

REC'D IN FILES SECTION

MAR 14 1955

CONFIDENTIAL -- (F.R.)

To Members of the Executive Committee

March 11, 1955

From R. G. Rouse

Subject: "Best-price" Trading
for the System Open Market
Account

The Management of the System Open Market Account, in carrying out the Committee's instruction to buy or sell at the best price available in the market, has made it a practice, before entering into a purchase or sale commitment, to ask for offerings or bids from each of the eighteen dealers and dealer banks that currently make markets and normally maintain a position in Treasury bills. Difficulties have arisen from time to time in executing credit policy in this way. The "go-around" to all the dealers is time-consuming, sometimes has undesirable repercussions on the bill market, and in general confines System Account transactions to a rigid form. The cumbersomeness is not always a handicap, to be sure, but it does greatly limit flexibility in scheduling and carrying out open market operations. Therefore, the Account management proposes, unless the Executive Committee should direct otherwise, to revise the narrow interpretation that it has placed on the Committee's instructions and, when such procedure would be the most effective method, to trade for the System Account after contacting only enough dealers to ascertain that the contract prices are "best prices".

In contacting eighteen dealers for bids or offers on Treasury bills, the trading desk has attempted to contact all dealers as nearly simultaneously as possible, by spreading the calls among all available qualified personnel. This normally involves four to five people and the initial contacts are completed in a matter of minutes. But after the quotations have been received, additional time is necessary to collate the information and to make comparisons among all the different prices and maturities that have been quoted. During the 20 or 30 minutes necessary for the complete process, the market is left in a position of uncertainty as to the scale of the System's operation and the prices that will be paid. Moreover, since the bids or offerings to the System Account must be on a "firm" basis so that the best price can be ascertained, the System Account has frequently "tied up" several hundred million dollars of bids or offerings for the 20 to 30 minutes required. To that extent the fluidity and breadth of the bill market has been temporarily but markedly interrupted--frequently, when dealers' bill portfolios are small, a System Account request for offerings from the dealers has immobilized all of the bills that were then available in the market, and dealers have had to pass up other transactions until the System operation was completed and they could know where they stood and what they could offer.

The length of time necessary to complete the operation when all dealers are contacted has occasionally discouraged transactions late in the day (between 3:00 P.M. and 3:30 P.M. when the market closes). Since data on member bank reserves for the preceding day are usually not available until 3 o'clock or later, the restriction on late trading imposed by the practice of contacting all dealers has at times been a real impediment to flexible operations aimed at influencing the level of bank reserves.

Another drawback of the complete market survey is the effect it can have upon conditions in the bill market. Occasionally the available supply of bills is held by only a few dealers, while the position of the remaining dealers may actually be nominal or short. When this situation exists, a request to submit offerings of bills to the trading desk may cause those dealers, who do not have enough bills in position to take care of their best customers, to start raising prices defensively so as to be sure to "miss" in the offerings to the System Account. At times, some dealers seem to have deliberately withheld bids or offerings so that they could capitalize on the rate reaction to System operations, i.e. hold off and buy bills from others at higher rates if System was selling, or wait to sell bills to others at lower rates if System was buying.

A scarcity situation has existed from time to time in February and March of this year, for example, when only a few dealers were making broad markets in bills. It is probable that if the trading desk had gone only to those dealers who had bills for sale, the decline in the bill rate during early February would have been less pronounced. Several dealers had actually offered bills to the System Account unsolicited, but before the full-scale procedures of a "go around" were decided upon, and carried through, some or all of the bills were gone, and the entire market had felt the impact associated with the phrase then current "the Fed is in again".

The proposed change in trading procedures for the System Account would not eliminate the practice of contacting all dealers; in many cases there would be no reason for not contacting all the dealers as at present. But in those cases where, because of the time involved or the probable market effect, it would be inexpedient to make the full circuit, the trading desk should plan to contact only the five or six dealers who on that day are making the most active markets in those bills the System Account is interested in buying or selling. The dealers would be selected, on the basis of information available at the trading desk, to assure that the "best price" could be obtained from the dealers and that they were in a position to buy or sell in the size necessary to exert the desired effect on bank reserves. To avoid any implication of favoritism, careful rotation of transactions could spread requests for bids and offers around among the dealers--a procedure that has for some time been followed in executing transactions for Treasury, foreign, and other accounts with good results.

An extension of the proposed trading practice would be to enter into transactions from time to time "on the wire". That is to say, if a dealer should come to the trading desk to bid or offer substantial amounts of bills, it might sometimes be appropriate to close a commitment with that dealer on the transaction he had initiated. Whenever this was done, the trading desk would ask the dealer to hold his quotation firm for a few minutes while other dealers were canvassed to get a price measurement. In this case, as in the more frequent instances of transactions originating with the trading desk, a few dealers would be contacted rather than the full complement of dealers, and the practice would be employed only when time or other considerations pointed to it as the most effective way of executing the trade.

It is conceivable that on occasions the full amount of bills to be sold or purchased for System Account on a given day could be "worked out" with one dealer. Frequently, in the past, one or another of the dealers has submitted bids or offerings

in the amount of \$25 to \$50 million and sometimes larger. In a number of instances those bids or offerings were clearly at the "best price" due to special situations. If System Open Market operations were intended to have a minimum initial impact on rates or if it were deemed advisable to avoid "advertising" System transactions to the market, then the acceptance of those bids, or offerings, might have been appropriate without going to all eighteen dealers in establishing that these large lots were at the "best price". If, on the other hand, maximum "advertising" of a System market operation, or a signal of a policy shift, or a maximum rate reaction, were desirable then direct contact with the widest number of dealers would be more effective. It would produce much broader results in relation to the dollar volume of the change brought about in bank reserves than by doing business for the large lot offered or taken by the one dealer whose price clearly bettered all others.

In this connection the trading desk is in constant touch with trends in the short term market and would rarely make an error as to "best price" if other dealer markets were not simultaneously checked. It is the opinion of the Account management that a less rigid interpretation than the one it has placed on the Committee's instruction to trade at best price will facilitate the handling of open market operations in carrying out credit policy objectives.