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Statement of the Shadow Financial Regulatory Committee on

**Reforming the Primary Dealer Structure**

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The Federal Reserve has begun preparations to deal with implications of the scale of the anticipated increase in outstanding federal debt for its daily open market operations and the windup of its mortgage purchase and quantitative easing policies. It has initiated experiments with reverse repurchase agreements and it has also sought to increase the number of primary dealers to act as counter parties in its daily transactions. The small number of counter parties results from the Federal Reserve's own antiquated operational procedures in conducting daily transactions it books in the system's open market account. Federal Reserve officials have lamented the fact that the existing 19 primary dealers are capital constrained and this may adversely affect the redistribution of injected liquidity to support credit extension by the country's commercial banks.

Prior to the current financial crisis, the primary dealers were required to be extremely sound financial institutions. As a result these institutions were privileged to participate in the system's daily securities transactions. But the financial crisis has exposed the fact that most of these institutions were not as sound as had been presumed. During the financial crisis the Federal Reserve's first policy responses were to create special liquidity facilities that subsidized the primary dealers in an effort to get liquidity into the financial system. These facilities include the Term Asset-Backed Securities Lending Facility and the Primary Dealer Credit Facility, just to name two.

The primary dealer system evolved prior to the advent of electronics and computerization of the bid and auction process when institutions relied upon messengers to transmit paper bids to the Desk. For this reason, the primary dealers were all located in New York City in close proximity to the

Federal Reserve Bank of New York. The system is now outdated. There is no reason that qualified institutions could not participate in the daily Open Market transaction process through the System's electronic bidding process. This would open the participation to dealers with offices outside of New York City. The current dependence upon only a small and select number of institutions is neither necessary nor in the best interests of taxpayers.

Furthermore, the attempt by the System to extend reverse repurchase agreements, especially to selected money market mutual funds, is a de facto, incremental expansion of the primary dealer model. It continues its dependence upon a small number of institutions and risks creating a two tiered set of money market mutual funds—those that are and those that are not eligible to deal with the desk and potentially eligible for financial support and special treatment during times of financial stress.

The Shadow Financial Regulatory Committee recommends that the System follow the model used by the European Central Bank. The European Central Bank transacts routinely with more than 500 bank counterparties throughout the Euro Zone. The Fed should terminate the current primary dealer system. This would increase the efficiency of the SOMA transaction process, lower costs, reduce dependence upon a geographically concentrated set of counter parties, and enhance the monetary policy transmission process.