bank, with instructions to develop a more open system that contemplated transactions with anyone "actually engaged in the business of dealing in Government securities."

The evolution of the primary dealer system over the decade and a half following its formalization in 1939 has two prominent features. First, outside of the war and post-war period, Federal Reserve officials generally sought to fashion a system that was compatible with the existing structure of the Government securities market. They took the market as they found it and did not try to promote novel activities or suppress existing activities. However, during World War II – and continuing into the post-war period – they installed an aggressive regulatory regime.

1. Beginnings

There were no deep, liquid markets for U.S. Treasury securities when Congress passed the Federal Reserve Act in December 1913. In fact, the Treasury had not issued any marketable debt of any kind for almost two and a half years. Yet within little more than a decade there was a liquid secondary market for Treasury certificates, notes, and bonds and open market operations in those securities were underway and rapidly evolving.

Origins of Open Market Operations

Open market operations evolved out the growth in Treasury debt during World War I [1] and the Reserve Banks' need to acquire income-producing assets in the post-war period.

A New Market. Treasury officials financed about three-quarters of the costs of the war with debt, primarily interest-bearing certificates maturing in a year or less and long-term bonds. The bonds were sold in four large Liberty Loan drives and subsequently traded on the New York Stock Exchange. Certificates were sold in smaller, more frequent, offerings and were neither

[1] Chandler (1958, p. 133) states that the vastly enlarged national debt "provided the Federal Reserve Banks with a new and important medium for open-market operations. Extensive open-market operations in government securities would not have been feasible before 1917, even if the Reserve Banks had been disposed to engage in them, because the supply of those securities was so small and so firmly held."

listed on the Exchange nor traded over-the-counter. If a holder wanted to liquidate a certificate before maturity she sold it to a bank at the current yield on new offerings. The bank could, in turn, finance the certificate at a break-even interest rate at its district Federal Reserve Bank.[2]

Hostilities ended on November 11, 1918, but Treasury officials continued to issue certificates – to finance demobilization and to refinance maturing certificates. For more than a year they importuned the Reserve Banks to keep their discount rates low and commercial banks to continue to provide liquidity to certificate holders. Federal Reserve officials became restive with the inflationary consequences and Treasury officials finally agreed, in the spring of 1920, to higher discount rates and a free market in certificates.[3] Over-the-counter trading blossomed, supported by dealers such as C.F. Childs, Salomon Brothers & Hutzler, Bankers Trust Co., and Discount Corp.[4]

In the spring of 1921, the Treasury began issuing notes – interest-bearing securities maturing in more than one year and not more than five years – to term out some of its short-term debt and to facilitate bond redemptions. The new notes also traded over-the-counter, and by the mid-1920s Treasury bond trading had migrated to the over-the-counter market as well.[5]

The post-war Treasury market was national in scope. Most large dealers had their main offices and trading rooms in New York but kept in close contact with branch offices and regional dealers by telegraph and telephone. The development of an integrated national market was further advanced by the introduction, in 1921, of wire transfers of certificates and notes between Federal Reserve Banks and branches.[6]

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2 Garbade (2012, p. 191).

3 Garbade (2012, ch. 4 and 5 and p. 191).

4 Beckhart, Smith, and Brown (1932, p. 335).

5 Garbade (2012, pp. 161-163 and 196-198).

6 Smith (1956) and Garbade (2012, p. 195 and p. 196, fn. 30).

A New Instrument of Monetary Policy. Section 14 of the Federal Reserve Act authorized Reserve Bank transactions in gold, foreign currencies, Treasury securities, bankers acceptances, and short-term state and local government debt. Prior to World War I the Banks used that authority to acquire earning assets, primarily state and local government securities and bankers acceptances.[7] Following the termination of their wartime support programs, the Banks turned to Treasury securities to satisfy their need for income.[8] (Income was not a problem during the war because the Banks had ample earnings from discount window loans extended in support of the Liberty Loan drives.[9])

In the spring of 1922 the twelve Reserve Banks formed the Committee on Centralized Execution of Purchases and Sales of Government Securities by Federal Reserve Banks to coordinate their purchases. The committee consisted initially of the Governors of the Boston, New York, Philadelphia, and Chicago Banks; the Governor of the Cleveland Bank was added in the fall of 1922.[10] The committee met for the first time on May 16, 1922, and elected Benjamin Strong – the Governor of the Federal Reserve Bank of New York – chairman.

Chandler (1958, p. 215) points out that, "as originally conceived, the function of the committee was to be only that of executing orders received from the various Reserve Banks. It was not to determine policy." Nevertheless, the committee soon began to recommend purchases and sales of Treasury securities for the express purpose of making reserves more or less readily available to the banking system. The Federal Reserve Board became alarmed at the growth of a policy-making body outside of its purview and, in March 1923, ordered the committee replaced by the Open Market Investment Committee ("OMIC"). OMIC membership was identical to that of the Committee on Centralized Execution and Strong was again elected chairman, but the new

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7 Chandler (1958, p. 76).

8 Chandler (1958, pp. 208-209).

9 Garbade (2012, ch. 9).

10 Chandler (1958, pp. 214-215).

committee, unlike the committee that it replaced, operated under the Board's "general supervision." [11]

Open market operations quickly became quite sophisticated. Chandler observes that,

> Before the end of 1924 the [Open Market Investment Committee] was engaging in open-market operations to offset disturbing effects of Treasury operations around tax-payment dates, selling securities to mop up excess funds resulting from net outpayments by the Treasury, and buying securities to offset net Treasury withdrawals of money from the market. In 1925 it began to buy and sell securities to offset net outflows of currency into circulation and net inflows of currency from circulation, especially around Christmas and other holiday periods.[12]

Chandler concludes that, "in a period of only about three years, Federal Reserve officials had come to understand open-market operations, to develop economically meaningful objectives for them, to centralize control of them, and to use them with force and skill. In some instances, the committee employed them 'defensively' to prevent undesirable effects that would otherwise have resulted from such things as gold movements … But it also used them 'dynamically' to initiate desired changes in the money market." [13]

Consequences of the Great Depression

The Great Depression had two important consequences for the institutional framework of open market operations: it expanded the size of the Treasury market and it led to a change in governance.

Between mid-1930 and mid-1939, marketable Treasury debt increased from $14.4 billion to $33.8 billion.[14] Almost a dozen firms, including Chemical Bank and Trust Co., C.J. Devine &

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[11] Chandler (1958, pp. 217-219 and 227-228) and Meltzer (2003, p. 147).

[12] Chandler (1958, p. 234).

[13] Chandler (1958, p. 234). The terms "defensive" and "dynamic" originated with Roosa (1956, p. 9, fn. 1).

[14] Statement of the Public Debt of the United States, June 30, 1930, and June 30, 1939.

Co., and the Guaranty Trust Company, joined the half-dozen firms already active as government securities dealers.[15]

The growth of the market led to the appearance of a number of significant regional dealers, but trading remained centered in New York. A 1940 study by the Federal Reserve Bank of New York noted that,

> All of the facilities existing outside New York for trading in Government securities are operated "on the basis" of the New York market, both with respect to price quotations and the relative breadth of the market existing for various issues of Government securities. Except for a small amount of orders which are "matched off" by banks and investment firms in local markets (on the basis of New York quotations), all of the trading is ultimately with or through the Government security dealers in New York. For example, [a major Chicago bank] … keeps in close touch with the New York market by telegraph and has a staff member permanently located in New York who checks quotations and condition of markets for individual issues, and executes transactions for the bank with the dealers in New York. Most of the other banks located outside New York transact their Government securities business either for their own account or for account of correspondents and other clients through the branches and representatives of the New York dealers, permanently located outside New York, or directly by wire with New York.[16]

The "catastrophic failure" of monetary policy in the early 1930s [17] led Congress to create the Federal Open Market Committee, consisting (after 1935) of the seven members of the renamed Board of Governors and representatives of five Reserve Banks.[18] The Committee held its first meeting in Washington, D.C., on March 18, 1936.

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15 Childs (1947, pp. 383-384).

16 Federal Reserve Bank of New York (1940, pp. 14-15).

17 Quoting Mussa (1994, p. 111).

18 As prescribed by the Banking Act of 1935, the representatives were chosen by the boards of directors of (1) the New York and Boston Reserve Banks, (2) the Philadelphia and Cleveland Banks, (3) the Chicago and St. Louis Banks, (4) the Richmond, Atlanta, and Dallas Banks, and (5) the Minneapolis, Kansas City, and San Francisco Banks. The Act of July 7, 1942, made the New York representative a permanent member of the FOMC and provided that the other four representatives would be chosen by the Boards of directors of (1) the Cleveland and Chicago Banks, (2) the Boston, Philadelphia, and Richmond Banks,

Article II, Section 5 of the by-laws adopted during the March 18 meeting called for the selection of a Reserve Bank to execute transactions and to designate a manager for the System Open Market Account. The Committee chose the Federal Reserve Bank of New York. George Harrison, the president of the New York Bank, announced that W. Randolph Burgess, a vice president of the Bank, would serve as the first manager.[19]

Article III of the by-laws provided for the selection by the full committee of an executive committee, consisting of the Chairman of the full committee, two other Governors, and two Bank presidents who were members of the full committee. The Executive Committee was tasked with directing "the execution of transactions in the open market account in accordance with the ... policies adopted" by the full committee and performing "such other functions and duties in connection with open-market operations as may be assigned to it" by the full committee.[20] In practice, many crucial decisions of the FOMC came out of Executive Committee discussions and recommendations.[21]

Dealers: The Interface Between the Federal Reserve System and the Market

The structure of the market for U.S. Treasury securities as an over-the-counter dealer market did not determine how the Federal Reserve Bank of New York would execute open market transactions. One possibility was to solicit bids from the general public when the Bank wanted to sell (just as the Treasury did in bill auctions) and offerings when the Bank wanted to buy (as the Treasury did in three "reverse auctions" in the 1920s [22]). Alternatively, the Bank

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(3) the Atlanta, St. Louis, and Dallas Banks, and (4) the Minneapolis, Kansas City, and San Francisco Banks.

19 Minutes of the Federal Open Market Committee, March 18, 1936, pp. 4 and 6-7.

20 Minutes of the Federal Open Market Committee, March 19, 1936, pp. 2 and 3.

21 The Executive Committee was abolished by vote of the full committee in 1955. Minutes of the Federal Open Market Committee, June 22, 1955, pp. 3-26.

22 Garbade (2012, pp. 209-213 and Box 14.2).

could limit its solicitations to the core of the market, the dealers, and leave it to the dealers to distribute securities to, or gather securities from, the public.

At least from the mid-1920s, the New York Bank limited its relations to dealers. The 1940 New York Bank study stated that "it has always been the policy of the Federal Reserve System not to deal directly with 'investment' holders of Government securities but only with … dealers and other merchandisers." [23] In practice, the Bank directed most of its business to a small set of "recognized" dealers, although it also executed transactions with other, "responsible," dealers when those dealers volunteered attractive bids or offers.[24]

The concept of a recognized dealer was somewhat amorphous. An October 1939 Bank memo remarked that the term was "not an exact appellation" and noted that "the principal factors which we consider in extending such recognition are: (1) reputation for integrity, experience, and knowledge, (2) capital at risk of the business, (3) willingness to make markets under all ordinary conditions and to take positions both long and short, and (4) large volume [of business] of national scope, with the contacts which such trading provides." [25]

There were eight recognized dealers at the end of the 1930s:

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[23] Federal Reserve Bank of New York (1940, p. 15). A 1952 Bank report noted that, because it was "in the public interest to have a strong dealer market and in the System's interest to have a strong private market, the System deals with, and does not attempt to step around, the market." Federal Reserve Bank of New York (1952, p. 2-7). In his 1956 monograph on open market operations, Robert Roosa observed that "The results of dealer performance through the years have been to provide a market of considerable scope and diversity for Government securities. It is to the interest of the Treasury as issuer of these securities, and of the Federal Reserve as a major buyer and seller of these securities in carrying out credit policy, that such performance continue and improve. For that reason … both the Treasury and the Federal Reserve confine all of their market transactions for the purchase and sale of outstanding Government securities to the dealer firms which continue, day in and day out, at risk to themselves, to 'make markets' in these securities to everyone." Roosa (1956, p. 36).

[24] Memo from Messrs. Rouse and Miller to Mr. Sproul, Federal Reserve Bank of New York, "Authorizations and procedure with respect to the purchase and sale of securities for System Account and others," July 21, 1939, pp. 4-5.

[25] Memo from Allan Sproul to Mr. Harrison, Federal Reserve Bank of New York, "Authorizations for the Purchase and Sale of Securities," October 30, 1939, p. 2.

- Bankers Trust Co.,
- C.F. Childs & Co.,
- C.J. Devine & Co.,
- Discount Corp.,
- First Boston Corp.,
- Guaranty Trust Co.,
- New York Hanseatic Corp., and
- Salomon Brothers & Hutzler.[26]

Continental Illinois National Bank and Trust Company was sometimes also characterized as a recognized dealer in Treasury bills.[27]

2. Formalization of the Recognized Dealer Program

Robert Rouse joined the Federal Reserve Bank of New York as an assistant vice president in the Securities Department on July 1, 1939.[28] Rouse had been with the Guaranty Trust Company for twenty years, most recently as a manager of its government bond department, and was hired by the New York Fed to be the next manager of the System Open Market Account.[29]

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[26] Memo from R.G. Rouse to Mr. Sproul, Federal Reserve Bank of New York, October 26, 1939, p. 9.

[27] Memo from R.G. Rouse to Mr. Sproul, Federal Reserve Bank of New York, October 26, 1939, p. 11, and memo from Mr. Sproul to Mr. Harrison, Federal Reserve Bank of New York, "Authorizations for the Purchase and Sale of Securities," October 30, 1939, p. 2.

[28] "Reserve Bank Aide to Retire June 30," *New York Times*, June 16, 1939, p. 43, and "Robert G. Rouse to Become Officer of N.Y. Reserve Bank," *Wall Street Journal*, June 16, 1939, p. 4.

[29] Rouse's promotion to vice president and designation as Manager of the System Open Market Account was announced on November 15, 1939; his selection was approved by the Federal Open Market Committee on December 13, 1939. "Three Promoted by Reserve Bank," *New York Times*, November 16, 1939, p. 35, "R.G. Rouse Named Vice President of N.Y. Federal Reserve Bank," *Wall Street Journal*, November 16, 1939, p. 9, and minutes of the December 13, 1939, meeting of the Federal Open Market Committee, p. 2.

Allan Sproul, the Bank's first vice president and interim manager of the Account since the departure of Burgess in September 1938,[30] set Rouse to work familiarizing himself with the operations of the Securities Department. Rouse soon made a surprising discovery: during Burgess's tenure the Bank had entered into transactions with dealers without specific authorization from the Bank's Board of Directors.[31] He suggested that specific authorization be obtained from the board; Sproul forwarded the recommendation to President Harrison.[32]

On November 2, 1939, the Board of Directors explicitly authorized the Bank's recognized dealer program, stating, in pertinent part,

> (1) that it is the policy of this bank, in executing purchases and sales of United States Government securities … for account of the System Open Market Account, … to effect such purchases and sales through ordinary market channels with ... recognized dealers, the term "recognized dealer" … being defined to mean a firm or corporation (including a bank) which is a substantial dealer ... in United States Government securities, … and which has furnished to this bank a recent statement of assets and liabilities, and such other information as this bank may have requested, showing to the satisfaction of this bank that such firm or corporation is a substantial dealer and has … adequate capital and is otherwise in satisfactory financial condition;
>
> *provided, however*, that purchases and sales of United States Government securities … for the System Open Market Account … may also be effected with ... responsible concerns (including banks) other than recognized dealers ... when in the judgment of the president, the first vice president, or the vice president in charge of the open

30 "W.R. Burgess Quits Reserve Bank Post," *New York Times*, September 14, 1938, p. 33, "New Task for Official of Reserve Bank Here," *New York Times*, September 23, 1938, p. 43, and minutes of the September 21, 1938, meeting of the Federal Open Market Committee, p. 2.

31 Memo from Messrs. Rouse and Miller to Mr. Sproul, Federal Reserve Bank of New York, "Authorizations and procedure with respect to the purchase and sale of securities for System Account and others," July 21, 1939, p. 7 (noting that "no action was ever taken by our board of directors with respect to the selection of firms for the execution of ... purchase and sale orders for the System Open Market Account ..."). See also memo from Allan Sproul to Mr. Harrison, Federal Reserve Bank of New York, "Authorizations for the Purchase and Sale of Securities," October 30, 1939, p. 1 (noting that the New York Bank had entered into transactions in the over-the-counter market "without obtaining any ... formal authority...").

32 Memo from Allan Sproul to Mr. Harrison, Federal Reserve Bank of New York, "Authorizations for the Purchase and Sale of Securities," October 30, 1939.

market function of this bank, this will properly aid in the execution of System open market policy …; and

(2) that the president and the first vice president are … authorized to determine and designate the firms and corporations which are from time to time recognized dealers as defined in this resolution.

The Board resolution had two notable features. First, transactions were to take place only through "ordinary market channels" in the over-the-counter dealer market. Bank officers were not authorized to introduce public auctions in connection with either purchases or sales. Second, transactions were generally limited to recognized dealers that met prescribed standards, although the Board did allow transactions with other responsible dealers when such transactions would "aid in the execution of System open market policy."

The standards for recognition indicated what was important: capital and scale of operations. Bank officials subsequently developed somewhat more extensive standards, including,

1. a reputation for integrity, experience, and knowledge,
2. capital at risk in the dealer's business of not less than $2,500,000,
3. a willingness to "make" markets (except for very large transactions) under all ordinary circumstances, and to take moderate positions, both long and short, and
4. a large volume of business of national scope with the contacts which such trading provides.[33]

That these were the same as the informal requirements in place before November 1939 supports the proposition that the Board resolution marked a formalization of, but not a new direction for, the Bank's recognized dealer program.

One day after the Board action, Sproul submitted to Harrison the names of nine dealers "for determination and designation by you as 'recognized dealers' with or through whom we may

[33] Federal Reserve Bank of New York (1940, p. 42).

execute purchases and sales of United States Government securities." [34] The nine dealers included,

- Bankers Trust Co.,
- C.F. Childs & Co.,
- Continental Illinois National Bank & Trust Co.,
- C.J. Devine & Co.,
- Discount Corp.,
- First Boston Corp.,
- Guaranty Trust Co.,
- New York Hanseatic Corp., and
- Salomon Brothers & Hutzler.

Consistent with past practice, the designation of Continental Illinois was limited to Treasury bills. On November 15, 1939, Harrison designated all nine as recognized dealers.[35]

In addition to satisfying the qualifying standards, a recognized dealer was required to report, on a daily basis, its position in Treasury securities, long or short, in prescribed maturity brackets; its trading volume in each maturity bracket; and the amounts of money and securities borrowed to finance its positions. The data allowed the New York Reserve Bank "to keep a continuous record of the activities of each of the dealers, and also of the activities of the dealer market as a whole." [36] Bank officials met daily, on a rotating basis, with representatives of the respective dealers. Their familiarity with market conditions was further enhanced by intra-day telephone conversations with the dealers.[37]

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[34] Memo from Allan Sproul to Mr. Harrison, Federal Reserve Bank of New York, November 3, 1939.

[35] See memo from R.G. Rouse to Mr. S.A. Miller, Federal Reserve Bank of New York, November 20, 1939, citing the action by President Harrison on November 15.

[36] Federal Reserve Bank of New York (1940, pp. 42-43).

[37] Federal Reserve Bank of New York (1940, p. 44).

3. Advent of the Qualified Dealer Program

Following U.S. entry into World War II, the focus of monetary policy changed from managing reserves to keeping interest rates low. The key decision was a 1942 agreement between Treasury and Federal Reserve officials that interest rates on long-term Treasury debt would be capped at 2½ percent for the duration of the war.[38]

The cap was intended to solve a problem that Treasury Secretary William McAdoo had encountered during World War I: investors were reluctant to buy long-term fixed-rate bonds when the duration of the war was uncertain and there was a risk that an unexpectedly lengthy war would result in higher bond yields in the future.[39] However, as FOMC economist (and Director of Research and Statistics at the Board of Governors) E. A. Goldenweiser noted, if bond yields were capped, "prospective investors will realize that there is nothing to gain by waiting, and a flow [of funds] into Government securities … may be confidently expected." [40] A 2½ percent ceiling was deemed appropriate because that was the rate at which Treasury had sold $2.7 billion of long-term bonds in October and December 1941 [41] and because senior Federal Reserve officials believed that higher rates would not prevent inflation, would increase the cost of government borrowing, and would burden existing bondholders with capital losses.[42]

In addition to capping long term bond yields, System officials agreed to cap the 3-month bill rate at ⅜ percent.[43] They later tried to raise the bill rate (when wartime expenditures began

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38 Murphy (1950), Walker (1954), and Wicker (1969).

39 Garbade (2012, ch. 5).

40 Minutes of the Federal Open Market Committee, June 10, 1941, p. 8. See also Thomas and Young (1947, p. 91) and Thomas (1951, p. 622).

41 Murphy (1950, p. 93)

42 Minutes of the Federal Open Market Committee, September 27, 1941, p. 27. See also Thomas and Young (1947, p. 91) and Meltzer (2003, p. 580).

43 Federal Reserve Bank of New York Circular no. 2430, May 8, 1942, "Treasury to Issue New Type of Bond," *New York Times*, May 1, 1942, p. 29, and "Treasury Plans New 'Tap' Issue: An Innovation," *Wall Street Journal*, May 1, 1942, p. 6. See also Murphy (1950, p. 98).

to stimulate rapid growth in economic activity) but Treasury officials rejected their entreaties; the ⅜ percent cap held for the duration. Maximum yields on securities between bills and long bonds were interpolated to give a smooth curve: the yield on 1-year certificates was capped at ⅞ percent and the yield on 7- to 9-year bonds was capped at 2 percent.

Given their druthers, Treasury officials would have financed World War II with debt that could not be sold or redeemed for the duration. When that proved infeasible they chose to issue non-marketable but redeemable war bonds and conventional marketable debt, aggressively discouraged early redemption of the war bonds and, to the extent possible, suppressed trading in the marketable debt. The System had a parallel interest in limiting market activity: in order to limit inflationary pressures it did not want to purchase any more securities than necessary to maintain the structure of maximum yields.

Following completion of the first war loan drive at the end of November 1942, the FOMC began to focus on the role that government securities dealers might play in the war effort. Governor John McKee suggested a study "of the functions [dealers] should perform and how their operations should be fitted into the [war] financing program." [44] The committee agreed and asked Goldenweiser to prepare a report.

The Goldenweiser report advanced three key findings:

- dealer services were essential to financing the war effort,
- dealers were willing to submit to regulation that advanced the war effort, and
- dealers sometimes "stirred up" unnecessary trading and exacerbated market volatility, but suppressing such activity might be difficult.

With respect to the need for dealers, the Goldenweiser report asserted that "in this war-time situation the dealers unquestionably serve an essential purpose. Through their widespread branch offices and their network of telegraphic and telephonic wires they cover the country and have numberless contacts with banks, corporations, and individuals on whom the Government

[44] Minutes of the Federal Open Market Committee, January 26, 1943, pp. 3-4.

must depend for absorbing its securities." More particularly, "if [the dealers] did not exist or were eliminated, the Federal Reserve System would be obliged to build up a similar mechanism, at great expense and with much costly delay. The cost to the System would probably be greater than the cost of operating through the dealers." [45]

With respect to regulation, the report asserted that dealers wanted to "cooperate in promoting a smooth financing of the war" and that "their activities are, in practice, closely supervised and kept in line with System policy by constant contact with the management of the open-market account." [46]

Dealers were not, however, beyond criticism. The Goldenweiser report observed that,

> Probably the least desirable thing that dealers do is one which is difficult to control, namely, suggestions and advice that they pass on to their customers in conversations, on the telephone and otherwise. It is clearly to the financial interest of dealers that the market should be lively with movements of prices and with a large volume of operations. That dealers sometimes suggest sales or purchases for the purpose of stirring up the market and that they sometimes jiggle their quotations for that purpose, it would be very hard to establish, and yet it is almost certainly done to some extent.[47]

The report had "no remedy to offer for this situation other than watchfulness by the System and warnings to dealers when such practices come to its attention."

Marriner Eccles, the chairman of the Board of Governors and of the FOMC, was not pleased with Goldenweiser's report.[48] He asked Leroy Piser and David Kennedy, the Chief and Assistant Chief, respectively, of the Government Securities Section of the Division of Research and Statistics, to prepare a memo addressing "certain questions in relation to the regulation of the Government security market" that he wanted considered.[49]

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[45] Goldenweiser et. al. (1943, p. 2).

[46] Goldenweiser et. al. (1943, p. 2).

[47] Goldenweiser et. al. (1943, pp. 4-5).

[48] Minutes of the Federal Open Market Committee, June 28, 1943, p. 8, stating Eccles's belief that "the report did not appear to him to cover adequately certain aspects of the problem."

[49] Minutes of the Federal Open Market Committee, June 28, 1943, p. 8.

The memo prepared in response to Eccles' request suggests that Eccles was interested in a significant expansion of Federal Reserve supervision of the government securities market. The memo advanced several regulations and requirements "that might be made applicable to all dealers and brokers in Government securities," including regular examination of dealer books and records and prohibition of (a) "the dissemination of information, whether true or false, to the effect that prices are likely to rise or fall because of the operations of [the Federal Open Market Committee]," and (b) "the effecting of transactions in series for the immediate purpose of causing the market to be active or causing quotations to move with the ultimate purpose of inducing other persons to buy or sell." [50]

Revising the Institutional Framework of Open Market Operations

The FOMC discussed the Goldenweiser report and the Piser-Kennedy memo on June 28, 1943.[51] Eccles opened the discussion by expressing his belief that "developments in the future might make the regulation of the activities of the dealers under a voluntary arrangement [such as the New York Bank's recognized dealer program] much more difficult," particularly if the number of dealers increased. That being the case, he felt the FOMC should "develop with the Manager of the System Account something in the way of regulations which would govern the relationship with the dealers in somewhat the same manner as would be done under a statutory requirement." Eccles suggested that a panel of committee members meet with Rouse "for the purpose of working out a program that would be approved by the Committee, and that if the dealers were unwilling to accept regulation of this kind the … Committee should undertake to get the necessary statutory authority to handle the situation."

50 Memo from Leroy Piser and David Kennedy to Chairman Eccles, Federal Open Market Committee, June 26, 1943.

51 Minutes of the Federal Open Market Committee, June 28, 1943, pp. 8-11.

Sproul, the president of the New York Fed since January, pronounced himself in agreement with the Goldenweiser report and stated that, while he recognized the difficulties identified in the Piser-Kennedy memo, he "questioned the desirability and effectiveness of an attempt more formally to regulate dealers' activities." [52] He observed that "the principle question raised by the [Piser-Kennedy memo] was whether the System needed to have more control over the activities not only of Government security dealers but of all other elements in the Government security market." [53]

Following the June meeting the New York Bank prepared a report on the relationship between the System and government securities dealers [54] and Piser prepared a companion memo identifying possible requirements for dealers who wanted to participate in open market operations (Box 1). Following discussion of the Bank's report and Piser's memo, the Executive

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52 Minutes of the Federal Open Market Committee, June 28, 1943, p. 9.

53 Two memos written by Robert Rouse in 1940 suggest what Sproul may have had in mind when he referred to "all other elements in the Government security market."

In one memo Rouse noted "the presence in the market of many banking institutions, a number of non-dealer investment houses, corporate holders, and even some individuals who are trading holders, who are probably every bit as volatile as the dealers. The efforts of such holders towards small quick trading profits are not subject to control of any kind, and it seems to me, cannot be unless the whole government bond market is to be subject to legal control. The holders just described, I think, are those who, more than any single group, affect the market when any sudden news develops, and cause the market to be marked up or down without any substantial volume of business being transacted." Memo from R.G. Rouse to Mr. Sanford, Federal Reserve Bank of New York, "The Place of the Dealer in the Government Security Market," April 18, 1940.

In a later memo Rouse observed that "if dealers' portfolios are eliminated or closely controlled, the activity would still be in the market but in different hands – the trading banks and other non-dealer traders. The next step would be to control them, and so on, until the whole market would have to be controlled, which, of course, would end up in substantially no market at all as we understand it." Memo from R.G. Rouse to Mr. Sanford, Federal Reserve Bank of New York, "The Place of the Dealer in the Government Security Market," April 26, 1940.

54 "The Relationship Between the Federal Reserve Bank of New York and the Dealers in United States Government Securities," Robert Rouse, Federal Reserve Bank of New York, September 4, 1943.

Committee recommended that dealer relationships be governed through "formal rules and regulations to be adopted by the [FOMC] under its existing powers." [55] The FOMC accepted the recommendation at its October 18, 1943, meeting and charged the Executive Committee with preparing a draft of appropriate terms and conditions.[56] The Executive Committee in turn directed Rouse to prepare the draft.[57]

Box 2 shows the terms and conditions suggested by Rouse. The provisions in italics echo the requirements of the Bank's recognized dealer program; those in boldface reflect additional concerns voiced by Board staff and members of the FOMC. The latter included disclosure of whether a dealer was acting as a principal or agent in a transaction with the System Open Market Account, agreement to abstain from soliciting orders in anticipation of System open market operations, and cooperation in the maintenance of an orderly market.

Rouse pointed out that many of the requirements itemized in the Piser memo were either already part of market practice or "'vows against sin,' practically impossible of enforcement by a formal or informal supervisory agency." He opined that "on the whole, it appears that the informal influence now exercised [by the New York Bank over the dealers], while not completely effective, is adequate for the System's purposes and does not entail responsibilities which the prescription of a definite rule might bring upon the System." [58]

Executive Committee discussions on February 21 and 29, 1944, led to a revised draft that the committee recommended to the full FOMC.[59] The revised draft introduced the term "qualified dealer" and included a more explicit specification of what was expected of a dealer in

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[55] Minutes of the Federal Open Market Committee, October 18, 1943, pp. 3-4.

[56] Minutes of the Federal Open Market Committee, October 18, 1943, p. 6.

[57] Minutes of the Executive Committee of the Federal Open Market Committee, October 18, 1943, afternoon meeting. p. 2,

[58] Rouse (1944, pp. 6 and 9).

[59] Minutes of the Executive Committee of the Federal Open Market Committee, February 29, 1944, pp. 3-8.

connection with the maintenance of an orderly market. The FOMC approved the recommended terms and conditions and, after some further editorial tweaks, the Executive Committee adopted a final version.[60]

Implementation

Following the FOMC action, Rouse set about conferring with the recognized and non-recognized dealers, explaining the new rules and deciding which dealers satisfied the FOMC's terms and conditions.[61] Eleven dealers ultimately qualified, including,

- Bankers Trust Co.,
- C.F. Childs & Co.,
- Continental Illinois National Bank and Trust Co.,
- C.J. Devine & Co.,
- Discount Corp.,
- First Boston Corp.,
- First National Bank of Chicago,
- Guaranty Trust Co.,
- Harriman Ripley & Co.,
- D.W. Rich & Co., and
- Salomon Brothers & Hutzler.[62]

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60 Reprinted in 1944 Board of Governors Annual Report, pp. 49-51. See also "Reports Required of Bond Dealers," *New York Times*, May 17, 1944, p. 25, and "Reserve Board Sets Up New Policy for Dealers in Government Securities," *Wall Street Journal*, May 17, 1944, p. 9.

61 Minutes of the Board of Directors of the Federal Reserve Bank of New York, May 18, 1944, pp. 164-169.

62 First National Bank of Chicago, Harriman Ripley & Co., and D.W. Rich & Co. were new additions. New York Hanseatic Corp., a dealer that the New York Fed had recognized in 1939, withdrew from the government securities business in 1940. "New Concern Here to Deal in Bills," *New York Times*, November 2, 1940, p. 25.

Five non-recognized firms (Briggs, Schaedle and Co., Harvey Fisk and Sons, R.W. Pressprich and Co., Charles E. Quincey and Co., and J.B. Roll and Co.) that had previously done business with the New York Reserve Bank did not qualify "because of the relatively small volume and restricted scope of their business and the limited amount of capital at the risk of their business." Sproul explained that New York Bank officials chose to exclude dealers "if they do not clearly qualify under the written terms and conditions now effective. The line of demarcation must be as clearly defined as possible, if our practice is to be understood and defensible, and if future requests for qualification are to be capable of determination." [63]

4. Subsequent Expansion of FOMC Supervision

Following the launch of the qualified dealer program, Eccles suggested a variety of modifications and extensions, including,

- closer supervision of dealer positions, with more detailed reports to the Executive Committee showing the magnitude of long and short positions by issue, borrowings by creditor class, government securities borrowed by issue, and loans to officers and directors, and
- introduction of a program for Federal Reserve Banks to report, to the Executive Committee, complaints of dealer violations of the terms and conditions for qualification. [64]

Additionally, Eccles proposed limiting open market operations to agency transactions with dealers, so that dealers would be no more than conduits between investors and the System Open Market Account, and to limit commissions on such agency transactions to not more than a

[63] Minutes of the Executive Committee of the Federal Open Market Committee, July 28, 1944, pp. 4-5.

[64] Minutes of the Executive Committee of the Federal Open Market Account, September 21, 1944, pp. 12-14, memorandum from L.M. Piser to Board of Governors, "Government security dealers," October 15, 1945, and minutes of the Executive Committee of the Federal Open Market Committee, February 28, 1946,pp. 1-2.

64th of a percent of principal for notes and bonds. (The typical commission at that time was 1/64th of one percent for securities maturing in five years or less and 1/32nd of one percent for longer issues.[65]) Eccles wanted to limit the ability of dealers to profit from buying from investors and selling to the System Account and, more generally, to limit dealer incentives to promote sales of Treasury securities to the Fed.[66]

Eccles' suggestions were discussed at length by the Executive Committee on February 28, 1946. Rouse noted that, "with one exception, there had been no really serious cases of extended positions on the part of the dealers." Eccles nevertheless felt that the Executive Committee "had responsibility for conditions in the market … and that as a guide to the Manager of the System Account a reasonable limitation on dealers' positions should be established."

Eccles further expressed his belief that "it would be better if the dealers did not take positions and securities were purchased or sold directly to and from the Federal Reserve Banks."[67] When Rouse stated that he wanted authority to pay up to a 32nd of a percent of principal in commissions, Eccles "questioned the need for such leeway," stated that he "would

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65 Federal Reserve Bank of New York (1940, p. 19).

66 In commenting on a 1952 System study of the government securities market, the Federal Reserve Bank of New York observed that, prior to 1951, "the Federal Open Market Committee showed a pronounced preference for effecting transactions with dealers in United States Government securities acting as agents rather than as principals. The Committee's concern with the capacity in which a dealer acted in connection with a System transaction was an outgrowth of the increase in the public debt, an expansion in over-the-counter activity in Government securities and the need for more active participation by the System in the market in connection with wartime rate stabilization operations. It reflected, in part, an effort to limit dealer revenues arising from System operations and, to that extent, to encourage the conduct of business away from the System insofar as commissions might be an influence." Joint Committee on the Economic Report (1954, p. 318).

67 Minutes of the Executive Committee of the Federal Open Market Committee, February 28, 1946, pp. 2-3.

like to consider the matter from the standpoint of paying no commissions," and even questioned the need for dealers.[68]

The Executive Committee revisited Eccles' suggestions during its June 1946 meeting and agreed that:

- open market operations would, outside of exceptional cases, be limited to agency transactions with dealers,
- commissions would be limited to a 64th of a percent of principal for notes and bonds and one one-hundredth of one percent of principal for certificates,
- the manager of the System Open Market Account would include in his weekly report to the committee a statement of any dealer positions that he deemed excessive, a report of any actions taken as a result, and a report of the dealer's response, and that
- each Federal Reserve Bank would report complaints of dealer violations of the terms and conditions for qualification to the manager of the System Open Market Account.[69]

The mid-1946 actions of the Executive Committee established the high water line of direct FOMC supervision of the government securities market.

5. The End of the Qualified Dealer Program

On Saturday, March 3, 1951, Treasury and Federal Reserve officials announced that they had reached "full accord with respect to debt management and monetary policies to be pursued in furthering their common purpose to assure successful financing of the Government's

[68] Minutes of the Executive Committee of the Federal Open Market Committee, February 28, 1946, pp. 3-4.

[69] Minutes of the Executive Committee of the Federal Open Market Committee, June 10, 1946, pp. 1-3.

requirements and, at the same time, to minimize monetization of the public debt." [70] Crucially, the System was no longer committed to keeping bond yields below 2½ percent.[71]

The FOMC soon began discussing how open market operations might best be conducted in the dawning era of a free market in Treasury debt. At an FOMC meeting on May 17, the newly appointed chairman of the Board of Governors, William McChesney Martin, suggested that the Committee "authorize him to appoint a committee ... to make a study of the scope and adequacy of the Government securities market." Martin felt that a "broader market" was needed and that "the time may come when the Federal Open Market Committee might find it necessary to change the procedure whereby it did business with only a small number of qualified dealers."[72] The Committee approved his suggestion.

Martin unveiled the objectives of what would become known as the "ad hoc subcommittee study" at the April 21, 1952, Executive Committee meeting.[73] The objectives included developing a better understanding of

- the "organization and functioning of the market for Government securities, with particular attention to its suitability as a medium for flexible open market operations directed towards economic stabilization,"
- the "organization and operation of [the System] Open Market Account," and
- the "advantages and disadvantages of [the System's] dealer relationships." [74]

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[70] Federal Reserve Bank of New York Circular no. 3665, March 5, 1951. See also "Treasury Settles Rift with Reserve Over Bond Policy," *New York Times*, March 4, 1951, p. 1.

[71] The ⅜ percent posted rate on 13-week Treasury bills had been abandoned in July 1947. The ceiling rate on 1-year certificates was raised from ⅞ percent to 1 percent in August 1947, to 1⅛ in November, and to 1¼ percent in October 1948. Garbade (2012, p. 345).

[72] Minutes of the Federal Open Market Committee, May 17, 1951, p. 7.

[73] Martin delayed the start of the study because he thought "we should have more experience with the unpegging of the market." Minutes of the Federal Open Market Committee, March 4-5, 1953, p. 26.

[74] Outline of "Ad Hoc Subcommittee of the Open Market Committee to Study the Government Securities Market with Special Reference to the Organization and Operation of the Open

The Federal Reserve Bank of New York Study

Working in parallel with the ad hoc subcommittee, the Federal Reserve Bank of New York undertook its own appraisal of open market operations, including a review of the existing framework, an appraisal of the prospects for fundamental change, and an appraisal of more modest changes.

The Existing Framework. The Bank study started by stating the key responsibility of a central bank: "to maintain general control over the quantity of money and the cost and availability of the credit that accompanies the process of money creation," [75] and by noting that the principal mechanism for maintaining control was open market operations in Treasury securities.

The study next observed that Treasury securities traded in an over-the-counter market intermediated by dealers:

> As a general rule, relatively little trading occurs directly between the investor who wishes to sell and the investor who wishes to buy. … Instead, a number of highly specialized dealers have sprung up to fulfill an indicated need for intermediaries who are willing to act as principals. Although these dealers on occasion may act as agents or as brokers, their main activity consists in buying Government securities outright from those who wish to sell, and in selling Government securities outright to those who wish to buy.[76]

The study conceded that, since almost every major dealer had its main office in New York, "it would probably be physically possible for the System Account to engage in transactions with most of the dealers." Nevertheless, "the System has limited its relationships to those dealers who

Market Account," April 21, 1952, referenced in minutes of the Executive Committee of the Federal Open Market Committee, April 21, 1952, p. 9.

75 Federal Reserve Bank of New York (1952, p. 2-1).

76 Federal Reserve Bank of New York (1952, pp. 2-4 to 2-5).

… have broad national contacts, do a large volume of business in all segments of the maturity range and have adequate capital.” [77]

Prospects for Fundamental Change. The New York Bank study examined two proposals for fundamental change. (A third proposal concerned Treasury debt management and is not relevant to the present discussion.)

The first proposal asked whether an exchange market, patterned after the New York Stock Exchange, might not be better suited to the needs of investors, the Treasury, and the System. The study observed that the over-the-counter market had emerged during the 1920s in direct competition with exchange trading of Treasury bonds and concluded that “the fact that the over-the-counter market … displaced the Exchange as a medium for transactions … seems to indicate that the former was better adapted to handle effectively the type and volume of business which developed.” [78]

The second proposal asked whether the System should “conduct transactions directly with all types of investors, thereby cutting out the dealers as intermediaries as far as System activities are concerned.” The study claimed that “if the System were to trade with all comers, it would face the difficult task of maintaining bid and offer quotations on all Government securities at all times. By becoming, in effect, a dealer in its own right, the System might eventually crowd most of the private dealers out of business.” [79]

Prospects for More Modest Change. The New York Bank study also examined several more modest changes: expanding the number of qualified dealers, increasing System supervision of the Treasury market, and reverting to principal transactions with qualified dealers.

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[77] Federal Reserve Bank of New York (1952, p. 2-8).

[78] Federal Reserve Bank of New York (1952, p. 12-6).

[79] Federal Reserve Bank of New York (1952, pp. 3-5 and 3-6).

Expanding the Number of Qualified Dealers. Rather than asking whether there was any justification for continuing to maintain stringent qualification requirements, the New York Bank study examined instead whether there was any basis for relaxing the requirements. It concluded that "no significant gain, and some possible risks, would be involved … in any attempt to loosen present standards materially for the simple objective of increasing the number of qualified dealers." [80]

The study also considered whether it would be useful to add a category of "limited qualification" by allowing otherwise non-qualified dealers to, for example, purchase Treasury bills from, and sell bills to, the System Open Market Account. The study did not come to a conclusion on the matter but did point out that the qualified bank dealers did a disproportionate business in short-term securities and suggested that there was "some basis for the contention that [expanding the number of banks qualified for open market operations in bills] would be in line with the System's interest." [81]

Expanding System Supervision of the Treasury Market. With respect to Federal Reserve supervision of the Treasury market, the study noted that "qualification primarily concerns the business relations between the Federal Reserve Bank of New York and the dealer" but acknowledged that "because of the System's assumed public responsibility and the character of its role in the market, there is inherent in the qualification process a limited element of supervisory responsibility." However, in a clear warning against mission creep, the study concluded that "it would seem unwise for the Federal Reserve System to undertake an active supervisory influence over [the government securities market]. The System would be involved in

[80] Federal Reserve Bank of New York (1952, p. 3-6).

[81] Federal Reserve Bank of New York (1952, p. 13-7).

an operation quite apart from its statutory responsibility and it might create an unwholesome mixture of credit control and market administration." [82]

Principal Transactions with Qualified Dealers. By 1952 the System had returned to executing purchases and sales of short-term securities on a principal basis with qualified dealers but continued to execute transactions in intermediate and long-term securities on an agency basis. The New York Bank study conjectured that "the System might gain greater flexibility in accomplishing desired immediate effects upon bank reserve positions if it could sell directly into dealers' positions, or buy directly from them." The study concluded that "on balance, particularly under the relatively free market conditions now prevailing, there would seem to be a basis for giving the Manager of the System Account full latitude in deciding upon the technique best suited to immediate objectives in specific situations." [83]

The Ad Hoc Subcommittee Report

The report of the ad hoc subcommittee covered a variety of topics, including dealer qualification requirements and agency transactions.

Dealer Qualification Requirements. Following extensive discussions with market participants, the subcommittee reported significant dissatisfaction with the qualified dealer program. Several participants suggested that "some of the presently qualified firms do not appear to possess as many of the attributes for qualification as some of the nonqualified dealers." Others "supported the view that the distinction between qualified and non-qualified firms might have been necessary as a wartime expedient but that the need for this arrangement had long since expired." Most believed that "the open market management should be free to transact business with those dealers who in the judgment of the management were best equipped to handle

[82] Federal Reserve Bank of New York (1952, p. 13-18).

[83] Federal Reserve Bank of New (1952, pp. 3-8 to 3-9).

transactions for the account in the most efficient and least costly manner" and that "a more proper relationship between the open-market account and the dealer organization would be one that would conform as nearly as possible to that which exists between dealers and other customers." [84]

With respect to the consequences of the qualified dealer program for non-qualified dealers, the report concluded that,

> The lines drawn by the Federal Open Market Committee … struck the unrecognized dealers in a most vulnerable spot, namely, in their ability to service their customers. It cut down the range of their customer potentialities and thus reduced their ability to attract or earn capital to meet the minimum capital requirements of the Federal Open Market Committee. It acted in the same way to impair the ability of a non-recognized dealer to earn recognition by developing customer relations that were nationwide in scope and that extended to all sectors of the list. In short, once the lines were drawn and recognition was accorded to some dealers and not others, a hurdle of some magnitude was imposed on the unrecognized dealers which impaired their ability to develop their business to the point where it would be able to meet the standards imposed by the committee.[85]

The subcommittee suggested that the distinction between qualified and non-qualified dealers was fraught with difficulties and that its continued existence had to be affirmatively justified:

> The Federal Open Market Committee cannot afford to be complacent about this situation. It has explosive potentialities. Privilege as such is repugnant to the spirit of American institutions. The privilege of dealer recognition, if it is to be continued, must be justified on grounds of high public policy as essential and necessary to the effective conduct of open market operations. It is not sufficient to aver that dealer recognition was once useful or that it should be maintained because it is already in existence, in the absence of any positive reason for change. The fact that privilege exists by virtue of actions of the Federal Open Market Committee is in itself a positive reason for its eradication unless there are necessary and compelling considerations to require its perpetuation. [86]

[84] Joint Committee on the Economic Report (1954, pp. 295-296).

[85] Joint Committee on the Economic Report (1954, pp. 277-278).

[86] Joint Committee on the Economic Report (1954, p. 278).

The subcommittee recommended that the FOMC drop the qualified dealer program "completely."

Agency Transactions. The subcommittee report also noted that "dissatisfaction was general throughout the group of recognized dealers" with respect to agency transactions in open market operations. "This dissatisfaction was expressed most openly and acutely with respect to the commissions allowed by the [FOMC]," which were claimed to be too small to cover costs. The subcommittee recommended that agency transactions "be abandoned and that the Federal Open Market Committee … enter into transactions with dealers as principals on a net basis." [87]

Termination of the Qualified Dealer Program

The Federal Open Market Committee unanimously approved the ad hoc subcommittee's recommendation that "the present system of rigid qualifications for dealers … be abandoned, with the understanding that henceforth transactions would be carried on with any persons or firms actually engaged in the business of dealing in Government securities." [88] The decision swept away the requirement that a dealer had to service a national market, that it had to do business in all segments of the yield curve, that it had to have some minimum size, and that it had to assist in the maintenance of orderly markets. The press release announcing the termination of the qualified dealer program stated that:

> The Federal Open Market Committee has discontinued ... its requirement that transactions with the Open Market Account be confined to dealers in Government securities who meet certain specified qualifications. The requirement, adopted by the Committee in 1944 to meet wartime conditions, is no longer deemed necessary or desirable now that open market operations of the Federal Reserve Banks are divorced

[87] Joint Committee on the Economic Report (1954, pp. 273-274).

[88] Minutes of the Federal Open Market Committee, March 4-5, 1953, p. 44.

> from support of any particular pattern of prices or yields in the Government securities market.[89]

The FOMC also accepted the subcommittee's recommendation to abandon agency transactions.[90]

6. Primary Dealers in the 1950s

Following the termination of the qualified dealer program, a primary dealer was any dealer that the Federal Reserve Bank of New York was prepared to accept as a counterparty in the conduct of open market operations. Unlike practices under the Bank's recognized dealer program and the FOMC's qualified dealer program, after the spring of 1953 there were no specific requirements for becoming a primary dealer.

The termination of the qualified dealer program led to a significant expansion of the primary dealer community. The list of seventeen primary dealers at the end of the 1950s [91] included nine that had qualified in 1944:[92]

- Bankers Trust Co.,
- C.F. Childs & Co.,
- Continental Illinois National Bank and Trust Co.,
- C.J. Devine & Co.,
- Discount Corp.,

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89 Minutes of the Executive Committee of the Federal Open Market Committee, April 8, 1953, pp. 12-13. See also "Books Close on 3¼% U.S. Bonds; Heavy Oversubscription Indicated," *New York Times*, April 15, 1953, p. 47, and "'Qualified' Dealers Only Rule Dropped by FRB's Open Market Group," *Wall Street Journal*, April 15, 1953, p. 15.

90 Minutes of the Federal Open Market Committee, March 4-5, 1953, pp. 46-47.

91 Joint Economic Committee (1959, pp. 1507-1509) and Meltzer and von der Linde (1960, p. 2).

92 A total of eleven dealers were qualified in 1944. Harriman Ripley & Co. surrendered its designation as a qualified dealer in 1946. Minutes of the Executive Committee of the Federal Open Market Committee, October 3, 1946, pp. 8-9. D.W. Rich & Co. was removed as a qualified dealer in 1947. Letter from Robert Rouse to Marriner Eccles, November 6, 1947.

- First Boston Corp.,
- First National Bank of Chicago,
- Morgan Guaranty Trust Co.,[93] and
- Salomon Brothers & Hutzler.

one, Chemical Corn Exchange Bank, that qualified in 1948 (under the name Chemical Bank and Trust Co.[94]), and seven designated after the termination of the qualified dealer program (three of whom had traded with the New York Reserve Bank on an occasional basis before the advent of the qualified dealer program [95]):

- Bartow Leeds & Co.
- Briggs, Schaedle & Co.,
- Aubrey G. Lanston & Co.,
- New York Hanseatic Corp.,
- William E. Pollack & Co.,
- Charles E. Quincey & Co., and
- D. W. Rich & Co.

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93 So named following the merger of Guaranty Trust Co. and J.P. Morgan & Co. in 1959.

94 Minutes of the Executive Committee of the Federal Open Market Committee, February 26, 1948, p. 1.

95 The three included D. W. Rich & Co., Briggs, Schaedle & Co., and Charles E. Quincey & Co. New York Hanseatic Corp. had been designated a recognized dealer in 1939 but withdrew in 1940. The remaining three firms were organized after the advent of the qualified dealer program. William E. Pollock & Co. was formed in late 1944 ("Bond Concern Organized," *New York Times*, December 20, 1944, p. 31), Bartow Leeds & Co., in 1945 ("New Bond House Announced," *New York Times*, June 1, 1945, p. 27), and Aubrey G. Lanston & Co. in 1949 ("New Lanston Concern to Deal in Federal, Municipal Issues," *New York Times*, September 8, 1949, p. 45).

All seven firms were designated within a year of the termination of the qualified dealer program.[96]

Between 1953 and 1959, the New York Reserve Bank received several inquiries, but no requests, to do business.[97] A highly-regarded study of the Treasury market concluded that the most important barrier to entry during the 1950s was the profitability of the business, that "the relative profitability of the present dealers in Government securities was not sufficient to attract sizable financial commitments to the business from dealers in corporate or municipal bonds. The availability of equally profitable or more profitable opportunities in other branches of the securities business combined with the high degree of risk inherent in trading Government securities limits the expansion of the number of dealers." [98]

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96 Two additional firms, Northern Trust Co. and J.G. White & Co., were designated as primary dealers shortly after the termination of the qualified dealer program but were de-designated in 1956.

97 Joint Economic Committee (1959, p. 1509, testimony of Robert Rouse that "since 1953 a number of firms have come in and talked with me and my associates with respect to dealing in Government securities. None have asked [to be recognized as a primary dealer].").

98 Meltzer and von der Linde (1960, p. 26).

Box 1. Requirements, Suggested by Leroy Piser, October 1943, for Dealers Who Wanted to Participate in Open Market Operations [99]

(a) Recommendations to any client to buy, sell, or swap securities should be made only at the request of the client, should be made only by a senior member of the firm, and should be on an investment basis and not on a speculative basis.

(b) Dissemination of rumors as to future Treasury financings, as to amounts of subscriptions or allotment percentages, or as to other matters that might influence the market should be prohibited.

(c) Dissemination of information, whether true or false, to the effect that prices are likely to rise or fall because of the operations of some investor, such as the Federal Open Market Committee, should be prohibited.

(d) The making of false or misleading statements as to any material fact should be prohibited.

(e) Quotations should not be changed when there are no buying or selling orders or only nominal orders, except after consultation with the Federal Reserve Bank of New York.

(f) No dealer should transmit false or misleading quotations.

(g) All transactions when on a dealer basis should be free of commission and should be executed at a fair price, and all transactions on a brokerage basis should be executed at a fair commission.

(h) Dealers should keep for two years a record of all transactions, including the name, issue, amount, price, accrued interest, tax, commission, and other charges.

[99] "Relationship of the Federal Reserve System to Government Security Dealers," Leroy Piser, Board of Governors, October 6, 1943, as restated in Rouse (1944).

(i) Deliveries on all transactions, except where special arrangements are made otherwise, should be effected by 2 p.m. of the following business day, except Saturday, and settlement should be made in immediately available funds.

(j) All confirmation tickets should state whether the transaction was executed on a principal or agency basis.

(k) The amount of borrowings by a dealer should at no time exceed ten times the net worth of the dealer.

(l) No dealer should effect with or for any customer's account in respect of which such dealer has discretionary power any transactions that are excessive in size or frequency.

(m) No dealer should give anything of value to any employee of another person for the purpose of influencing or rewarding such employee.

(n) No dealer should give anything of value to any person for the purpose of influencing such person to publish or rewarding such person for publishing any matter designed to affect market prices.

Box 2. Federal Reserve Bank of New York Draft of Terms and Conditions Governing the Relationship Between the Federal Reserve Bank of New York and Dealers in Government Securities, February 1, 1944.[100] Text in italics parallels existing Bank requirements for a recognized dealer. Text in boldface reflects additional concerns articulated by FOMC members.

The Federal Reserve Bank of New York, as agent for the Federal Open Market Committee of the Federal Reserve System is willing to transact business in United States Government securities, both direct and guaranteed, with reputable brokers and dealers in United States Government securities provided they agree in writing to the requirements set forth below.

In determining whether a person (individual, partnership or corporation, including a bank) is a reputable broker or dealer with whom the Federal Reserve Bank of New York, as such agent, will transact business, and the extent to which business will be transacted with such person, the following factors are taken into consideration by the Reserve Bank:

(a) *Integrity, knowledge, and capacity and experience of management*;

(b) *Willingness to make markets (over-the-counter) under all ordinary conditions, and to take positions*;

(c) *The volume and scope of business and the contacts such business provides*;

(d) **Cooperation in the maintenance of an orderly market**; and

(e) *Financial condition and capital at risk of business*.

The requirements of the Federal Reserve Bank of New York, as Agent, to which a broker or dealer must agree in writing are as follows:

1. He shall promptly furnish the Agent with a statement showing as of the close of business each business day:

    a. the *total amount of money borrowed*;

    b. the *par value of all Government securities borrowed*;

[100] Rouse (1944, Exhibit B).

c. his *position, both long and short, in Government securities, classified by classes of securities and maturity groups* (or by issues, if so requested by the Agent);

d. the *volume of transactions during the day in Government securities, classified by classes of securities and maturity groups* (or by issues, if so requested by the Agent); and

e. such *other statistical data* as in the opinion of the Agent will aid in the execution of transactions for the System Open Market Account.

2. **At or before the completion of each transaction with the Agent, he shall furnish the Agent with a written notification disclosing whether he is acting as a broker for the Agent, as a dealer for his own account, as a broker for some other person, or as a broker for both the Agent and some other person. In the absence of a special agreement to the contrary with the Agent with respect to a particular transaction, he will not act as a broker for any other person in connection with any transaction with the Agent**.

3. In the absence of special arrangements with the Agent, delivery of securities shall be made at the office of the Bank before 2:15 p.m. on the next full business day following the day of the contract and all payments by the broker or dealer shall be in immediately available funds.

4. He will furnish the Agent not less frequently than once during each calendar year with a *report of his financial condition* as of a date not more than 45 days prior to the delivery of the report to the Agent in form acceptable to the Agent and prepared or certified by a public accountant acceptable to the Agent.

5. **Unless the Agent shall have informed him of the Agent's desire to purchase or sell a particular issue of Government securities, he shall not solicit from any other person offerings of or bids for any issue of Government securities for the purpose of placing himself in a position to offer to sell to or buy from the Agent securities of such issue**.

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