United States General Accounting Office 132740

GAO

Fact Sheet for the Chairman, Subcommittee on Domestic Monetary Policy, Committee on Banking, Finance and Urban Affairs, House of Representatives

April 1987

U.S. GOVERNMENT SECURITIES

The Federal Reserve Response Regarding Its Market-Making Standard

UNITED STATES GENERAL ACCOUNTING OFFICE

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GAO United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-221597

April 21, 1987

The Honorable Stephen L. Neal
Chairman, Subcommittee on Domestic
Monetary Policy
Committee on Banking, Finance and
Urban Affairs
House of Representatives

Dear Mr. Chairman:

At a September 29, 1986, hearing held by your Subcommittee, we discussed our work on the U.S. government securities market and the primary dealer system performed at the request of Walter Fauntroy, then Chairman of the Subcommittee. At that time, we were asked to submit material on our analysis of primary dealers' participation at Treasury auctions for inclusion in the hearing record. This material is now part of the hearing record (Serial No. 99-103).

We also noted in our testimony that we had analyzed primary dealers' adherence to the market-making standard, had posed several questions to the Federal Reserve, and were waiting for their response. As agreed with the Subcommittee at the hearing, we are sending you our letter to the Federal Reserve System, dated September 15, 1986, and the Federal Reserve Bank of New York's response, transmitted to us on January 13, 1987.

As arranged with your office, we are sending copies of this report to the Board of Governors of the Federal Reserve System, the Secretary of the Treasury, various congressional committees and subcommittees, and other interested parties.

If you need additional information about this report, you may call me on 275-8678.

Sincerely yours,

Craig A. Simmons
Senior Associate Director

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GAO United States
General Accounting Office
Washington, D.C. 20548

General Government Division

September 15, 1986

The Honorable Paul A. Volcker
Chairman, Board of Governors of the
Federal Reserve System

Dear Mr. Volcker:

In a letter to you dated July 2, 1986, we requested answers to several questions concerning primary dealers' participation at U.S. Treasury auctions. Auction participation is one of the standards the Federal Reserve System uses in naming U.S. government securities dealers to its published list of daily reporting primary dealers. This letter requests your answers to several questions about another primary dealer standard--market-making activity. As with the previous letter, this is being sent to you in connection with work we are performing for the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Finance and Urban Affairs.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our study of the market-making standard focused on the following areas

-- the rationale for the standard;

-- the Federal Reserve's measurement of primary dealers' market-making performance;

-- comparison of primary dealers' market-making activity, and

-- how the Federal Reserve seeks compliance with the standard.

The scope of our work included (1) discussions with officers of the Federal Reserve Bank of New York (FRBNY) Dealer Surveillance Unit, (2) a review of Federal Reserve primary dealer standards, and (3) analysis of primary dealers' market-making activity. This analysis covered the years 1982 through 1985, with the greatest emphasis on 1985. The questions contained in this letter are presented following a discussion of the market-making standard and an analysis of primary dealer market-making activity.

We recognize that market-making is but one of the standards used in designating primary dealers. We chose to analyze this standard for reasons similar to those we earlier applied to dealer participation at Treasury auctions. First, market-making in Treasury and agency securities represents one of the responsibilities that primary dealers are asked to assume in being accorded primary dealer status. Second, market-making is subject to quantitative analysis.

More generally, we are concerned with primary dealer standards because the primary dealer designation seems to be an important one in the government securities market. You have testified that primary dealers probably have some advantage over other dealers because market participants are likely to be more willing to trade freely with primary dealers. It is also clear that some government securities brokers limit access to their trading wire networks to current or aspiring primary dealers. Nonetheless, in view of the apparent significance of primary dealer status for the market, we think it important that the rationale for the market-making standard and how it is administered be as clear as possible.

On May 30, 1986, the Northern Trust Company announced it had been dropped by the FRBNY from the list of daily reporting primary dealers. The reason cited by the Northern Trust for this action was lack of trading volume, indicating the importance which the FRBNY apparently places on the market-making standard.[1]

THE MARKET-MAKING STANDARD

The FRBNY considers primary dealers to be the core of the government securities market. These dealers are expected to maintain an active market through their willingness to buy and sell a full range of Treasury issues at all times. These dealers help provide the liquidity that characterizes this most active capital market in the world. Primary dealers are also the only dealers used by the FRBNY's open market desk in conducting monetary policy operations.[2]

The Federal Reserve standards for primary dealers were outlined in an April 19, 1985, letter from E. Gerald Corrigan, President of the Federal

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[1]"Northern Trust Ousted by Fed as Bond Dealer," American Banker, June 3, 1986, p. 1.

[2]This description of primary dealers is based upon the FRBNY publication Fed Points 2: Primary Dealers Defined, revised February 1986.

Reserve Bank of New York.[3] The standards include the extent of dealer participation at Treasury auctions, market-making activity, financial strength, the depth and experience of management, and management's commitment to the market.

As contained in Mr. Corrigan's letter, the Federal Reserve measures market-making as follows:

> "To measure volume of market-making activity, we receive reports for a number of months from firms seeking to be added to the primary dealer list. We compare the dealer's volume of purchase and sale activity in various sections of the market to that of other dealers currently on the list. We pay particular attention to the volume of trading activity with 'customers'--i.e., activity excluding trading with other primary dealers. In the past our minimum standard for a new primary dealer was that such a firm should allow customer activity for a sustained period equal to at least one percent of the total of all existing primary dealers. More recently, we have modified that criterion somewhat in order to avoid making the entry barrier too high. As the number of primary reporting dealers increased from 25 or so a decade ago, to about 35-37 in recent years, it became more difficult to reach and maintain a one percent level. Accordingly, our current approach is to compare the volume of activity of a prospective addition to the list to that of several of the smaller dealers currently on the list whose volume is considered adequate.
>
> "In addition to overall activity with customers, we look for a degree of diversity in maturity areas covered, as well as a reasonable diversity of the customer base. (A firm that traded almost entirely with a very few customers would not be considered a true 'market-maker')."

A February 1986 publication of the FRBNY states that the minimum guideline for primary dealers is "about three-quarters of one percent of the total customer volume of all current primary dealers."[4]

Although the FRBNY only conducts open-market trades with primary dealers, simply meeting the market-making guideline is apparently not sufficient for qualifying a primary dealer for an open market trading relationship with the FRBNY. The FRBNY indicates that "to establish a

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[3]Mr. Corrigan's letter is contained in a hearing record of the Subcommittee on Domestic Monetary Policy, House Subcommittee on Banking, Finance and Urban Affairs (Serial No. 99-20, April 1, 1985).

[4]FRBNY, Fed Points 2: Primary Dealers Defined, op. cit.

trading relationship with the Federal Reserve a dealer must be regarded as making sizeable and continuous markets in the full range of government securities and must achieve somewhat higher trading volume than required for designation as a primary dealer."[5] The names of primary dealers trading with the FRBNY at any given time are not disclosed, nor is the standard for a trading relationship explicitly stated.

It is our understanding that the FRBNY's Dealer Surveillance Unit analyzes dealer market-making principally by using statistics of average daily cash market transactions with customers in three general categories: Treasury bills, Treasury coupons (notes and bonds), and agency securities. No maturity or other distinctions within the above categories can be made from the data analyzed by the FRBNY on a daily basis. However, primary dealers are expected to make markets in a wide range of Treasury issues.

By focusing on total customer trades, the FRBNY market-making standard gives equal weight to secondary-market transactions in Treasury and agency securities. In this respect, the market-making standard differs from the auction participation standard. Primary dealers are expected to participate actively and meaningfully in auctions for Treasury securities, but there is no standard concerning primary dealer participation in the initial sale of agency securities. Federal Reserve officials told us that beginning in 1986, trading in mortgage-backed agency securities has been excluded from the basic analysis of primary dealer market-making activity.

The vast majority of FRBNY open market transactions do not involve outright transactions in the cash market. Open market transactions principally involve repurchase agreements and matched transactions, and these market activities are not included in the FRBNY market-making standard.

The market-making standard also takes no account of trading in forward, futures, and options markets. Over the past few years, trading in these markets, which many market observers believe contributes to the liquidity of the cash market, has grown rapidly.

ANALYSIS OF PRIMARY DEALER MARKET-MAKING

This section summarizes information about primary dealer market-making activity based upon published sources and upon annual average daily transactions volume submitted by each primary dealer to the FRBNY. Our discussion follows the FRBNY practice of concentrating on primary dealer customer trades in bills, coupons, and agencies.

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[5]Ibid.

Total volume

The transactions volume of the primary dealers increased greatly during the 1970s and 1980s.

Table 1 shows the number of primary dealers and their average daily transaction volume in U.S. Treasury and federal agency securities from 1980 through 1985. Total volume increased more than fourfold during this period.

Table 1

Number of Primary Dealers and Their Daily Average of all Transactions[a]

Year ended	Dealers	Treasury securities Bills	Treasury securities Notes and bonds	Federal agency securities	Total[b]
		(billions)			
1980	34	$ 11.2	$ 6.7	$ 3.1	$ 21.0
1981	36	14.6	9.9	3.3	27.8
1982	36	18.4	13.8	4.1	36.4
1983	37	22.4	19.7	5.6	47.6
1984	36	26.0	26.7	7.8	60.5
1985	36	32.9	42.4	11.6	86.8

[a]Purchases and sales are added together. Thus, in this table, the purchase and subsequent sale of the same $1 million security would be reflected as $2 million in transaction volume. Excludes repurchase agreements and forward transactions. Transactions reported at par value of securities.

[b]Totals may not add due to rounding.

Source: Federal Reserve Bank of New York.

In the first quarter of 1986 primary dealers' average daily transactions in U.S. government securities continued to rise to a level of about $100 billion.[6]

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[6]In interpreting the volume information in table 1 it should be recognized that the table measures only primary dealers' transactions, not total market transactions by all dealers and market participants. Information on total market transactions is not kept by the Federal Reserve System.

Between 1970 and 1980, the number of primary dealers went from 20 to 34, a 70 percent increase. Since that time the number of primary dealers has remained relatively constant while trading volume has increased greatly. Press reports indicate at the present time a number of dealers appear to be aspiring to become primary dealers.[7]

As noted above, the FRBNY market-making standard emphasizes trading with customers, not total trading. Total primary dealer average daily trading volume with customers for the years 1983 through 1985 is shown in table 2. Primary dealer trading with customers increased by about 92 percent from 1983 to 1985. Trades with customers increased somewhat more than total trades over that period, and constitute about half of all primary dealer trades.

Table 2

Primary Dealer Daily Average Trading Volume and Trades with Customers, 1983-1985

(In billions)

	Trading volume	Trades with customers	Trades with customers as percentage of total volume
1983	$47.7	$22.6	47.4%
1984	60.5	29.4	48.6
1985	86.8	43.3	49.9

Source: Federal Reserve Bank of New York

Larger primary dealers tend to have trades with customers which represent a larger percentage of total trading volume than is true of smaller primary dealers. In 1985, for 7 of the 10 largest dealers (ranked by size of total trading volume with customers), trades with customers as a percentage of total trading volume exceeded the average of 49.9 percent for all primary dealers. By contrast, the percentage exceeded the average for all primary dealers for only 1 of the 10 smallest primary dealers.

[7]"Rush Is On to Join the Exclusive Club of Primary Dealers in U.S. Securities," Wall Street Journal, June 26, 1986.

Types of securities traded

The share of total customer trading in bills, coupons, and agency securities for the years 1983-1985 is shown in table 3. During this period, the most notable changes were that the share of trading in coupons increased and the share of bills decreased. In 1985, trading of bills, coupons, and agencies accounted for 35 percent, 47 percent, and 18 percent, respectively, of all primary dealer customer trades.

Table 3

Share of Customer Trades in Bills, Coupons, and Agency Securities, 1983-85

	Percent of trades in bills	Percent of trades in coupons	Percent of trades in agencies	Total
1983	46%	37%	17%	100%
1984	42	40	18	100
1985	35	47	18	100

Source: Federal Reserve Bank of New York.

All primary dealers conduct trades with customers in bills, coupons, and agency securities. However, the proportions of the business of some individual dealers in the three security categories vary considerably from the industry average. A considerable degree of specialization thus exists.

The 1985 distribution for all 36 primary dealers of the percentage of customer trades falling in the three categories of securities is shown in table 4.

Table 4

Distribution of Primary Dealers Showing the Percentage of Customer Trades By Category of Security, 1985

(Number of primary dealers)

Percent of total trades with customers	Number of Firms By Type of Security		
	Bills	Coupons	Agencies
above 70	0	2	0
60-70	2	2	0
50-60	10	6	0
40-50	6	16	1
30-40	8	7	4
20-30	10	3	5
10-20	0	0	7
0-10	0	0	19
Total firms	36	36	36

Source: Prepared by GAO based on information provided by the Federal Reserve Bank of New York.

The degree of specialization that now occurs among dealers is underscored by the highest and lowest share information contained in table 5. Thus, one dealer conducted about 70 percent of its total customer business in bills, while another conducted about 22 percent. One dealer conducted 46 percent of its customer trades in agency securities, another less than 2 percent.

Table 5

Highest and Lowest Shares of Primary Dealer Customer Trades Accounted for by Bills, Coupons, and Agency Securities, 1985 Type of Security

	Bills	Coupons	Agencies
Highest share of total customer trades	69.9%	75.6%	46.0%
Lowest share of total customer trades	21.8	26.2	1.6
Industry Average	35.2	47.2	17.6

Source: Prepared by GAO based on information provided by the Federal Reserve Bank of New York.

Market shares of larger and smaller firms

The combined market shares of customer trades (by type of security and in total) for 1982 through 1985 are shown in table 6 for the five leading firms in each category. In 1985, the leading five firms accounted for about 36 percent of all customer trades. Since 1982, the share of total trading accounted for by the largest five dealers has varied between about 34 and 37 percent. Since 1982, the leading five dealers' market share has been greatest in agency securities and least in bills.

Table 6

Combined Market Shares of the Leading 5 Primary Dealers: Trades With Customers, 1982 to 1985

Type of Security

	Bills	Coupons	Agencies	Total
1982	29.8	37.4	54.5	33.5
1983	30.3	40.1	62.4	36.9
1984	31.9	37.6	59.5	36.8
1985	33.7	37.0	60.7	36.4

Source: Prepared by GAO based on information provided by the Federal Reserve Bank of New York.

The combined market shares of the five smallest primary dealers in each category are shown in table 7. The share of total customer trades accounted for by the smallest five dealers was the highest (in the years cited) in 1982 when the share was 4.7 percent. The share of the bottom five has fallen since that time to 3.3 percent in 1985.

The smaller primary dealers do not account for a great deal of the total primary dealers' trading with customers. In 1985, the market share of the five smallest dealers was greatest in bills at 4.0 percent. For coupons and agencies, the percentages were 2.4 percent and .8 percent, respectively.

It is not possible to know how the volume of the smaller primary dealers compares to the volume of trading in the market as a whole because the FRBNY only gathers statistics on the trades of primary dealers. By the same token, it is not possible to know whether designating new primary dealers adds to the liquidity of the market. It is possible that the liquidity added by a new primary dealer could represent business taken away from an existing primary dealer or business that would have been performed by a non-primary dealer.

Table 7

Combined Market Share of the 5 Smallest Primary Dealers: Trades With Customers, 1982 Through 1985

	Type of Security			
Year	Bills	Coupons	Agencies	Total
1982	5.4%	3.2%	1.4%	4.7%
1983	5.1	2.8	1.2	4.4
1984	4.3	2.4	1.2	3.5
1985	4.0	2.4	.8	3.3

Source: Prepared by GAO based on information provided by the Federal Reserve Bank of New York.

Comparison of 1985 trading with the market-making guidelines for primary dealers

The share of market-making by primary dealers in relation to the Federal Reserve's current and former market-making guidelines is shown in table 8. In 1985, four primary dealers failed to achieve the current Federal Reserve market-making guideline of .75 percent of total primary dealers' customer trading volume. One of the dealers that failed to meet the 1985 guideline was the dealer removed from the list in 1986, but it appears that the problem of complying with the guidelines exists among other dealers as well. Ten dealers achieved a volume less than that of the previous guideline of 1.0 percent of total customer trades.

A more complete picture of the smaller firms can be obtained by looking at the guideline in relation to the three types of securities. In 1985, all dealers were above a .75 percent market share for bills, but 9 were below a .75 percent market share for coupons and 16 were below that level for agency securities. Since only four dealers were below .75 percent on an overall basis, it would appear that the many smaller dealers trading in bills compensates for a relative lack of activity in coupons and agency securities. It is generally acknowledged that trading in bills tends to be less risky than trading in securities of longer maturity because for a given change in interest rates, prices do not change as much.

Table 8

Market Shares of Primary Dealers' Trades With Customers in 1985

(Number of primary dealers)

	Type of security			
Market share	Bills	Coupons	Agencies	Total
Market share less than .75 percent	0	9	16	4
Market share of .75 percent or more but less than 1.0 percent	5	2	3	6
Market share of 1.0 percent or more	31	25	17	26
Total	36	36	36	36

QUESTIONS FOR THE FEDERAL RESERVE

The preceding analysis provides the background for the following questions upon which we are seeking the Federal Reserve's comments.

1. The primary dealer system facilitates the ability of the FRBNY to conduct open market operations and to oversee the market. It is not clear to us, however, how the market-making standard relates to each of these FRBNY activities. Why does eligibility for a trading relationship with the FRBNY require a higher demonstrated market-making capability than that required for primary dealer designation? What is the rationale for designating primary dealers whose trading volume is not sufficient for participating in trades with the FRBNY? Do efforts to oversee market operations make it desirable for the FRBNY to monitor the daily activity of a larger number of firms than the number needed for the conduct of open-market operations?

2. If additional primary dealers are designated by the FRBNY, do you think some existing dealers should be dropped as new dealers are added? Would the designation of additional primary dealers make it

necessary to lower the market-making guideline below .75 percent of total trades with customers?

3. In your opinion, what basis should be used in reaching a judgment about the optimum number of primary dealers? Is the optimum number likely to be considerably different when viewed from the perspective of overseeing market operations rather than from the perspective of open market trading? What is your view of the optimum number of primary dealers that would be justified at the present time? What market-making standard is likely to be implied by this number?

4. We have several questions about the rationale for basing the market-making guidelines on the total of customers trading in bills, coupons, and agency securities.

   a. What is the basis for giving agency securities equal weight with Treasury securities in the market-making guideline?

   b. In view of the FRBNY's extensive use of repurchase agreements and matched transactions in the conduct of open market operations, what is the basis for excluding this aspect of the market from the market-making guideline?

   c. Since forwards, futures, and options trading in recent years have come to play a large part in the government securities markets, what is the basis for excluding this aspect of market practice from the market-making guideline?

   d. We understand that market participants distinguish short, intermediate, and long term maturities within the coupon category. What is the basis for excluding this aspect of market practice from the market-making standard?

5. Although all primary dealers conduct customer trades in Treasury bills, coupons, and agency securities, our analysis indicates that a measure of specialization by many primary dealer firms is also evident. What is the rationale for requiring a primary dealer to trade with customers in a broad range of securities of different maturities? Do firms trading in a broad range of maturities or types of securities enhance liquidity more than firms specializing in particular types of securities or maturity ranges? Are there reasons that make it essential that each firm trading with the Federal Reserve conduct trades in a broad range of securities and maturities? If firms which specialize in types or maturities of securities are excluded from open market trading, how can the Federal Reserve know it is getting the most advantageous prices for its trades?

6. Our analysis noted differences among dealers in the percentage of trading with customers. In particular, many smaller firms conducted a relatively low percentage of their trades with customers. Does the Federal Reserve place any significance on the ratio of customer to total trading? Can firms with a relatively low proportion of business in customer trades be presumed to be more risky or less risky than others?

7. By basing the market-making guidelines on market-share, does the FRBNY market-making guideline in effect hurt smaller firms whose business does not grow as rapidly as the market as a whole? In a rapidly expanding market, does the market-share guideline provide an incentive for firms to take on greater risks in order to continually increase their trading volume--at least at the growth rate of the market as a whole? If the growth rate in the total market slows down, could the market share standard lead to overaggressive competition to maintain business?

8. We noted that the market-making guideline was lowered in 1985 and that several firms still do not meet the revised guideline. What are the procedures for enforcing compliance with the market-making standard for existing primary dealers? Over what time period is compliance expected? To what extent are market-making in bills, coupons, and agencies given separate consideration in determining compliance? What types of warning or sanctions are taken?

9. Do you believe data should be collected on trading by all dealers in government securities, not just primary dealers?

10. How important does the Federal Reserve believe the market-making standard is? How does this standard compare in importance to participation at Treasury auctions, management capability, and creditworthiness?

We would very much appreciate your response to the questions raised in this inquiry. If you would like to further discuss the matters addressed in this letter, please contact Stephen Swaim of my staff at 452-2833.

Sincerely yours,

W. J. Anderson

William J. Anderson
Assistant Comptroller General

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

OFFICE OF STAFF DIRECTOR FOR
MONETARY AND FINANCIAL POLICY

January 13, 1987

Mr. William J. Anderson
Assistant Comptroller General
General Accounting Office
General Government Division
Washington, D.C. 20548

Dear Mr. Anderson:

In your letter of September 15 to Chairman Volcker you raised a number of questions about Federal Reserve policy with respect to the market-making activity of primary dealers. The enclosed comments from the Federal Reserve Bank of New York respond to those questions.

Sincerely,

Donald L. Kohn

Donald L. Kohn
Deputy Staff Director for
Monetary and Financial Policy

Enclosure.

Responses to GAO Questions about Market-Making Standards

1. The primary dealer system facilitates the ability of the FRBNY to conduct open market operations and to oversee the market. It is not clear to us, however, how the market-making standard relates to each of these FRBNY activities. Why does eligibility for a trading relationship with the FRBNY require a higher demonstrated market-making capability than that required for primary dealer designation? What is the rationale for designating primary dealers whose trading volume is not sufficient for participating in trades with the FRBNY? Do efforts to oversee market operations make it desirable for the FRBNY to monitor the daily activity of a larger number of firms than the number needed for the conduct of open-market operations?

In the first instance, the primary purpose of primary dealer designation is to identify firms with whom, as a straightforward business matter, we are prepared to conduct transactions. Market-making ability is one of the key factors that enters into that designation, as we have sought to identify firms who play a central role in the marketplace, as well as financially reliable counterparties. The emphasis on market-making as a criterion encourages greater liquidity and efficiency in the government securities market.

While the list includes firms with whom we are prepared to do business, it was never intended to imply we would do business with each and every firm on the list every time that we are in the market for ourselves or as agent for others (for example, for other central banks). In fact, there are several ways in which there may be differences among the firms with respect to the amount of business conducted--notably because our trading is done on a competitive basis, and the actual volume of business done will depend on the terms presented. Also, we do some smaller scale customer operations with a limited number of dealers. Thus, we do not expect that our trading will be of the same magnitude with each dealer or be proportional, say, to that firm's market-making activity.

Further, we typically phase in trading relationships with new primary dealers. As a general practice, at least a brief, transitional time interval passes before the Federal Reserve begins trading with a primary dealer. This interval provides an additional period to observe the capability of a new primary dealer to ensure that it has made a firm commitment to making satisfactory markets to customers and will not backslide after receiving initial designation as a primary dealer. If a firm had just barely met our market-making standard in being designated a primary dealer, we would typically look for some further improvement in market-making in the meantime; this would be a further demonstration of the firm's long-term staying-power. This process has in fact worked as almost a natural progression with there being very few cases of new primary dealers who do not become trading partners fairly soon after receiving the primary dealer designation. Similarly, it would be unusual for a dealer to lose its trading relationship but retain over a long period its designation as a primary dealer.

To be sure, the nature of our interest in the Government securities market transcends the matter of pure business relationship, important as that is. Contact with firms operating in the market helps us achieve a better understanding of financial market developments and practices, which in turn is useful to us as a central bank in the formulation and execution of monetary policy, and helps us as well to serve the Treasury better in meeting its debt management responsibilities.

Likewise, our "oversight" of primary dealers, while rooted in our business need to monitor trading counterparties, also has some broader aspects in that we have a concern with the over-all healthy functioning of the Government securities market as a vital part of our financial system. Viewed broadly, a market oversight role by itself could imply having a considerably larger number of daily reporting dealers than might be strictly necessary, say, from the standpoint of having a sufficient number of firms to conduct our transactions on an efficient, competitive basis. However, we have deliberately not sought to expand our oversight to the point, say, of becoming a "rating agency" for dealers. Rather, we believe that market participants should form their own business judgments about whom to trade with.

Finally, it should be noted that the market has been undergoing rapid change in size and character in recent years, including greater internationalization as well as the direct application of formal regulation under new legislation passed in 1986. Against this background our own relationships with the market must, by necessity, maintain a considerable element of flexibility and adaptibility.

2. If additional primary dealers are designated by the FRBNY, do you think some existing dealers should be dropped as new dealers are added? Would the designation of additional primary dealers make it necessary to lower the market-making guideline below .75 percent of total trades with customers?

There is no plan, nor should it be necessary, to drop existing primary dealers if they continue to meet established standards. We do not believe a maximum number of primary dealers should be fixed or constrained by a formula which is not responsive to an expanding market. Nor are we inclined at this time to adjust the market-making guideline of .75 percent. Until we feel there is a need for a change it may well be more difficult for some firms to retain their status as primary dealers, but we regard that as part of a healthy competitive adjustment process in an expanding and changing market. Yet, over the longer run, there undoubtedly will be further changes in the market-making standard in adapting to the evolution of this market.

3. In your opinion, what basis should be used in reaching a judgment about the optimum number of primary dealers? Is the optimum number likely to be considerably different when viewed from the perspective of overseeing market operations rather than from the perspective of open market trading? What is your view of the optimum number of primary dealers that would be justified at the present time? What market-making standard is likely to be implied by this number?

This question, as does an earlier, touches on the point of how best to balance the Fed's dual interest in having a group of primary dealers. In one sense, the Fed already trades with enough dealers to conduct its operations efficiently. However, healthy price competition is encouraged by a larger group of primary dealers than some lesser number that might directly satisfy open market operational requirements. Thus, in terms of the broader significance of primary dealer status -- firms with a substantial commitment to making markets in government securities -- the public benefits would seem to lie with permitting open entry for firms which meet a "significant market making" standard as well as the other standards described below and it would be unfortunate to freeze the number of firms at a level that did not allow for expansion as the market expands. In view of these considerations, and the changing character of the market-place, we would be reluctant to cite an optimum number of primary dealers since a realistic view of what is optimum will, of necessity, change from time to time.

The listing standards describe firms that stand ready to serve investors in Treasury securities by being willing to buy or to sell at very competitive spreads, in weak as well as in strong markets. They should be well capitalized in order to assume the legitimate risk of making markets. They should be significant participants in Treasury auctions. They should also be capable of assisting the Federal Reserve in its open market operations. They should have earned the respect of investors and have a customer base which provides them the liquidity needed to make markets. That the Federal Reserve may not need this many firms to conduct its open market operations is perhaps not a good or sufficient reason to otherwise limit the number of such firms.

4. We have several questions about the rationale for basing the market-making guidelines on the total of customers trading in bills, coupons, and agency securities.

a. What is the basis for giving agency securities equal weight with Treasury securities in the market-making guideline?

The fact that Federal legislation in the 1960's broadened the scope for Federal Reserve purchases and sales of securities issued by instrumentalities of the Government or organizations that were Federally sponsored makes it appropriate that the Federal Reserve take some account of activity in these issues when evaluating dealer qualifications.

However, Treasury issues do get greater weight; if a dealer showed very light activity in Treasury issues and met our overall standard only by virtue of very heavy activity in agencies, it would not be considered a satisfactory primary dealer. On the other hand, we would not be particularly troubled if a firm met the overall standard even though it was relatively light in agency issues.

We have also been inclined recently to distinguish trading in mortgage-backed agency securities as being somewhat different in character from other agency issues or Treasury issues. The mortgage-backed securities are typically traded within separate and specialized departments of dealers, possess special features, and are subject to different trading conventions including delivery dates. The Federal Reserve does not operate in these securities for its own account. In recognition of these factors, we appraise a dealer's market-making both including and excluding mortgage-backed securities transactions. To an even greater extent than with ordinary" agency issues, a dealer whose overall activity met our standards primarily through heavy reliance on trading mortgage-backed securities would be less likely to be considered a satisfactory primary dealer than if trading volume were better diversified particularly in Treasury issues.

b. In view of the FRBNY's extensive use of repurchase agreements and matched transactions in the conduct of open market operations, what is the basis for excluding this aspect of the market from the market-making guideline?

Repurchase agreement activity is more a reflection of a dealer's financing needs than an indication of market making. While we do not collect information on the overall volume of repurchase agreement purchases and sales at reporting dealers, we would be concerned that a measurement that included such activity could be dominated by a heavy volume of financing transactions as compared with outright investing and trading activity. Moreover, we do not believe such data would tell us more than outright transactions about market-making activity.

Although not used as part of the primary dealer standard itself we do keep track of the volume of repurchase transactions that a dealer arranges with the Federal Reserve, and this is part of the evaluation of the dealer's usefulness as a trading counterparty to the Federal Reserve Trading Desk.

c. Since forwards, futures, and options trading in recent years have come to play a large part in the government securities markets, what is the basis for excluding this aspect of market practice from the market-making guideline?

Trading in derivative products such as forwards, futures, and options has become an increasingly important aspect of the market, but they remain derivative products which at best provide only indirect benefits to the Treasury and the Federal Reserve. The Federal Reserve does not use derivative products for its open market operations, nor does the Treasury in its debt management. The Federal Reserve recognizes that dealers who use futures and options may be more effective market makers, but if so, this should tend to be reflected in their cash market trading as well. Moreover, a substantial share of the trading in these derivative products is interdealer activity rather than customer activity, and in some cases - notably for that portion of futures and options traded in organized exchanges - we cannot readily distinguish from reported statistics customer and interdealer activity. We would have little interest in adding firms as primary dealers who, while active in derivative markets, lack the commitment we expect to the Government securities market itself -- both secondary and primary.

d. We understand that market participants distinguish short, intermediate and long term maturities within the coupon category. What is the basis for excluding this aspect of market practice from the market-making standard?

The Federal Reserve expects primary dealers to make markets to some extent in all maturities and considers that factor in its evaluation of a dealer although we recognize that there are degrees of specialization or concentration on certain areas at particular firms. While we have not attempted to define precisely the appropriate balance expected between maturity categories, a severely deficient degree of market making in a particular maturity sector could be cause for counseling the dealer.

5. Although all primary dealers conduct customer trades in Treasury bills, coupons, and agency securities, our analysis indicates that a measure of specialization by many primary dealer firms is also evident. What is the rationale for requiring a primary dealer to trade with customers in a broad range of securities of different maturities? Do firms trading in a broad range of maturities or types of securities enhance liquidity more than firms specializing in particular types of securities or maturity ranges? Are there reasons that make it essential that each firm trading with the Federal Reserve conduct trades in a broad range of securities and maturities? If firms which specialize in types or maturities of securities are excluded from open market trading, how can the Federal Reserve know it is getting the most advantageous prices for its trades?

Firms which specialize in particular securities or maturities are respected participants in the market and may contribute to market efficiency in the sector in which they operate. Their concentration of effort may be most appropriate for the nature of their firm and their expertise is a valuable quality. At the same time, versatility is a quality which we believe is highly valuable and desirable in the context of open market operations and overall market efficiency. We do not expect dealers to be equally active in each Government securities market sector, but we feel total neglect of a sector--particularly of any significant part of the Treasury market--is not consistent with our concept of a primary dealer.

The Federal Reserve potentially operates for itself and its customers in all sectors of the market. The large number of primary dealers through which the Federal Reserve currently carries out open market operations tends to insure that prices will always be very competitive. There is no reason to think that a dealer who concentrates its activity in one maturity sector will be significantly more competitive in its specialty than a well rounded dealer. Indeed, such a dealer may be less competitive because it may not be in touch with a broad group of investors who provide dealers with liquidity or sources of securities.

We also value versatility because firms which trade a broad range of securities of different maturities can increase market efficiency by providing greater opportunities to customers. Investors can more readily change their investment strategies or accommodate variable investment timeframes if dealers are active in all areas of the market. Dealing in all maturities allows a firm to be more competitive in arranging swaps or arbitrages. Versatile dealers also provide us with more insights on market developments. The Federal Reserve prefers primary dealers to diversify maturities because the policy supports a broad market and adds value to Treasury securities by increasing the market's depth and breadth.

6. Our analysis noted differences among dealers in the percentage of trading with customers. In particular, many smaller firms conducted a relatively low percentage of their trades with customers. Does the Federal Reserve place any significance on the ratio of customer to total trading? Can firms with a relatively low proportion of business in customer trades be presumed to be more risky or less risky than others?

Our main focus, in evaluating market-making, is in the volume of activity with customers. We would not typically place great significance on the ratio of customer to total trading although unusually low or high proportions would probably be discussed with the dealer to gain a better sense of the nature of the dealer's activity. An unusually high or low ratio of customer to total trading might also raise questions about the accuracy of the dealer's reports and result in further inquiries. We see no reason in and of itself to associate a low ratio of customer to total trading with more or less risk.

7. By basing the market-making guidelines on market-share, does the FRBNY market-making guideline in effect hurt smaller firms whose business does not grow as rapidly as the market as a whole? In a rapidly expanding market, does the market-share guideline provide an incentive for firms to take on greater risks in order to continually increase their trading volume--at least at the growth rate of the market as a whole? If the growth rate in the total market slows down, could the market share standard lead to overaggressive competition to maintain business?

The market share guideline is administered with care to avoid unnecessarily damaging firms which fail to meet our standards. A firm whose business is not growing is not immediately removed from the list of primary dealers. A primary dealer is allowed a substantial amount of time to correct substandard market-making. Over an extended time, a firm's failure to participate in market growth would raise serious questions as to whether the firm should continue to be considered a primary dealer.

The market-share guideline may tempt some firms to be less cautious about their counterparties as they seek to maintain standards. However, the quality of a dealer's business is an important element embodied in the standard and the Federal Reserve periodically reviews the nature of trading volume as part of the evaluation process. The Federal Reserve emphatically cautions dealers that it is not acceptable to build volume through high risk, imprudent transactions or those which serve no purpose but to inflate volume. Of course, there is always risk associated with market-making, but an adequately capitalized dealer is capable of managing the risk associated with active market-making. While a temptation toward over-aggressive competition to maintain a market-making standard is possible in periods of either rapid or slow over-all market growth, we would expect a well-managed dealer to resist the temptation. And, the market-making standard must always be taken in the context of the financial strength of the firm as depicted, for example, by its capital position.

8. We noted that the market-making guideline was lowered in 1985 and that several firms still do not meet the revised guideline. What are the procedures for enforcing compliance with the market-making standard for existing primary dealers? Over what time period is compliance expected? To what extent are market-making in bills, coupons, and agencies given separate consideration in determining compliance? What types of warning or sanctions are taken?

Compliance with the market making standard has been achieved quite effectively through the counseling of primary dealers if their volume falls to marginal levels. Of the four firms whose market making activity fell below .75 percent on a daily average basis in 1985, three have increased their market share in 1986 above the minimum and one is no longer a primary dealer.

A temporary decline in a dealer's volume will prompt an informal discussion which usually obtains the desired result. A more deep-seated deficiency will incur sterner comment and ultimately the failure to improve market making will result in termination of the primary dealer status. Final action to end the dealer's primary dealer status is generally preceeded by limited, but forceful measures such as suspending all or part of a trading relationship.

The time allowed a dealer to redress market-making deficiencies depends on the circumstances, causes, or prospects for improvement. The time may be a calendar quarter or two if a positive management attitude is not in evidence. The Federal Reserve is not forebearing if management signals through its actions that it lacks genuine commitment to its primary dealer obligations. Patience is greater if a dealer appears to be addressing shortcomings that are not deeply rooted and seem correctable. Many months may be allowed if a dealer gives evidence of resolve and appears capable of meeting standards.

A deterioration in a dealer's market-making in one segment of the market is usually not a serious condition. It could reflect the loss of a particularly talented trader or a desire of management to redistribute resources. However, if a decline in activity in one sector suggests a dealer is abandoning that sector of the market the development would be serious and action might be taken by the Federal Reserve depending on the circumstances.

9. Do you believe data should be collected on trading by all dealers in government securities, not just primary dealers?

No, we do not believe it is necessary to collect data on trading by all dealers. Collecting data is expensive and burdensome for the providers and recipients of the data, and we do not see enough to be gained to warrant this costly effort. The Federal Reserve currently receives impressions of the amount of trading by non-primary dealers from several sources. They include aspiring primary dealers, "secondary dealers" who report monthly, and indirectly through some knowledge of the counterparties of primary dealers. While the Federal Reserve's view is limited, its perspective covers the great bulk of what we believe to be the significant dealers and a high percentage of the volume of all dealers. In addition, reporting requirements that might be promulgated under the Government Securities Act of 1986 may provide information on the activities of more government securities dealers.

10. How important does the Federal Reserve believe the market-making standard is? How does this standard compare in importance to participation at Treasury auctions, management capability, and creditworthiness?

Market-making is clearly an essential characteristic of primary dealers. However, it is not sufficient in itself to assure that a firm is fit to be a primary dealer. For example, an undercapitalized dealer cannot be a primary dealer even if the firm reports very substantial activity. Indeed, for a thinly capitalized firm, heavier activity might be a source of additional concern in and of itself. At the same time, a dealer that is not willing to make markets to a broad group of investors cannot be considered a primary dealer regardless of the size of its capital. While all standards are important, some carry less weight in our evaluation of a dealer. The degree of a dealer's interest in Treasury auctions is somewhat secondary in importance to its commitment to active market making or its creditworthiness. Moreover, some standards are more time critical than others. For example, one can tolerate a primary dealer experiencing declining customer volume for a temporary period but we would not be prepared to see a dealer assuming risk that is significantly out of proportion to its capital even for a brief period. The standards that the Federal Reserve uses to evaluate dealers should be considered to be an integrated whole. However, standards pertaining to capital adequacy and market making stand out as criteria that must clearly be met independently of how well the dealer measures up in other respects.

Federal Reserve Bank of
New York
January 1987

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