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SECOND SEGMENT OF SEC MARKET STUDY REPORT FILED

The Securities and Exchange Commission today filed with Congress the second segment of the Report of the Special Study of Securities Markets on the adequacy of investor protection in the securities markets. The first was filed on April 3d and it is expected that the final segment will be submitted to Congress shortly. The four chapters announced today* deal primarily with the trading markets for securities, as follows:

Chapter V	-	Trading Markets - Introduction
Chapter VI	-	Exchange Markets
Chapter VII	-	Over-the-Counter Markets
Chapter VIII	-	Trading Markets--Inter-Relationships

In his letter in behalf of the Commission transmitting the four chapters to Congress, Chairman William L. Cary states:

"I have the honor to transmit the second segment of the Report of the Special Study of Securities Markets, containing Chapters V, VI, VII and VIII. This Report is submitted pursuant to Section 19(d) of the Securities Exchange Act of 1934, Public Law 87-196, which directs the Commission to make a broad study of the adequacy of investor protection in the securities markets. The first installment of this Report, Chapters I through IV and IX, was delivered to the Congress on April 3, 1963; the final installment should be transmitted within the next few weeks.

"The chapters of the Report here transmitted deal with the trading markets, the exchange markets and the over-the-counter market. As we stated in our first letter of transmittal, this Report should not impair public confidence in the securities markets, but should strengthen it as suggestions for raising standards are put into practice.

I.

"There is a wide diversity among the various markets. An exchange market is concentrated in a single place and has a limited group of professional participants, as well as a selected list of traded securities. The over-the-counter market, on the other hand, has no boundaries; it is everything outside the exchange markets. It is scattered throughout the country and represents in essence the sum of many markets. It is characterized by unlimited entry both from the viewpoint of securities traded and persons trading. It is vast, diffuse and heterogeneous. Indeed, there was no composite picture of the over-the-counter market today until this Study was completed.

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* This Release incorporates the Commission's transmittal letter and summarizes the Special Study's transmittal letter as well as Chapter V. Summaries of Chapters VI, VII and VIII will be found in Release Nos. 29, 30 and 31, respectively. Copies of the four chapters will not be available for public distribution until they have been printed by the Government Printing Office (a further announcement will be made when they become available). Printed copies of the first four chapters of the Report are now available for purchase from the Superintendent of Documents, Government Printing Office, Washington, D. C., as Part 1 of House Document No. 95 ($2.25 per copy), and Chapter IX as Part 3 ($.50).

"Because of these differences, the markets have received different regulatory treatment. The Report points out the more extensive, and intensive, degree of controls over trading practices in the principal exchange markets as compared with the over-the-counter market. Consequently, the problems and needs of the over-the-counter market appear greater. But in both markets there are serious inadequacies in investor protection. Certain of these shortcomings have been of continuing concern to the Commission, such as floor trading in the principal exchange markets. Others are presented in a new context, as in the case of the odd-lot dealers. In still other situations, the Special Study has amassed the technical data necessary for a thorough analysis, for example, of the specialist system or of the operation of the over-the-counter market. Finally, the Study affords a unified picture of the markets which previously have been viewed only in more or less isolated fashion. Thus, we are now in a position to appreciate the effect of the New York Stock Exchange commission rate schedule on the regional exchanges and the evolution of the 'third market.'

"The Study has properly focussed on problem areas. To these the Commission, the self-regulatory agencies and the financial community must respond with promptness and thoroughness. The importance of the capital markets to our economic progress does not permit otherwise.

II.

"As we said with respect to Part I of the Report, we have been exceedingly fortunate to have assembled such a superior group to conduct the Study. The Special Study was given freedom to analyze and point out problems as they appeared to it; in this respect, the judgments, analyses, and recommendations in the Report are those of the Special Study and not the Commission.

"In connection with this installment, we highlight three further points. In the first place, we emphasize that the recommendations in this part of the Report, with the important exception of controls over operators of quotations bureaus, can be effected, without amending the securities acts, through the medium of the rule making authority of the Commission or of the self-regulatory agencies. Moreover, as the Congress is aware, the Commission has made legislative recommendations which have been embodied in S. 1642, H.R. 6789, and H.R. 6793. These recommendations are substantially based upon and supported by the first installment of the Report of the Special Study. The Subcommittee on Securities of the Committee on Banking and Currency, United States Senate, has reported out S. 1642, as amended. It is the Commission's opinion that these bills represent essential amendments to the securities laws and that their enactment will significantly improve investor protection. Improvement will be achieved not only through more reliable disclosure as to companies traded in the over-the-counter market, but in the market itself, through raising qualification standards for those dealing in over-the-counter securities. We further point out that, although our legislative program is a part of a general effort to raise standards in the securities markets, the program stands by itself; thus consideration of the bills can appropriately proceed independently of the discussion and resolution of the questions raised in the chapters here transmitted.

"Secondly, as we have indicated, this section of the Report contains recommendations designed to be carried out by the Commission under its rule making power or by the self-regulatory agencies. It is inappropriate, therefore, for us to speak definitively on various of the questions presented, which involve substantive changes in our rules or the rules of the self-regulatory agencies. In most cases, we cannot legally take final action until interested persons are afforded an opportunity to present their views. In other instances, a hearing and the making of a record may be necessary. In any event, we believe the responsible course of action calls for discussions with the securities industry before any final decisions are made.

"Finally, as the Study itself has so carefully pointed out, these problems are subtle and complex; many are just emerging; and many call for further study. Some subjects, such as automation, are long-range in nature, far-reaching in impact, and require a continuing and more elaborate analysis of a development only in its infancy in the securities industry. Many other recommendations are of a similar nature. For example, any conclusions about certain of the recommendations concerning the over-the-counter market must await further exploration and consultation with the industry. Similarly, any proposals regarding the structure of the New York Stock Exchange commission rate schedule must be premised upon a thorough understanding of the impact any change in that structure would have on other sectors of the securities markets, such as the regional exchanges.

"These considerations, of course, do not preclude our endorsement of the general soundness of the Report as a point of departure for discussion with the industry and for rule making. They do serve as a background to a more detailed response by us to the recommendations. We recognize that the Congress expects such a response, as evidenced by a letter dated April 5, 1963 from the Honorable Oren Harris, Chairman, Committee on Interstate and Foreign Commerce, House of Representatives, requesting our views as to the specific recommendations contained in the first part of the Report. We expect to send a letter within the next few days detailing our views on the specific recommendations in the second installment.

III.

"At the present time the Commission's efforts are heavily committed to our legislative program which is under consideration by the Congress and to the completion of the Report of the Special Study. Upon completion of these efforts, we shall concentrate upon those areas calling for exercise of our rule making authority or that of the self-regulatory agencies. In the meantime, the staff of the Commission is preparing proposals for presentation to the Commission and to the industry. A special Office of Program Planning has been established whose initial task will be to coordinate and assist the operating divisions and offices of the Commission in this large and very important task of carrying out recommendations of the Special Study."

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In its transmittal letter, the Special Study observes that "the total picture emerging from our studies is one of basically strong institutions subject to many specific weaknesses and abuses. The balance is, of course, different for different market institutions. In particular, the over-the-counter markets have received less systematic and thorough attention than exchange markets under existing regulatory measures and mechanisms and the need and opportunities for improvements are correspondingly greater, even allowing for inherent differences in the nature of the two types of markets.

"The faults and defects disclosed in the Study do not call for public alarm as to the basic integrity of the securities markets but neither do they permit of complaceny. The weaknesses that have been found in trading practices and regulatory controls are of various kinds and perhaps varying degrees of seriousness, but in the opinion of the Special Study all of them call for attention and action--if not following the specific recommendations of the Report on each matter, then seeking an alternative way of meeting the disclosed need--if our market institutions are to achieve and maintain a quality commensurate with their importance to the American economy and the American public."

CHAPTER V. Trading Markets.--Introduction

Chapter V introduces the three succeeding chapters on the exchange markets, the over-the-counter markets and the interrelationships of securities markets, with brief discussions of basic components, concepts and standards applicable to trading markets and basic differences and similarities between types of markets.

The Report distinguishes between the broker-dealer community of "professional" participants on the one hand, and "public" participants on the other, drawing attention to the widely varying characteristics and activities of persons and firms within each group. It points out that the number of individual public participants has almost trebled in the past decade but that the proportion of the total volume of shares traded by individuals appears to be declining, while the proportion accounted for by institutions appears to be increasing.

The Report refers to the two basic categories of trading markets--exchange markets and over-the-counter markets--and observes that the two are fundamentally similar in purpose and functions but substantially dissimilar in mechanics and practices. After outlining a series of basic differences and similarities between the two types of trading markets, the Report notes that these markets have shown a capacity to change, grow and adapt to the needs of their times and that the process of change and adaptation has not ended, citing the increasing volume of over-the-counter trading in securities listed on exchanges and recent improvements in communications and data processing which herald further changes in the mechanics of doing business and the allocation of business among the trading markets. The Report observes that there are strong indications that the full potential of these developments has not yet been realized.

Chapter V also examines various statutory and non-statutory criteria of a "good" trading market, such as "fair," "honest," "free," "efficient," "orderly," "continuous," "liquid (or fluid)," noting that these terms must be interpreted and applied in light of Congressional emphasis on the "public interest" and the "protection of investors" and that they at best supply guidelines within which there are large areas for definition of policy on concrete problems. The chapter also provides an introductory discussion on "depth" in relation to continuity and liquidity of a market.

As a reminder that no rule or practice is immutable, inevitable or universal, Chapter V concludes with a brief description of some of the distinguishing characteristics of foreign securities markets, particularly the London Stock Exchange, pointing out that the London Stock Exchange requires members to reapply for membership annually and to elect whether to function as a broker or "jobber" (dealer), prohibits members from advertising in newspapers, and does not require disclosure of actual prices at which trades take place or of volume figures on transactions executed. This description is qualified by the statement that reference to variations of rules and practices in other markets by no means suggests a preference for any of them but merely suggests that a broad study and investigation of the adequacy of existing rules and practices should not be blind to other possibilities.

CHAPTER VI

EXCHANGE MARKETS

In Chapter VI, the Special Study of Securities Markets presents the results of its study and investigation of the exchange markets. The chapter deals primarily with the exchanges as trading markets and the roles of the exchange members most directly involved in the trading mechanisms; consideration of the stock exchanges as self-regulatory agencies is left to Chapter XII. The chapter focuses on the New York Stock Exchange in view of its dominance as the nation's leading securities market. The American Stock Exchange has been the subject of a separate Special Study Report; special problems of the regional exchanges are dealt with in Chapter VIII.

Although the chapter points to a considerable number of specific areas where changes from existing practices are recommended, no legislative proposals are made. The Report notes that the existing powers of the Commission, granted by the Securities Exchange Act of 1934, appear sufficiently broad to provide added controls or other remedies where the need is indicated.

The first three parts of the chapter include material relating to the diverse characteristics of securities traded on the NYSE, differences among its member commission firms, the mechanics of auction markets, and statistics on members trading as principal. The Report points out that although the NYSE has relatively high listing standards, the securities bought and sold on the Exchange differ considerably with respect to many significant features. Among the 1,145 common stocks traded on the Exchange at the end of 1961, the top 15 percent of stocks accounted for over 50 percent of the common stock volume. Although there was a median level of annual activity of 465,000 shares, 9 percent of common stocks traded less than 100,000 while another 9 percent had an annual volume of over 2 million shares. Differences were also notable with respect to number of shareholders, number of shares outstanding, total assets and total market value. The impact of these diverse characteristics in issues traded is pointed out by the Report. Thus, specialist participation may vary depending on trading activity; different kinds of stocks attract different traders and investors, etc.

In its analysis of the activities of some 370 NYSE commission firms for the year 1960 the Report notes that 43 percent of total income went to the top 5 percent of firms, while 9 percent was accounted for by the lower 50 percent of reporting firms. It found the greatest concentration occurred in income sources connected with the exchange--interest on customers' accounts and NYSE commissions--and the least concentration in over-the-counter income. While about 40 percent of total income of all reporting firms combined came from NYSE commissions and 13 percent from interest on customers' debit balances, the composition of income differed among firms--the larger the firm the higher the proportion of income derived from NYSE commissions and interest on customers' accounts and the lower the proportion from over-the-counter activities.

In studying the growth of reporting firms' income between 1954 and 1960 the Study found a general tendency for firms with the smallest income from each source to show the greatest growth rates for the same source. This was not true of NYSE commission income, however, in which there was a tendency for the largest firms to show relatively greater growth rates.

In its discussion of the mechanics of the exchange markets, the Report describes the methods by which the continuous auction operates; technical rules governing priorities by which orders are executed; mechanics by which orders are transmitted to the market place; and dissemination of market data to the public. It further identifies the classes of exchange members involved in the trading process. In the discussion of members, the Report notes that the NYSE and AMEX have recently initiated examination requirements for prospective exchange members who wish to perform specific functions.

The Report points out that the trading of exchange members falls into various patterns, and that trading by exchange members dealing for their own account represents a significant portion of all trading on the NYSE. It notes that while odd-lot dealers and specialists trade on the floor in connection with various auction market functions performed by them, floor traders trade primarily for quick in-and-out profits. Members who trade from off the floor are the least homogeneous group and their trading represents a broader mixture of personal investment, speculation, arbitrage transactions, etc.

In 1961, NYSE volume (shares sold) was about 1 billion shares; in that year members bought or sold about 500 million shares (viewed in terms of shares bought and sold, exchange members accounted for about 25 percent of all purchases and sales). In terms of the trading of each member class studied in 1961, specialist purchases and sales were equivalent to about 29 percent of NYSE volume, members off-floor 10 percent, odd-lot dealers 6 percent and floor traders 4 percent. The Report contains further breakdowns and refinements of these data showing the concentration of trading of each member class by the number of stocks in which they trade, by stock price, activity and price range.

The Report points out that in many instances this member participation in the market, especially by specialists and odd-lot dealers, improves the quality and usefulness of the exchange markets. However, the Report also cautions that potential conflicts of interest between members and non-members, and the possible impact of member trading on market activity, raise fundamental problems of Exchange regulation, and also that because member trading accounts for a substantial percentage of total Exchange trading, and because it is engaged in by individuals responsible for operating a public securities market, it necessarily poses many basic problems in the areas of exchange regulation and self-regulation. These problems are treated in detail elsewhere in Chapter VI.

Specialists

On the basis of its examination of the specialist system, focussing primarily on the NYSE, the Special Study states that the system "appears to be an essential mechanism for maintaining continuous auction markets and, in broad terms, appears to be serving its purposes satisfactorily," and that while it uncovered no widespread abuses or patterns of illegality, "serious problems have been found concerning the system and its surveillance and regulation by the Exchange." The Report calls for the adoption of rules by the Commission and the Exchange designed to restrict a specialist's trading for his own account, to increase capital requirements, to ameliorate conflict of interest situations, to facilitate the handling of block transactions, and to lessen the ability of specialists to control prices unilaterally.

There are about 350 NYSE members who are registered as specialists, organized into 110 firms or units. The specialist performs two basic functions with respect to his specialty stocks: As a broker, he executes orders forwarded to him by other exchange members, which are noted in his specialist "book" and for which he receives a part of the total commission paid by customers for the execution of their orders; as a dealer, he buys and sells for his own account for the purpose of providing reasonable price continuity from transaction to transaction by evening out temporary disparities between public supply and demand.

Specialists are involved as brokers or dealers in about half the transactions which take place on the NYSE. In 1961, as principals, they bought or sold 312,190,000 shares or about $12.7 billion worth of securities (29 percent of volume) and, as brokers, they executed almost one-third of all round-lot orders executed on the Exchange. The Report notes that "no other class of exchange member is so intimately connected with the trading process and in so crucial a position to affect trading as to prices and as to manner and speed of execution."

The Report states that three fundamentals are at the core of the problems of the specialist system: The first is that in the last 25 years the specialist's dealer function has become at least as important as the brokerage function; the second is that "the conflicts of interest inherent in any simultaneous combination of broker and dealer functions" have been intensified by the expansion of the dealer function and by certain extensions of the brokerage function beyond that of handling routine market orders and limited price orders; and, third, wide variations in financial and other capacity, and in performance, among the 110 different NYSE specialist units, result in considerable divergency in the nature and quality of markets for individual securities which indicates that the regulatory framework permits too wide a tolerance from acceptable norms.

In describing the specialist's brokerage function, the Report observes that the accumulation of a large number of limited orders on his book affords to the specialist exclusively a powerful tool giving him insight into the possible course of the market. A limited price order is one which the broker is instructed to execute at a price no less favorable than that designated by the customer. Noting existence of ambiguities concerning the kinds of orders specialists are permitted to accept, the Report recommends that all such orders be more precisely defined.

The growth of the specialist dealer function is shown by data analyzed in the study: specialists' participation as buyers or sellers in NYSE round-lot volume has increased from a range of 15 to 20 percent in the period of 1937 to 1953 to over 29 percent in the years 1959, 1960, and 1961. Furthermore, of gross specialist income of $40,827,000 (in 1959) and $34,688,000 (in 1960), dealer profits provided 52 percent in the first year and 45 percent in the second.

The Study concludes that the basic dealer function of specialists, that of providing price continuity, is a useful one. The Report states: "A market which moves in small fractions probably tends to discourage undue speculative activity" and that "a responsible dealer system can prevent sudden changes in prices caused not by changes in intrinsic worth or general market conditions but by vagaries of supply and demand at a particular moment." However, the Study also found that since the profit potential for specialists was greatest in the most active stocks, there was some tendency for specialists to neglect the inactive issues which are most in need of responsible dealer participation even though risks are greater and profit potentials are more limited. While the Exchange has a policy of assigning certain issues to well-capitalized specialist units, there is no attempt to give each unit a "balanced portfolio" so that a more or less assured dealer profit and brokerage income in stable issues can be available for volatile stocks and inactive issues.

The Special Study's examination of the various specialist units discloses that NYSE specialist units show great diversity in size, number of speciality stocks, source of income, capital and rate of return: Larger units tend to have more than their proportionate share of capital, indicating a greater ability to service the market adequately. Specialists' market participation seems to be keyed to their capital ability rather than to any uniformly interpreted standard of responsibility. Some other indicators of the diversity between specialist firms include: the volume participation rates of the various specialist firms as principal in their specialty stocks ranging from 11 percent to 51 percent; some firms earning in 1959 and 1960 substantially all of their income from the brokerage function, with others earning as much as 80 percent of the total from dealer profits; with respect to positions carried by each firm, during a test period a range was found varying from the highest unit which carried positions totaling 8 times daily average volume to the lowest unit having positions only about one-eighth of the daily average volume. Other indicators such as size of unit, capital and profitability showed similar wide divergencies.

The Report notes that in view of the increasing importance of the dealer function, the great diversity in capital resources and trading predilections of the various specialist units is making "the gulf [between various specialist units] so wide as to threaten the image of the Exchange as a market place whose specialist system assures strength in all markets." In view of the fact that the Exchange's minimum capital requirement, which has been unchanged for many years, requires each unit to have only that capital necessary to assume positions of 400 shares in each of its specialty stocks, the Study recommends that the minimum be at least tripled.

With respect to problems of the dealer function generally, the Report concludes that a more effective surveillance and regulatory pattern is needed: "The virtual disappearance of competing specialists makes it particularly important that there be uniform standards as well as close supervision. . . ." However, the Report also notes that for several reasons competition does not seem to function effectively in the specialist system, and thus does not provide the key to adequate performance by all specialists. The present thrust of the NYSE's surveillance of the dealer function is criticized as having been generally "marked by indiscriminate encouragement of a high level of participation, failure to take action with respect to inadequate participation, and an apparent desire to project the image of the specialist as a market 'stabilizer'."

With respect to the specialist's role in market stabilization, the Special Study found, on the basis of the analysis of about 100,000 separate specialist transactions, that for one test period in a normal market, most specialist trading appeared to have some stabilizing effect, but that in a significant group of stocks such trading tended to be destabilizing in nature. In view of the significant quantity of such destabilizing trading, the Report concludes that such activity " . . points to the need for developing methods of measuring specialist performance on a more valid and current basis" than those now used by the Exchange. In its analysis of specialist trading during the 1962 market break, the Report concluded that: "Specialists as a group did not have a significant stabilizing effect on the market." However, the Report also noted that "ordinarily the capacity of specialists to provide price stability is a distinctly limited one. No system of dealer trading can be expected to stabilize--in the sense of preventing price changes--in a market subjected to heavy public buying or selling."

The Study found that the stabilizing role of specialists has been publicly presented by the NYSE in a confusing and conflicting manner. The Report states: "As a public relations matter the Exchange has sought to project the image of the specialist as a stabilizer, but the problems in this area are too deep for any confusion to exist in the public mind . . . " between the specialist's basic function of maintaining price continuity and market stabilization. The Study found that some of the difficulties in this area were caused by the Exchange's use of an inadequate test of stabilization. The Exchange test is based on analyzing particular transactions in relation to the immediately preceding transaction--a measure which ignores significant market trends taking place over a longer period of time. The difference in price between two transactions may be caused not by changes in investor evaluation of the intrinsic worth of a security but merely by the random sequence in which buy and sell orders arrive in the market place.

Data analyzed in the Report regarding specialist activities in the period surrounding the 1962 break showed that as of December 29, 1961 specialists had an aggregate inventory of about 3,600,000 shares which they steadily reduced to a low of 1,850,000 shares on May 16, 1962. From this point until the close of business on Friday, May 25, 1962, specialist inventory increased to 2,400,000 shares. During the period from the end of December 1961 through May 25, the Dow-Jones Industrial Average declined from 731.14 to 611.88, a drop of almost 120 points or 16 percent. On May 28, 1962, the day of greatest decline, on which the Dow-Jones Industrial Average fell an additional 34.95 points, specialists bought and sold 3,093,220 shares and had a net purchase balance of 206,400 shares or 6.7 percent of their total purchases and sales. This percentage was not significantly different from specialist activity during normal periods and, as the Report points out, contrasts sharply with specialist activities on the first day after President Eisenhower's heart attack in 1955, when the trading of specialists as a group resulted in an unusually high purchase balance (595,550 shares) which "probably had a discernable market impact /but/ the same cannot be said of May 28, 1962." The Report speculates that the 1955 break was probably felt to be a temporary interruption in a strong bull market, a view which may have accounted for differing specialist activity in the two periods.

The Report also analyzed data concerning specialist trading in selected individual stocks during the break. It was found "on the basis of the available data that the dealer performance of the specialists in Avco, Brunswick, General Motors, and Standard Oil of New Jersey tended, if anything, to add reasonable depth to the market and to have a cushioning effect during the decline on May 28. On the other hand, the trading of specialists in Telephone, IBM and Korvette tended to be passive at best and possibly destabilizing in nature." In concluding the discussion of the breaks the Report again emphasized that while no one person has the capital to stem a selling wave such as that of May 28, the specialist, with his central market location, is in a position to "cushion the public's selling by giving depth to the markets, and some specialists undertook this function." On the other hand, other specialists "confined their activity to providing technical price continuity and a few specialists seemed to contribute to the 'pounding' down of prices by their selling."

The liquidation of specialists' positions because of financial difficulties was another problem which manifested itself during the period of the break when a few specialist units experienced some financial problems. The Report states that "it is not clear whether the Exchange was aware of the financial difficulties of these specialist units, but in any event no corrective action was taken." It is concluded that it is imperative that the Exchange keep informed on specialists' financial condition on a current basis and that stocks should be reallocated when specialists are unable to perform their dealer activities because of financial problems. It is also recommended that Exchange firms which finance specialist units not be permitted to take any action which might have harmful market consequences against a specialist unit in financial difficulties without adequate prior notice to the Exchange.

"Daylight trading," a term used to describe the tendency to end each day with as small a long or short position as possible, is another problem which has not been subjected to adequate surveillance according to data analyzed by the Study. In order to avoid risk and capital commitment, a specialist engaged in daylight trading seeks to assume only positions which can be liquidated by the end of the day. At the same time there are transactions by the specialist purely to liquidate his position not justified by market necessity. The Report states that such trading "is the antithesis of responsible dealer activity." It is concluded that the Exchange's "failure to investigate for daylight trading has undoubtedly encouraged such activity" and that "the surveillance policies of the Exchange should be extended to this area."

A problem of increasing importance to the Exchange, in part connected to the degree of risk specialists are willing and able to assume, notes the Report, is the handling of block transactions. Increasing institutional participation places additional demands on the specialist system because the tendency of institutional investors to deal in large blocks tends to increase temporary disparities between supply and demand. The Study found that specialists vary considerably in their willingness and ability to buy and sell substantial blocks. The Study found that when blocks are handled through the auction market they are generally bought or sold at fair prices but often a realistic discount is still insufficient to make block dealing attractive to specialists. Recommendations made by the Study, designed to improve the ability of the Exchange auction market to handle blocks, include a substantial increase in specialist minimum capital requirements, and exploration of the possibility of the establishment of a capital fund administered by the Exchange from which specialists could borrow and/or which could partially insure specialists against loss when dealing in large blocks.

In discussing the role of the dealer function in the handling of routine transactions as well as blocks, the Report concludes that the goal of specialists' trading should be to give the market in each stock "continuity with depth," i.e., reasonable volume at each significant price level. Closely related to this concept are other findings and recommendations. The Study concludes that the quotations in each stock should be reasonable in relation to the last sale, and that the practice of some specialists of providing nominal quotations in certain inactive stocks should be forbidden.

The Report states that: "Markets without depth detract from the worth of quotations and previous sales as an indication of value." It is recognized that by "providing depth in both good markets and bad the specialist is more likely . . . to increase his risk." However, as the Report also points out: "A responsibility to provide continuity with depth is the reasonable concomitant to the many privileges specialists enjoy." Many of the privileges referred to are discussed throughout the Report; some of these are: exclusive access to the "book"; enjoyment of the dealer advantage of buying from the public at the bid and selling at the offer, which enables the specialist to realize a "jobber's turn" (i.e., a middleman's profit); the ability to take positions in anticipation of market movements, which increases profit potential; the ability to "trade with the book" (buy and sell to customers whose brokerage orders are on the book) in order to offset his own positions; and finally, the substantial, and almost riskless, brokerage income derived from executing orders on the book. With respect to the latter point, the Report observes that "if the conflict of interest between the two functions /broker and dealer/ is to be tolerated the duty to the customer must include the obligation to maintain markets which are fair and reasonable..."

One area of dealer activity with the Report concludes is not consistent with the market making function is the practice of specialists' establishing long-term investment accounts in their speciality stocks to qualify for long-term capital gains treatment. The dimensions of the problem are indicated by the fact that on one sample day, June 16, 1961, of total specialist inventory of 3,229,556 shares, 890,733 shares were segregated into long-term accounts. The Report concludes that such accounts are incompatible with the specialist's market making responsibilities "because neither the acquisition of stock for investment nor the withholding of stock for investment reasons comports with the criteria for specialists' dealing as principal." The Report points out that long-term accounts give the specialist an investor's viewpoint and a motive to support the market instead of performing his function of providing continuity and depth to the market. Furthermore, such accounts detract from specialists' available capital and enable them to utilize an exemption from margin rules not available to other investors.

In considering all of the functions of the specialist, the activity of the issues traded on the NYSE and the technical nature of the exchange markets, the Study concludes that the "continuous auction" market is much more a dealer's market (in distinction to a market which merely matches bids and offers) than is generally realized. The Report states that except in the more active stocks, ". . . the specialist is in a position to, and does actually, 'administer' the market and affirmatively influences price levels and trends - that the specialist . . . may often be the market rather than a mechanism for linking buyers and sellers together."

This is made possible by the fact that not only does the specialist deal for his own account but as a broker he sometimes holds orders on both sides of the market capable of immediate execution, he has control of many customer orders, and, until recently, accepted so-called "not-held" or discretionary orders. Despite a 1952 Commission interpretation preventing specialists from executing "not-held" orders, many NYSE specialists continued to do so until a further Commission ruling in 1961. Where a specialist accepts a discretionary order, the Report states, "the degree of brokerage judgment which he is permitted to exercise may bring his obligations to his several customers into conflict." The Report recommends that the ban on such orders be continued.

An area where the specialist's ability to influence prices is particularly great is in arranging openings. Most orders at openings are given to specialists and they set the opening prices. The Exchange's main reliance in controlling specialists' activities in arranging openings is on certain technical rules limiting the amount of price movements without the approval of a governor. Pointing out that the opening price is "probably the most important price of the day," the Special Study urges that "here above all, the principle of a free and open market, with prices set by public supply and demand, should govern." To this end, the Special Study concludes that the specialist should not interfere in openings, except to maintain price continuity.

Other recommended changes in current practices are also in the direction of preserving the arms'-length quality of transactions--one of the prime indicia of a free market. Rules with respect to trading after the opening are urged for the purpose of limiting the ability of specialists to "reach" across the market (buying at the offer or selling at the bid). There should be public weekly reports of all specialists' purchases and sales as principal in each issue to give interested investors an indication of the degree of activity, exclusive of specialist participation, in particular issues. Specialist firms should not be permitted to have their own public customers since transactions for a specialist firm's own customers do not assist the specialist in the discharge of market making responsibilities ". . . and are fraught with possibilities of abuse." The Report also recommends that the Exchange abandon its so-called specialist corporate liaison program, under which specialists are required to meet and consult with corporate officials, on the grounds that it is unrealistic to encourage such contacts while having a policy designed to prevent the disclosure of inside corporate information. In addition, certain recommendations are made requiring a customer's broker who forwards an order to a specialist to take a more affirmative role in assuring that his customer receives a fair price.

The Study also examined another area of potential conflict of interest which involves so-called "stops." "Stops" are guarantees by the specialist that one investor's order will be executed at a specific price, often at the expense of another customer. The Special Study found that most stopped orders are, in fact, guaranteed by orders on the specialist's book sometimes in derogation of his brokerage obligation to customers whose orders are on the book. The Report recommends that specialists be prohibited by exchange rules from granting such guarantees to one customer at any price at which the specialist holds another customer's unexecuted order capable of execution, and that every stopped transaction taking place on the floor be reported on the tape (they may now be omitted).

The Report observes that no hard and fast rules can be developed to eliminate these problems entirely since it is precisely by competing with his own customers--by outbidding or underoffering them--that the specialist is able to contribute to price continuity. The Report notes that in recent months the NYSE's regulatory and surveillance program has improved in that at least one examiner has been assigned to work which may involve reconstructing specialist books. Despite this recent innovation and the fact that NYSE's surveillance procedures are in the hands of a "capable and sophisticated administration," the Report concludes that: "In the area of the conflicts of interest which arise from the specialist's unique role as both broker and market maker the Exchange's regulatory and surveillance program has been inadequate." The Report states that ideally there should be a "regular method by which the sequence of transactions, the specialist's book, and his own transactions in any stock could be quickly and conviently reproduced. Modern data processing equipment would very likely premit this to be done, but the NYSE has shown little inclination to move in this direction." The Report concludes that since there must be a large measure of judgment and discretion involved in the application of standards governing specialists "the administrators of the regulatory system--primarily the exchanges themselves--must exercise vigilance and discrimination in evaluating performance in particular situations," and that a "mechanical application" of any test used in surveillance does not "discharge the duty of surveillance which ultimately is the protection of individual investors in specific transactions."

Odd-Lot Dealers

The Special Study also analyzed the system by which "odd-lot" transactions are effected on the NYSE. Trading in the regular auction market on the floor of the Exchange is generally conducted in round-lots of 100 shares, and orders to buy or sell in any amount less than round-lots are called "odd-lots." The total odd-lot volume on the Exchange during 1961 exceeded 214 million shares or 9.1 percent of the total share volume. About 99 percent of all odd-lot transactions on the Exchange are handled by two firms, Carlisle & Jacquelin and DeCoppet & Doremus, through about 100 associate brokers working on the floor of the Exchange. The associate brokers and partners of the two odd-lot firms account for about 10 percent of the NYSE membership while the two largest commission firms doing business with the public have only about 1.5 percent.

The odd-lot dealers derive their compensation from a per share "odd-lot differential" which the public customer pays in addition to a brokerage commission. The differential amounts to one-eighth point for stocks selling below $40 per share and one-quarter point for stocks selling at $40 and above. An odd-lot transaction is handled by an associate broker on the basis of the next round-lot order executed on the Exchange which is said to "trigger" the odd-lot execution, a function which the Report says is essentially mechanical. The odd-lot dealer, who transacts his business exclusively with other brokerage firms, fills odd-lot orders by buying and selling round-lots for his own account as principal.

Competition between the odd-lot houses is, according to the Special Study, limited to various services offered to other exchange members. These services are only indirectly and partially for the benefit of public odd-lot customers who bear their cost. The Report observes that price competition has not existed between the two odd-lot firms for decades and that a uniform price policy adopted by the Exchange in 1938 effectively discouraged limited price competition from other member firms for odd-lot business.

The Report examines in some detail the circumstances surrounding a 1951 increase in odd-lot differentials. It concludes that the two firms decided between themselves, and then in consultation with certain regional exchanges, what the new differentials should be. Neither the NYSE nor the Commission treated the 1951 increase as within their regulatory responsibility.

According to the Report, the Exchange has clear statutory authority to regulate the differential, and in view of the domination of this large and important public business by two firms it would seem a classic case for rate regulation. The Special Study characterizes as unrealistic the Exchange's position--that the differential for odd-lots is purely a matter for negotiation between odd-lot dealers and other members. Negotiations between odd-lot dealers and other members do not assure that the public investor's interests will be represented because the commission houses must choose between better prices for their customers and better services for themselves. The Report states that the Exchange should recognize and meet its responsibility to regulate the odd-lot differentials and also urges the Commission, whose regulation of odd-lot transactions in the past has been at a minimum, to undertake a more affirmative role of oversight.

The Report points out that odd-lot automation is also a matter of public concern. It notes that past proposals for automating the execution of odd-lot orders on the floor of the Exchange offered prospects of substantial savings. In reviewing a study of the odd-lot system made in 1956 at the request of the Exchange by Ebasco Services, Inc., an engineering consulting firm, the Special Study notes that the two odd-lot firms regarded the possibility of automation as a grave threat. In the view of the Special Study, it is difficult to escape the conclusion that consideration of the Ebasco proposals on their merits was warded off by emphasizing the potential impact on seat values for all members and otherwise beclouding the real issues of economy and efficiency.

The Report concludes that the acceptance of the contentions of the odd-lot firms by the Exchange was regrettable, as was the failure of the commission houses to voice the interests of public odd-lot customers, whose business both the Exchange and the firms actively solicit. It calls upon the Exchange to advise the Commission as to, among several related matters, the feasibility of automating the execution of odd-lot orders and as to the possible effects of automation on floor operations, costs and odd-lot differentials.

The Special Study also observes that the handling by floor brokers of offsetting round-lot transactions involves possibilities of special advantage that would seem to call for surveillance if not affirmative regulation by the Exchange. Although such transactions have some of the elements of floor trading, Exchange rules on floor trading do not apply. Like the floor trader, the odd-lot broker's round-lot trading has the advantage of continuous, intimate and immediate contact with the stocks in which he is interested and with the specialist in such stocks; and the odd-lot broker has wide discretion as to whether, when, and how much to offset, within position limits established by his odd-lot firm. The Exchange does not exercise direct supervision over the floor activities of odd-lot brokers, nor has it provided rules with respect to odd-lot brokers' round-lot transactions which may affect odd-lot prices. The Report concludes that, in this area also, the Exchange should discharge its regulatory responsibility by promptly adopting rules governing (i) the odd-lot and offsetting round-lot transactions of the odd-lot brokers, including the triggering effect of round-lot transactions and (ii) systematic reporting and surveillance procedures concerning offsetting transactions. Apart from the recommendations relating to odd-lot business on the NYSE, the Report suggests additional study of the odd-lot business as conducted on the AMEX and regional exchanges.

Floor Traders

The Report also reflects the Special Study's analysis of the nature and characteristics of floor trading--the activity of a member in trading for his own account on the floor of the NYSE except as a specialist or odd-lot dealer.

Although the number of members effecting floor trades on the Exchange exceeds 300 per year, according to the Report, the 15 most active floor traders each week account for roughly half of all floor trading volume, and only some 48 members or member firms are engaged primarily in floor trading. Total floor trader purchases and sales, it is noted, amounted to 44.7 million shares in 1961, or 2.1 percent of total Exchange purchases and sales. Floor trader participation in given stocks over given periods frequently is much higher than 2 percent, however; data for three one-week periods studied show that between 35.8 and 51.5 percent of all floor trading in each week was concentrated in less than 38 issues and that in each of these issues floor traders accounted for more than 7.5 percent of all purchases and sales. The Report also notes a very high concentration of floor trading in active stocks; in each of the three weeks studied between 40 and 50 percent of all floor trading took place in the 25 most active stocks on the Exchange.

The Report notes that floor traders are the only members who enjoy access to the floor without any accompanying market responsibilities. This privilege, acquired through purchase of a seat, is described as providing substantial trading advantages, including the opportunity to observe and react to trading activity before it is reflected on the tape, a "feel of the market" which can come only from actual presence on the floor, and appreciably lower commission costs than for off-floor trading, whether by members or the public. Noting that recent Commission cases and NYSE disciplinary proceedings have emphasized the unfairness of permitting those in possession of non-public information to trade on the basis of such information, the Report points out that although the advantages enjoyed by floor traders may differ, the basic regulatory principle--denial of special advantage--should apply. Accordingly, only some strong, demonstrable countervailing public benefit can justify the special advantages enjoyed by the floor trader.

The Report observes that proponents of floor trading claim that it serves as a stabilizing influence on prices and provides the market with added liquidity and continuity. As to stabilizing, the Report notes that past studies on at least 15 different occasions since 1934, and a variety of statistical studies made by the Special Study itself, have shown that floor traders are generally buyers in rising markets and sellers in declining markets, with respect to both the market as a whole and to individual stocks. Their trading, as a result, is inimical to the orderly functioning of the market, tending to accentuate rather than to stabilize price movements.

With regard to the asserted benefit of added liquidity the Report states that floor trading, as does any kind of trading, adds liquidity to the market, but that inasmuch as the same may be said of transactions effected in error, pool operations, wash sales, or other transactions generally acknowledged to be undesirable elements of a sound market, added liquidity standing alone cannot justify trading that in other respects is deleterious. In assessing the contributions of floor trading to liquidity, the Report points out that floor trading is heavily concentrated in the active stocks where added liquidity is needed least. With respect to the argument that market price continuity is enchanced by floor trading, the Report observes that because floor traders concentrate their trading in the active stocks, the continuity they add is limited for the most part to the stocks that suffer least from lack of continuity. Such continuity, moreover, is obtained at the expense of permitting a type of floor activity that has an adverse impact on price stability. The Report notes that there are occasions on which floor trader participation in the market has a negative impact on price continuity. Due to the tendency of floor traders to trade with price trends, their participation in auction proceedings often adds to the imbalance of buyers and sellers and thereby encourages more rapid and sizable price changes. The Special Study finds that while floor traders may occasionally improve liquidity and add continuity, thus performing the functions of a specialist, at no time do they incur the specialist's obligations.

The Special Study finds that past attempts to retain or expand the benefits of floor trading and at the same time curtail its undesirable characteristics have been nominally successful at best. The Report cites a 1945 Commission proposal to abolish floor trading which was deferred upon assurances of the exchanges that effective self-regulation of this activity would be developed. Reviewing the frequent and often substantial changes in the major floor trading rule adopted by the NYSE in 1945, the Report describes the changes made in the rule or its interpretation on nine subsequent occasions, but concludes that despite the great variety and complexity of exchange rules experimented with to date, floor traders still retain their significant private trading advantages in a public market, continue to concentrate their activities in the more active stocks, and continue to accentuate price movements. It also points out that the public interest cannot ignore the administrative burden created by the elaborate rules and complicated enforcement mechanisms designed to restrict floor trading activities which are primarily of private benefit, rather than to assure adherence to obligations designed to benefit the market.

The Special Study recommends that, as a vestige of the former "private club" character of exchanges, floor trading should not be permitted to continue on the NYSE or AMEX. A termination date of January 2, 1964 is recommended for those members whose income from floor trading amounts to less than 25 percent of their total gross income from all activities in the securities business, and a final termination date of January 2, 1965 is recommended for all floor trading activities. Having noted in its discussion of the specialist system that the financial capacity of some specialists is in need of strengthening, the Special Study further recommends that the NYSE, AMEX and Commission study the feasibility and desirability of permitting present floor traders, or other members, to register as "auxiliary specialists" with permission to trade on the floor in any security providing all transactions of such auxiliary specialist are either undertaken at the unsolicited request of a specialist and in accordance with rules similar to those governing specialists, or are effected for the purpose of reversing in whole or in part a transaction so undertaken. Finally, the Report recommends that since floor trading on regional exchanges in dually listed stocks does not appear to influence price movements or involve special advantages, such floor trading should be the subject of separate consideration by the Commission.

Members Off-Floor Trading

In a section of the Report dealing with members' off-floor trading (transactions on the Exchange for members' own accounts which originate away from or "off" the floor), the Special Study observes that the purpose, nature, and significance of such trading remain concealed in the aggregate data reported by such members to the NYSE each week, and concludes that "the propriety of expanding the present reporting requirements of members trading from off the floor should be considered by the NYSE and the Commission." In this connection, the Report refers to the authority conferred on the Commission by the Securities Exchange Act to prevent such excess off-floor trading as the Commission may deem detrimental to the maintenance of a fair and orderly market.

On the basis of data presently filed, it is possible to determine only the total number of shares purchased and sold each day on the Exchange by members whose orders originate from off the floor. These data, it is noted, reveal that such transactions account for approximately 5 percent of total NYSE round-lot purchases and sales, and that members' exchange sales have exceeded their exchange purchases by a yearly average of about 3.5 million shares. The Report states, however, that these data do not indicate the extent to which this trading is attributable to investment, speculation, arbitrage, or other purposes; they do not indicate variations in member off-floor participation from stock to stock; and they do not show to what extent the shares sold on the Exchange in excess of those purchased are traceable to stock splits, new issues, arbitrage operations, or other sources.

Data obtained from a Special Study questionnaire for three one-week periods in 1961 indicate that member purchases or sales initiated from off the floor on occasion account for more than 50 percent of all Exchange purchases or sales in a given stock over a given day or week. The questionnaire data also indicate that member trading from off-floor tends to favor the more active stocks. Until more complete data are available, however, the Special Study finds that no conclusions as to the significance of such trading may be reached.

Short Selling

Another subject reported on by the Special Study was that involving "short selling," the practice of selling stock which the seller does not own or which he owns but delivers by borrowing stock. At some later date the short seller buys in the market to cover his short sale, realizing a profit if the price is lower. Speculation in anticipation of a price decline is but one of the many motivations for short selling, according to the Study. Other, nonspeculative types are the so-called technical short sales, e.g., by arbitragers, specialists and odd-lot dealers, and the hedging short sale for tax purposes.

Concentrating primarily on short selling of all types on the NYSE, the Study analyzes short selling over an eight year period and finds a tendency for the ratio of short sales to total sales to increase as a market decline progresses, for members as well as nonmembers. The Report observes that this calls into question the classic argument that short selling has a stabilizing influence during market declines. Although the volume of short selling by exchange members generally far exceeds that of nonmembers, the increase in times of price decline is usually attributable to nonmembers. The Study shows that during the April through June 1962 decline non-members increased their proportion of short selling and accounted for more than 50 percent of all short selling during the drastic decline in the final days of May.

In a study of the trading in eight selected market leaders on May 28, 1962, the Report found that over 10,000 shares were sold short in each of three of the stocks, and in two cases short sales constituted over 16 percent of total sales. The Report adds that much of the short selling in the eight stocks occurred when the stocks were under greatest pressure and, despite the general decline, there were many "ticks" on which additional short selling would have been permissible under present rules.

The Report observes that while the number of stocks with substantial short positions tends to increase as prices fall and decrease as prices advance, the large short positions tend to be concentrated in no more than 100 stocks including both the so-called "market leaders" and the "trading favorites." This concentration indicates that short selling has a more telling influence on the market than is indicated by the aggregate statistics. The Report finds that the substantial volume of short selling in prominent stocks during intervals of price weakness indicates an inadequacy of the current rules to cope with the harmful effect which they were designed to prevent. An important aspect of that inadequacy is the reliance placed upon a trade-to-trade "tick" test for determining whether a short sale is permissible. (Under current rules, a short sale can only be effected at a price above the last different price.)

The Report concludes that there is a need for a rule of broader perspective focusing upon the underlying trend, to provide an effective limitation on short selling in a security when its market is under extraordinary selling pressure, or when the market generally is under severe pressure. Accordingly, the Report recommends that present rules be amended to provide more effective control of short selling at such times.

The Report also finds that the data on short selling presently compiled by the New York and American Stock Exchanges are inadequate for regulation, particularly with respect to determining the degree of short selling in individual issues, the effect of such short selling on the price stability of a security, and compliance with the Commission's rules. Accordingly, the Study recommends improvements in the Exchange's reporting systems that will provide more frequent information on the volume of short sales in particular stocks classified as between the public and the principal classes of members. In addition, the Report recommends that the Commission should designate the information to be furnished to it on a regular basis, and should determine the extent and type of short selling data to be made available to the public.

Commission Rates

In examining the commission rate schedules of the exchanges, the Special Study was concerned with the structure of rate schedules and with the standards and procedures involved in the review of rates. It gave no consideration to the level of a particular commission rate or rate schedule. Thus, its analysis and recommendations are not in any sense to be construed as comment on the reasonableness or the level of rates. The Study first describes the rate schedule of the New York Stock Exchange, which sets the pattern for rates charged by the AMEX and the regional exchanges, and summarizes the Commission's power under section 19(b) of the Exchange Act to alter or supplement exchange rules relating to "the fixing of reasonable rates of commission."

The NYSE commission schedule (which historically has been set in terms of minimum prescribed charges), notes the Report, distinguishes between rates charged members and nonmembers, but the nonmember schedule makes no differentiation for different categories of nonmembers. The Study points out that a nonmember broker must pay the same commission rate, based on the dollar value of the round-lot of stock traded, as his public customer for transactions placed on the Exchange; all public customers, including large volume, block transaction investors, pay the same commission per round-lot regardless of the size of their order; and the rates include the cost of various ancillary services provided to customers. Among the consequences of these characteristics of the schedule, according to the Study, has been the establishment of a variety of ad hoc practices designed to temper the rigidity of the schedule without violating the letter of the NYSE's rule prohibiting members from granting commission rebates to nonmembers.

Under one set of arrangements, referred to as "reciprocal business" arrangements, exchange members who receive commission business from nonmember brokers direct business, in ratios favoring the NYSE member, to the nonmembers for transaction on regional exchanges or over-the-counter. The Study reports that of 447 members of the four largest regional exchanges not members of the NYSE, 298 reported participation in such arrangements, and that 175 of these attributed a minimum of 20 percent of their income to such arrangements.

The Study also describes the arrangements whereby Exchange members reward both nonmember brokers and large volume investors for commission business by furnishing such special services as installation and maintenance of wire services, special research, and promotional materials and displays. In addition, large volume and block transaction customers, chiefly mutual funds, are allowed to direct their brokers to give up a portion of the commission to other brokers in return for services rendered to the fund or, more usually, its underwriter or adviser. As in the case of reciprocal commission arrangements, the regional exchanges are used to channel such give-ups of commission to their members and, in some instances, to brokers who are not members of any exchange.

Summarizing the consequences of these practices, the Special Study states that what the rate schedule fails to do, the industry accomplishes informally, unevenly and largely covertly by means of these arrangements. It finds that these arrangements have complicated the administration of the commission schedule, have to some extent clouded cost data, and have created delicate conflict-of-interest questions. At the same time, their failure fully to meet underlying needs has spurred a diversion of trading volume from the NYSE to other markets.

The Study points out that the NYSE committees have in the past rejected the associate membership concept employed by the American Exchange and some of the regional exchanges. Associate members on the American Exchange are professionals who, although not full members, are permitted to execute orders through members at commission rates between the member and nonmember rate. The Report recommends that "the advantages and disadvantages of associate memberships and/or special nonmember commission rates, from the viewpoint of the NYSE and its members and of the public interest, should be a subject of joint Commission-Exchange study, particularly with reference to problems of competition, depth of markets and reciprocity."

The Study also reviews the history of Exchange action with respect to some form of volume discount in the commission rate schedule. It points out that a proposal for a change in the direction of a graduated rate was rejected by a close vote of Exchange membership in 1953. It also quotes statements from a number of institutional investors who urged modification of the public commission schedule in this regard. In view of the public importance of this subject, the Report concludes, the Commission itself should undertake a broad study of the matter with the aid of or in conjunction with the exchanges and other affected institutions and parties.

The Report also considers questions arising from the fact that the public commission rates include a charge for services performed by brokers in addition to the basic brokerage function. Such services include investment advice, safeguarding of securities, collection of dividends, and many other similar services. After stressing the lack of cost data necessary to evaluate the factors involved in this problem, the Study recommends that "with the aid or in conjunction with the Exchange and other interested parties the Commission should consider the feasibility and desirability of (1) a separate schedule of rates for the basic brokerage function and for ancillary services, or alternatively (2) a schedule of maximum rates, or minimum-maximum rates covering all services."

The public cost of an odd-lot transaction, the Study observes, represents the total of the commission paid to the customer's broker and the odd-lot differential realized by the odd-lot dealer. It recommends that customers' confirmations of odd-lot transactions should be required to show separately the odd-lot differential and the brokerage commission.

As already noted, the Study expressly avoids all discussion of the reasonableness of any particular rate level, but in this area concentrates on the standards and methods used in arriving at given rate levels. It stresses the unique character of the problem of setting and reviewing rates in the securities commission business stemming from (1) the multiplicity of firms, (2) an erratic and largely uncontrollable volume factor, and (3) competition with other markets and other media of investment; and states that reviewing the level of rates presents problems at least as complex as those of rate structure.

The Report points out that income, costs and profits of commission firms have been the basis for adjustments in commission rates. The Exchange has developed an income and expense report, which was revised in 1961 as a result of a cost study undertaken by the Exchange at the instance of the Commission two years earlier. Though describing the present form as a notable improvement over its predecessor, the Study concludes that its ultimate usefulness in the review of rates will depend on its being supplied by all firms rather than on a voluntary basis, and also on its adaptability in relation to criteria and standards that remain to be more clearly articulated.

The Report emphasizes the importance of the Commission's role of oversight in this area because of the nature of the problem of arriving at reasonable rates and the manner in which the rates are initially set by exchange rule, and recommends improvements in three separate respects: the gathering of more complete data on a continuous basis, public articulation by the Commission of its criteria for the evaluation of commission rates, and a strengthening of the review procedure. It also recommends the clarification of a number of specific questions bearing on the definition of income, costs and profits, and the submission of income and expense data by all member firms doing a public commission business as well as, with modification, by other classes of member firms deriving income from member or nonmember commissions. It further recommends that "the Commission in conjunction with the exchanges should seek to develop improved standards and procedures to take account of significant changes in volume from time to time," and that consideration be given to the "feasibility of establishing unit costs for various components of the brokerage function and ancillary services."

Automation

Focusing on the needs and possibilities of automation in the last part of its chapter on Exchange Markets, the Special Study's Report concludes that automation "seems certain to have an increasingly important impact on exchanges as trading markets and as self-regulatory agencies." The Report notes that methods of executing orders have undergone no basic change since the NYSE floor took its present form over half a century ago. The Report also finds that the numerous different reports presently collected from NYSE members for regulatory purposes are designed and analyzed only for their own specific uses, and are of limited value in constructing a comprehensive picture of market developments. There are indications that volume data presently available are incomplete and unreliable, according to the Study, and that accurate market information is extremely difficult to obtain and must be drawn from different sources for volume, the time of transaction, and the identification of the buying and selling firm. The Report states that the automated reporting procedures recently announced by the NYSE will not result in more accurate reporting or the preservation of a significantly greater amount of data. Also, since the possibilities of modern technology may involve functional matters, e.g., execution of orders from off the floor, these possibilities deserve objective exploration in the public interest.

On the other hand, the Study observes that some technological innovations are being utilized by the exchange community, citing the use by some firms of automated data processing techniques linking the transmission of orders to the floor with their back office operations and in their internal surveillance. In addition, the NYSE's clearing house and stock watch surveillance system use electronic equipment to great advantage, and the Midwest Stock Exchange has pioneered in the development of centralized bookkeeping for its members.

The use of advanced data processing methods for the accumulation of accurate and complete market data, the Report notes, "is an area which is particularly appropriate for a cooperative effort by the various exchanges and the Commission to simplify the reporting burden on members while increasing the usefulness of the whole product to all concerned." The Report recommends that the NYSE promptly undertake to revise its floor reporting procedures to make volume data complete and accurate, and to restudy its recently announced automation plans to obtain and preserve more market data at the time orders are executed than is presently contemplated.

Noting that there is a public interest in efficiency and economy of market mechanisms, the extent and reliability of information and the possibilities of market surveillance, the Report concludes that the Commission has a continuing responsibility to be informed of the developments and potential developments in the area of automation. Pointing out that there are many intermediate possibilities between present mechanisms and various far-reaching uses of automation occasionally suggested, the Report recommends greater consideration of such possibilities and the issues involved. It notes that these problems are of particular importance and immediacy in view of the NYSE's intention to move into a new building.

CHAPTER VII

OVER THE COUNTER MARKETS

In its Report on the over-the-counter markets, the Special Study of Securities Markets concludes that essential disclosures to investors concerning individual markets and transactions are lacking. However, the Report points out that its emphasis on problem areas rather than on areas of achievement should not obscure the vitality and strength of the over-the-counter markets for many securities and their importance to the economy.

Nature and Growth of the Over-the-Counter Markets

The Report notes that the term "over-the-counter" encompasses all business in securities that is not done on organized exchanges. Two of the most important characteristics of the over-the-counter markets, according to the Report, are their diffuseness--the absence of a central market place, and their diversity--the variety of securities traded, broker-dealer participants and trading practices.

The Report states that the dollar volume of over-the-counter trading has grown dramatically in recent years, increasing by approximately 700 percent from 1949 to 1961. It is estimated in the Report that the dollar volume of over-the-counter stock sales in 1961 amounted to 61 percent of exchange sales. For some individual firms, according to the Report, the pattern of growth has been even more impressive with several broker-dealers, including some of the larger ones, increasing their volume of over-the-counter sales by more than 20 times between 1949 and 1961. This increase in volume was accompanied by a significant increase in the number of issues traded and in the number of broker-dealers participating. The Report contains a detailed statistical review of the over-the-counter markets showing the volume of over-the-counter stock trading, its growth since 1949 and its relative importance. Statistics are presented on the size and types of broker-dealers who participate in the market as well as data on the characteristics of over-the-counter stock issues. During a sample period in 1961-62, the Report estimates that broker-dealers advertised markets in approximately 14,000 domestic over-the-counter stocks. Of the 4,964 broker-dealers registered with the Commission, 3,303 participated in over-the-counter transactions in equity issues in 1961. From a study of trading by all broker-dealers on a "typical" day (January 18, 1962), an analysis is made of types of public customers, the size and value of their transactions, and the frequency of agency and principal transactions. In addition, the Report presents extensive price analyses of transactions among dealers and with the public, and examines the various factors which affect the net price to public customers.

Because there is no central location (or "trading floor") where public orders can be collected, matched and executed, the participation of broker-dealers as principal is more important in the over-the-counter markets than in the exchange markets, according to the Report. It is observed in the Report that there is a dichotomy in the over-the-counter markets between the wholesale (or interdealer) market and the retail market where most public investors buy and sell securities. On the other hand, there is a close and continuous relationship between the wholesale and retail over-the-counter markets.

Broker-dealers doing business in the over-the-counter markets may be broadly classified into wholesale dealers, retail firms and integrated firms. Wholesale dealers make markets by standing ready to buy or sell securities for their own account in transactions with other broker-dealers who may be acting for themselves or for public customers. Retail firms execute purchases and sales with or for public customers by dealing with wholesale dealers. Some firms--called "integrated firms"--combine both wholesale and retail activities. The Report notes that although over-the-counter business is done by a large number of broker-dealers, volume is concentrated at both the wholesale and retail levels in a small percentage of firms. It states that less than 2 percent of the broker-dealer firms accounted for over half of all over-the-counter dollar sales in 1961. Member firms of the New York Stock Exchange were responsible for 55 percent of the dollar volume of over-the-counter sales in 1961, primarily at the retail level. Seven of the 9 largest wholesale dealers, however, were non-NYSE members.

Wholesale Markets

The Report describes the wholesale dealer as "the key firm in the over-the-counter markets." By his willingness to buy or sell for his own account, the wholesale dealer makes it possible for a member of the public to dispose of his securities without attempting to locate an ultimate public buyer and for a buyer to acquire shares without searching out the ultimate public seller. Thus, the wholesale dealer acts as a conduit through which orders flow from broker-dealers whose customers are selling to broker-dealers whose customers are buying. To the extent that the wholesale dealer purchases or sells on balance for his own account, his participation, the Report states, adds "depth" to the market.

The Report observes that information about the inter-dealer market in which over-the-counter trading is principally conducted is generally not available to the public as a result both of its trading mechanisms and of industry policy. Public investors ordinarily do not have access to quotations or prices in the wholesale markets, the number and identity of firms making markets in a security or the size of their "spreads." Wholesale dealers, or market makers, generally advertise their willingness to buy or sell through the facilities (known as the "sheets") offered by the National Quotation Bureau, Inc., a private service which publishes on a daily basis for the use of professionals, the names of broker-dealers making markets in specified securities and their quoted prices. The price at which a wholesale dealer announces it is willing to buy is known as the "bid" or "bid price;" the price at which it is willing to sell is known as the "offer" or "asked price." The difference in price between the bid and offer, known as the "spread," is the ordinary source of profit for the wholesale dealer.

The Report notes that prices quoted by wholesale dealers to other broker-dealers are known as "inside" or wholesale prices; those quoted to the public are "outside" or retail prices. Although it is frequently said that transactions in over-the-counter markets are "negotiated," a quoting wholesale dealer who receives an inquiry from another firm may ordinarily expect to do business at his own quoted prices.

Without a central market place, communications are of vital importance in the over-the-counter markets in order to execute customer orders and for the exchange of information between wholesale dealers. The Report describes some of the communication systems now in use and points out that improved communications permit broker-dealers to "shop around" for customers to determine which wholesale dealer is quoting the best price. Another important aspect of the inter-dealer network is the correspondent system by which firms linked together by wire or telephone provide wholesale dealer services to one another. The Report describes the various kinds of correspondent relationships between firms and their effect on the operation of the wholesale markets. The development and improvement of communication systems since World War II have had an "enormous impact on organization, trading practices, and the growth of the markets," according to the Report. Markets "for most securities can be located almost instantaneously and transactions consummated within a matter of seconds" and at relatively small costs.

The primary reason for trading stock is to profit through activity, says the Report, but wholesale dealers sometimes make markets to accumulate or dispose of positions or at the request of other dealers. "Some firms may commence to make markets upon the promise of reciprocal business or the grant of options or cheap stock by underwriters or issuers, which may result in a deceptive appearance of broadness of the market and may create incentives and possibilities for manipulation," the Special Study finds. The Study points out that there is no disclosure of whether a wholesale dealer is making a market for its correspondent or another firm or whether it is trading in a joint account with another firm.

The Report notes that the termination of market making is not subject to standards other than the obligation sometimes felt by individual dealers toward their individual or professional customers. It is noted in the Report that many securities in the over-the-counter market may have only one or two dealers quoting a market, in some cases only sporadically--facts which are not generally disclosed to public investors--and that if these dealers abandon market making, investors may have difficulty in finding markets in which they can sell their securities. The Report notes, for example, that during and after the new issue phenomenon of 1959-61 investors frequently complained that the market for small issues which they had purchased at premium prices had disappeared.

In describing the conduct of wholesale trading, the Report discusses the significance of "firm" quotations and "backing away" from ostensibly firm markets (i.e., quoting bids and offers but refusing to execute on them). The study points out that on the basis of ostensibly firm quotations "professionals check competing markets and prices and make their trading decisions. Broker-dealers also obtain these quotations in connection with their retail activities, so that investment decisions of customers and the quality of executions for customers may depend on them. In these and other respects, backing away from quotations impairs a basic mechanism on which orderly operation of over-the-counter markets depends." The Special Study concludes that the practice of "backing away" appears to persist in sufficient degree to be of concern because of the misleading impression of prices and market depth which it creates. The Report recommends that all quotations should be firm, when supplied, to the extent of the security's acknowledged trading unit; that the National Association of Securities Dealers, Inc., should establish appropriate surveillance and enforcement programs; and that broker-dealers be required to keep a timed record of changes in their quotations.

The Report describes the nature of, and existing limitations on, the contribution of the factors of diversity and competition to the integrity of the wholesale markets. Where competition exists, according to the Report, each competing dealer tends to make a market with narrow spreads between its bid and asked quotations. In addition, diversity between dealers narrows the spread between the best bid and asked quotations in individual securities. However, many securities by nature do not have competitive markets because of limited dealer or public interest; in others, the appearance of several dealers' interest in a security may not be a reliable indication of a competitive market because of practices which impair competition such as "handholding" (i.e., working in concert) between dealers. The Report quotes the testimony of several dealers who described cooperative practices among ostensibly competing dealers and concludes that "practices have come to be tolerated which are inconsistent with the frequent emphasis on the competitive nature of the wholesale markets." "A minimum need is to provide better means for the investor and the regulatory agencies to distinguish the latter situations," says the Report.

The Report concludes that specific regulatory standards governing the conduct of wholesale trading are largely lacking. "The commencement and termination of trading activity, the kind of markets maintained, the extent of participation by market makers, the supervision and compensation of traders and other matters of crucial importance depend mostly upon the varying economic interests and business practices and standards of individual firms rather than specific regulatory standards," states the Special Study. The Report states that greater attention should be given to the general subject of the conduct of wholesale trading by the NASD and the Commission, in some respects immediately and in others on a longer-range basis.

The Report analyzes the particular problems associated with the wholesale activities of the integrated firm which combines both wholesale and retail activities. It points out that the integrated firm may use its retail department to dispose of positions resulting from trading activities and its transactions are likely to be on a principal basis out of inventory, to customers who may be purchasing on the basis of the firm's recommendation. The Report describes the trading activities of an integrated firm in stabilizing the after-market for an underwritten issue, illustrating the conflicts of interest that may be inherent in the combined roles of retailer, wholesaler and underwriter.

After completion of a distribution, the Report states, an integrated firm may "sponsor" an underwritten issue, that is, undertake to provide a continuous market in securities in which it has placed its customers. The Report analyzes price and activity data regarding market making activities of firms that designate themselves as sponsors as compared with other market makers and concludes, on the basis of the data described, that there is "a very considerable disparity in the market making activities of the various firms designating themselves as sponsors and, on the other hand, a broad similarity in market making activities of the entire group of sponsors as compared with market makers generally."

Another aspect of the trading activities of the integrated firm covered by the Report concerns the integrated firm as the sole or dominant market maker for a security. The Report notes that for many securities in the over-the-counter markets, there may be a limited number of dealers--if any--actively making a market. For these securities the ultimate safeguard of competition among market makers is lacking so that both business and regulatory considerations applicable to such a market differ from those applying to securities with competitive markets. The Report observes that the prices of the sole or dominant market maker are not affected by competition but may be affected by the firm's own activity at the retail level.

The Special Study concludes with respect to firms engaged in both wholesale and retail business in the same security, "The potential conflict of interest inherent in the dual role, although normal in any merchandising activity including the securities business, may present particular difficulty where, as frequently occurs, the integrated firm is especially active in the immediate after-market of an underwriting which it has managed, or where it is the sole or dominant market maker in an issue at any later stage. Existing requirements for disclosures to retail customers at the time of solicitation and in confirmations do not appear adequate in light of possibilities of abuse."

The discussion of the conduct of wholesale trading in the Report concludes with a description of wholesale trading under two special sets of circumstances: during the acquisition or disposition of a block and during a period of extreme price stress. The Report discusses the handling of block transactions in the over-the-counter markets and notes that wholesale dealers are frequently used in the accumulation or disposition of large positions. The Report notes that there is flexibility in the methods used, reflecting the fact that various merchandising and distribution methods are available in the over-the-counter markets. Such regulatory requirements as would appear to be applicable, particularly in respect of making a market while handling a block disposition, are "often not observed and presumably not understood to apply."

With respect to the market break of May 1962, the Report says that many wholesale dealers quoted "subject" (i.e., "nominal" or not "firm") markets, widened their spreads, and reduced the number of shares for which they would bid or offer, so that a substantial loss of liquidity resulted.

The Report considers the function and importance of the sheets published by the National Quotation Bureau, Inc., which is the primary medium for the dissemination of wholesale quotations among professionals. It notes the central importance of the Bureau but points out that it is a private business, possessing monopoly power, subject to no direct regulation. The Report states that the Bureau exercises final control over who may advertise their quotations, what minimum capital such firms need, what securities may be quoted, what kind of listings may be made and what techniques of surveillance and sanctions are employed. It notes that the Bureau has been operated with a conscientious regard for the responsibility which its function and dominant position entail, but points out the anomaly of private hands holding "such crucial powers without public regulation or review."

The Report states that, as a result of the Bureau's limited authority as a private body, the growth of the markets and inadequate procedures, the Bureau's exercise of its powers has not kept pace with the needs of the market. The Bureau has been unable to do all that it might have desired in assuring the integrity and reliability of the sheets. For example, the sheets have been used by some firms in a manipulative and fraudulent manner. The Report points out that in case after case broker-dealers have abused the wholesale quotation system through inserting fictitious quotations to facilitate a fraudulent or manipulative scheme. The Report cites several examples of manipulations in which the insertion of quotations in the sheets by one firm at the request of another was utilized in the scheme. The exploitation of the sheets in this manner for manipulative purposes is a matter "which should be acted upon at once." It recommends that all quotations entered by one dealer on behalf of another be so designated.

The Report concludes that "The power that lies in running a wholesale quotation system for the entire over-the-counter market is far too important to the industry, to investors and to the economy to be entrusted to the hazards of changing ownership or management." Recent electronic developments leading to the possibility of competing systems and the fact that the Bureau will eventually pass into other hands emphasize the need for regulation. The Report also notes the necessity for greater recognition of responsibility on the part of the NASD in the surveillance and supervision of its members' use of wholesale quotation systems.

The Special Study recommends that quotations systems be brought under appropriate supervisory control of the Commission, and that the operator of any such system be vested with authority and responsibility to regulate the use of its system by broker-dealers. It states that the NASD and/or the Commission should have the power and responsibility to suspend the right of broker-dealers to enter quotations in an inter-dealer system for willful abuse of a quotations system or of rules governing such system. The Report also recommends that quotations systems identify "OTC listed" securities (discussed in Chapter IX), and securities eligible for extension of credit.

Retail Markets

The Report notes that when dealing with the public a broker-dealer may act either as principal or agent. Where the firm acts as agent (or broker) it does not take title to the security and reveals its commission to the customer on the confirmation sent to him. Principal transactions, the Study notes, are for the account of the firm and only a net price is revealed. The Study observes that principal transactions may be of two types: from an inventory position or "riskless." In the latter type of transaction, the broker-dealer buys the security from a wholesale dealer, places the security in its own account and immediately resells it to the customer. This kind of principal transaction has been called a "riskless" transaction "since the risks of ownership are absent."

The Special Study's data show that broker-dealers in a majority of transactions with individual customers deal on an agency basis, and in most transactions with institutions and other non-individual investors on a principal basis. According to the Report, agency transactions are less prominent in active stocks than inactive ones, and NYSE firms tend to act as agent more often than non-NYSE firms. Approximately three times as many firms acted exclusively on an agency basis as those acting only as principal. There appeared to be no tendency for firms with small volume to act more frequently on a principal basis than firms with larger volumes.

The Study finds that firms tended to act on a principal basis when handling customers' orders in inventoried stock, and notes that the tendency appears greater in sales to customers than purchases from them. The Report observes that the public in general transacts a greater volume of business with firms which do not have an inventory in the particular security at the time of the transaction than with firms which do. Firms without inventories must execute customers' orders with market makers, hence the importance of diligent execution if customers are to receive the benefits of competition and diversity in the wholesale markets.

The Study finds that the obligation of a broker-dealer to use reasonable diligence to obtain the best available execution for a customer is not always recognized or fulfilled. Inferior executions for individuals, says the Report, may be caused in particular instances by failure to negotiate and to check markets, by the channeling of business to certain firms on the basis of reciprocal obligations or patterns of doing business, or by indifference, incompetence, or venality of order clerks. The Study also finds that the practice of "interpositioning," in which a retail firm interposes a third firm between itself and the market maker, may add an unwarranted cost in some transactions.

Without access to inside prices, public customers are unable to check the diligence and costs of their executions. The Report notes that while the NASD has recognized the principle of best execution, it has not prescribed specific guidelines or standards with respect to it. The Report recommends that rules and standards be adopted by the Commission and/or the NASD requiring broker-dealers executing retail transactions, whether as principal or as agent, to make a reasonable effort to ascertain the best interdealer quotations and "to provide an execution as favorable as may reasonably be obtained in light of the kind and amount of securities involved and other pertinent circumstances."

The Report finds that although there may be a narrow price spread in the wholesale markets for active securities, a wide divergency frequently occurs in retail prices for the same securities due primarily to the size of markups where dealers sell to customers as principal. Thus, customers placing similar orders for the same security under similar wholesale market conditions may have significantly different costs of execution depending upon the type of firm executing the order and the capacity in which the firm acts in handling the order.

The Study notes that principal markups, which are undisclosed, are usually significantly higher than agency commissions, particularly in the case of riskless transactions. The latter constitute a substantial portion of retail principal transactions. "Not only does the customer typically pay more in a riskless transaction than he would in an agency execution," states the Report, "but he also usually pays more than he would pay in a principal transaction with a firm having a position." The Report concludes that riskless principal transactions are inherently susceptible to abuse and should not be permitted to take that form (subject to defined exceptions).

The Report points out that the NASD-sponsored retail quotations published in the newspapers are the primary source of information for a public customer, other than direct inquiries to a broker-dealer, concerning the markets for over-the-counter securities. These quotations do not represent prices at which transactions have actually been effected, as in the case of exchange quotations, nor do they represent specific dealer interests in doing business as do wholesale quotations. It is noted that retail quotations appearing in the newspapers purport to represent only the approximate range within which a public customer could have bought or sold at the time the underlying quotations were gathered. The Study observes that quotations of over-the-counter securities appearing in newspapers are in most cases furnished by NASD committees which take wholesale quotations (not always the best available) and add predetermined amounts to the asked prices before supplying them to newspapers.

The Study finds that retail quotations provide an incentive to handle purchase transactions on a "riskless" basis, with increased cost to the customer and provide no basis for evaluating the quality of executions. The Report states that "A long history of discussing and revising the system and of rewording the explanatory legend has produced what appears to the Special Study to be an indefensible result: a 'quotation' system that quotes neither actual bids and offers nor a range of actual prices. Such a system must be confusing if not deceptive to many investors, quite apart from the explanatory masthead that appears in some newspapers, and may be even more misleading with that masthead, which fails to explain what the bid and asked are, and ties them confusingly to a price range as if they related to a high and low in a trading day."

The NASD's tool for policing retail charges--the markup policy--has provided important protections but it cannot supply, nor is it designed to supply, material facts to investors about the over-the-counter trading markets. In tracing the background of the markup policy, the Report observes that, paradoxically, while the Commission originally proposed a disclosure approach, normally considered less drastic than substantive regulation, the NASD "opposed disclosure and turned instead to a regulatory solution." The Report observes that there have been confusions and misunderstandings in the application of the markup policy by broker-dealers and NASD examiners and District Committees. The Report notes the failure of the NASD to articulate the bases used in applying the markup policy to integrated firms and the failure to come "to grips with the question of what standards are to be applied in judging the fairness of retail prices where there is no independent market." The Report recommends that the markup policy be clarified and strengthened, especially in the case of securities for which there is no independent market.

The Report observes that the Commission's regulation of over-the-counter markets has relied essentially on the fraud provisions of the statutes. Although this approach has been successful in dealing with flagrant situations, says the Special Study, it does not meet the basic need of the investor for timely disclosure of information useful in appraising the quality of markets and executions.

Automation

According to the Report, rapid advances in technology now offer the prospect of major new applications in the over-the-counter markets. The Study notes that three companies now disseminate "retail" quotations by means of electronic devices and points out that further improvements would make possible the central storing of all bids and offers and reports of transactions, thus making possible compilation of actual price and volume data as in the case of listed securities, and possibly assisting in the execution of orders. The Report concludes that the possibilities of automation are of great importance to the industry and the public "because of the potential for solution of basic problems that have historically characterized both the operation and regulation of over-the-counter markets."

The Report describes the NASD as "the natural source of leadership and initiative in dealing with matters of automation in respect of over-the-counter markets" and accordingly the Report recommends that it should carry forward the study of automation possibilities and report to the Commission from time to time as to the progress and programs of the industry in this area. In the absence of a completely automated system, the Commission and the NASD are urged to consider the feasibility of establishing a reporting system to obtain, without undue burden, actual price and volume data for some or all over-the-counter transactions.

The Needs of the Over-the-Counter Markets

As an introduction to the statement of the Special Study's conclusions and recommendations, the Report states that the relative lack of regulation of the over-the-counter markets reflects a failure to keep pace with their growth and change since enactment of the original securities laws, plus the difficulty of encompassing their wide variety in uniform regulatory measures. Further, it points out that the heterogeneity of these markets means that general descriptions are difficult and that recommendations deemed essential in one area may be inapplicable in another. Finally, it notes that the measures recommended are intended both to bring marginal performance closer to the best level achieved and to improve generally the functioning of these markets in the interest of investors.

An important step toward better understanding and regulation, according to the Report, is "better identification and classification of what is involved in these markets--what securities, what broker-dealers, what practices." Pointing out that other recommendations in the Report (Chapters III, IX, and X) relate to the differentiation of various over-the-counter securities, the Special Study says that similar needs exist with respect to broker-dealer participants in the over-the-counter markets--needs for clear identification of those making markets for particular securities and for some categorization of markets. Accordingly the Report recommends that a system for identifying "primary market makers" in each security be established by the Commission or NASD as promptly as necessary mechanical arrangements can be worked out.

The Special Study also urges that the Commission and the NASD "make it part of their continuous agendas to seek further possibilities for strengthening the mechanisms of interdealer markets and the protection of investors in relation thereto." Among other matters suggested for possible coverage either generally or in respect of specified categories of securities or broker-dealers are: rights and obligations of primary market makers in maintaining fair, competitive and orderly markets; the grant of cheap stock, options or warrants to market makers; the handling of limit orders, standards of supervision and methods of compensation of traders; intra-firm responsibility for and supervision of the insertion of quotations and variations in application of broker-dealer capital rules to primary market makers.

The Report indicates that certain basic changes of over-the-counter mechanisms and practices are of the highest priority and that the objective of these changes is to provide more reliable and readily available information about markets and prices than exists under present rules and practices. Just as an investor needs basic disclosures about over-the-counter securities themselves, the Report states, he needs basic disclosures about their markets. He should be afforded information about the depth of dealer interest, the identity of the market-makers, price spreads and prices in the interdealer market--on which the retail market in which he deals is ultimately dependent in a most fundamental sense. Such disclosures are needed not only for intelligent investment decision by the customer and as aids to his assessment of the quality of execution of his order; as in all other areas of disclosure, "they serve the important prophylactic purpose of silently policing the performance of the broker-dealer himself."

In addition to recommendations aimed at increasing the reliability and informativeness of the wholesale quotation system, the Report recommends that the wholesale quotation system be made publicly available. It also recommends that retail quotations systems show the best prevailing interdealer bids and offers and the number of primary market makers for each security (with appropriate exceptions for categories of securities or situations). The NASD is urged to reexamine and strengthen the supervision and functioning of its local quotations committee, and to consider supplying in retail quotations indications of dividends, ex-dividend, insolvency or reorganization proceedings, etc., in the manner of stock exchange quotations and designating securities eligible for extension of credit.

The Study makes a number of other recommendations to provide customers at the time of their investment decision with information concerning the nature and quality of the markets for their securities. The Report recommends that a broker-dealer soliciting a customers' purchase of (a) any security for which there is no independent market other than its own, or (b) any security out of its own inventory, or (c) any security in which there is a spread of 20 percent or more in prevailing interdealer bids and offers, should be required to disclose such facts at the time of solicitation. On customer principal transactions of standard size or less the Study recommends that confirmations be required to show the best reasonably ascertainable interdealer quotations on the opposite side of the transaction. In order to provide the customer with an indication of the prevailing spread between interdealer bids and offers, so that he may judge the marketability of his investment, the Study recommends that the confirmation of a customer's purchase also show a representative bid.

The Report concludes that "whatever the appropriate level of markup or commission for a particular transaction and assuming that it may vary in different circumstances, it is difficult to see why it should be necessary to conceal what elsewhere in the securities business is considered essential to be disclosed." For example, there is complete disclosure of the spread in underwritten offerings, often amounting to as much as 10 percent or more on common stock issues, and of the sales load on mutual fund shares, typically amounting to 8 1/2 or 9 percent. "Disclosure in these situations has not discouraged merchandising activity or successful selling, and it is not apparent why it should do so in the over-the-counter markets generally."

CHAPTER VIII

TRADING MARKETS -- INTERRELATIONSHIPS

In Chapter VIII of the Report of the Special Study of Securities Markets, the Special Study deals with the various interrelations of the trading markets. The chapter discusses the basic allocation of securities as between exchanges and over-the-counter markets, as primary markets; the role of institutional investors in the markets; over-the-counter trading in listed securities; and the role of regional exchanges in multiple trading and as primary markets. It concludes with a summarization of the more crucial market interrelationships and their consequences.

Allocation Between Markets

In an analysis of the factors and forces which determine whether a specific security is to find its primary market on an exchange or over-the-counter, the Special Study focuses primarily on the significance of listing and delisting requirements of the various exchanges, the characteristics of securities traded in the different markets, and the criteria for determining the suitability of a security for trading in either of the two basic types of trading markets.

Noting that a crucial concept in allocation as between exchange and over-the-counter markets is that of "listing," the process by which securities are first admitted to trading on an exchange, the Report observes that delisting standards, while paralleling the listing standards, are generally far less stringent. The Study observes that the"wide discrepency now found between listing and delisting yardsticks seems questionable," particularly with respect to the New York Stock Exchange ("NYSE") where the most stringent listing requirements apply; and it recommends strengthening of delisting standards on that exchange.

In a comparison of the characteristics of stocks traded in the various markets, the Study measured ranges of assets, numbers of shareholders, numbers of shares outstanding and market value of shares outstanding, for stocks listed on the NYSE, American Stock Exchange ("AMEX"), major regional exchanges, and for active and inactive stocks traded in the over-the-counter market. The Report's statistical analyses show that NYSE stocks generally are in the highest size ranges, inactive over-the-counter stocks in the lowest ranges, AMEX stocks between the two,active over-the-counter stocks spread generally across the whole spectrum, and stocks listed solely on the major regional exchanges tending to fall between the active and inactive over-the-counter groupings. According to the Study, the assembled data indicate that securities traded in a particular market or category of markets tend to have broadly similar characteristics but with a great deal of variation within each category and with considerable overlapping among categories. Similar patterns appear with respect to trading activity.

The Report also observes that for a security to be well suited for an exchange's continuous auction market, its market must have adequate "depth," a need that is generally recognized in listing and delisting standards. The depth of buying and selling, according to the Report, is directly affected by the round-lot unit of trading;thus, a reduction in the round-lot trading unit would tend to add to the flow of buy and sell orders constituting the depth of the market at any given time. Accordingly, the Study recommends a "government-industry study of the feasibility and desirability of reducing the round-lot unit for all or some securities."

The over-the-counter market, the Report states, is more adaptable than the exchange markets in terms of depth, because it is a "shopping around"market rather than a centralized one and because there cannot be a uniform expectation of depth, continuity and fluidity for the wide variety of stocks traded over-the-counter. The Study concludes that the "pressing and continuing need" in the over-the-counter market "is to provide more specific identification of crucial facts about individual markets, so as to assure more realistic understanding on the part of public investors as to the kind and quality of market that may be expected for any particular security."

Institutional Participation and Block Transactions

An analysis was made by the Special Study of the relationship of institutions to the trading markets, based primarily on responses to a questionnaire sent to a sample of 91 different institutions consisting of non-insured pension funds, insurance companies, open and closed-end investment companies, college endowments, foundations and common trust funds. This phase of the Report concerns itself with the methods used by the institutions in executing stock transactions, the types of stock in which institutions invest, their procedures for handling large purchase and sale programs, the turnover of stock in institutional portfolios, and the relations between institutions and broker-dealers.

The Report emphasizes the growing importance of institutions relative to individuals as investors in stocks, although pointing out that the holdings and trading of stocks by institutions are still considerably less important than those of individuals. The Report also notes the "special importance" of institutions to the trading markets resulting from their large unit holdings and the concentration of decision-making power in relatively few investor units. In response to the growing significance of institutional participation in the trading markets, the Special Study stresses the need for an "adequate body of information about them on a continuous basis for the use of the Commission, the self-regulatory bodies and the investing public." The Report also recommends that the Commission maintain continuing contact and lines of communication with the industry and the institutions themselves with regard to changing impacts of institutional transactions on securities markets, related needs of institutional investors, and questions of public policy involved.

The Report observes that institutional transactions showed concentrations in issues listed on the NYSE. Transactions executed on the regional exchanges involve for the most part NYSE issues and most were by the open-end investment companies, a fact, the Report states, which "may well be related to the investment companies' desire to give 'reciprocal business' to regional exchange members and, in some cases, to non-members." While the NYSE is the most important market channel for institutional transactions in listed stocks, many institutions indicated that their use of the over-the-counter markets for listed stocks has been increasing in recent years. The "institutionalization" of the corporate bond market with resulting emphasis on over-the-counter trading is a "well-known phenomenon," the Report observes, and a similar phenomenon appears to have been developing with respect to preferred stocks and also higher grade, more stable investment-category common stocks.

According to the Study, relatively few of the institutions studied had transactions in issues of stocks which were newly offered to the general public in 1961. New-issue activity with respect to preferreds was almost entirely limited to purchases through original-offering allotments. In the area of new issues of common stock, on the other hand, the institutions' post-offering trading market purchases were nearly 2½ times the value of their original allotments. They also made post-offering sales of new issues of common stock equal to about one-tenth the value of their original allotments. More than one-half of such sales were made within 40 days of the original offering.

The Report also states that while the investment companies have noticeably higher stock turnover rates than other institutions, the turnover of the institutional portfolios as a whole was lower than the NYSE market. The institutions' lower turnover rate, according to the Study, "raises questions concerning the consequences of possible further increase in institutionalization of the markets for stocks," which may include the possible further "thinning of the markets in particular issues."

Most institutions were found to have concentrated their commission business among relatively few brokers: no more than 10 firms tended to account for more than 50 percent of the business of each institution. NYSE member firms received more than two-thirds of the total institutional commission business for the period studied. The survey shows that "reciprocal business" considerations were more important in the allocation of the institutions' commission business among stock exchange member firms than among dealers in the over-the-counter market, where price competition may exist.

The most frequent suggestion made by institutions for changes in the various securities markets was for a volume discount or lower commission rate for large purchase or sale programs on the NYSE. The Report refers to the recommendation for a study of commission rate structures made in Chapter VI and notes that any study of a possible volume discount "must take into account the patterns and practices revealed by the present survey." The Report cautions that volume discounts should be meaningful in terms of sizes of transactions and block purchase and sale programs of the institutions,and should not take a form which would give institutions incentives toward making larger single transactions than exchange markets can absorb.

With respect to pension funds, the Report observes that while they are one of the most important institutional-investor groups and are growing at the fastest rate, "they are notable for the dearth of information publicly available on their holdings." The Report concludes the Commission should recommend that the Federal Welfare and Pension Plans Disclosures Act be amended to require "periodic disclosure by pension funds of their holdings of individual corporate securities." While past recommendations by others that the Act require greater disclosure have been made with the purpose of informing and protecting the interests of the beneficiaries of such plans, the Report notes that the general importance of pension funds in the securities markets provides an independent reason of public policy favoring such disclosure.

Over-the-Counter Markets In Exchange Listed Securities

The Special Study reports that one of the most striking developments in the securities markets in recent years has been the growth of a market away from the floor of the stock exchanges for securities traded on the exchanges. Because of the market's unique character, combining elements of both the exchange markets and the over-the-counter markets, the Study refers to it as "the third market." The size of this third market may be judged, according to the Report, by the fact that in 1961 markets were made for 270 common stocks traded on the New York Stock Exchange. The Study points out that while the volume of this market is approximately only 4 percent of NYSE volume, it has more than doubled in the past 20 years and appears to be continuing to expand. The percentage increase in volume of such trading between 1955 and 1961 was 3 times the percentage increase in volume on the NYSE. The list of stocks is described as large, diversified and steadily expanding. Unlike the off-board trading of listed stocks of earlier years which tended to concentrate in issues of high quality and low activity, the list now includes some of the most actively traded stocks on the NYSE, as well as those in the highest size ranges, whether measured by number of stockholders or of shares outstanding or dollar amount of assets.

A notable characteristic of the market, according to the Report, is the stress on very large and very small transactions. The large transactions, it states, are hardly unexpected since the handling of block transactions by institutions has long been accepted as a prime function of the third market. The Study also found, however, that the share volume transacted in odd lots, i.e., transactions of less than 100 shares, constituted about 73 percent of the transactions and 18 percent of share volume on the off-board market,or about double the corresponding percentages on the NYSE.

The Study reports that institutions are the largest customers in the off-board market, being responsible for 62 percent of the dollar volume of the third market in 1961. All classes of institutions use the third market but, the Report notes, open-end investment companies (load) transact a relatively smaller portion of their business on this market than other institutions and are unique in that they transact a larger share of business in listed stocks on the regional exchanges than on the off-board market. In the larger transactions normally effected by institutions, the Study finds the Exchange commission schedule influential in two ways: One is the schedule's failure to provide for a discount in commission rates for the larger sized transactions. The other is the schedule's inclusion of a charge for services not directly related to the brokerage function and often not needed by institutions.

The relatively high percent of trading by individuals in the third market, 38 percent of dollar volume in 1961, is described by the Report as surprising. Transacted almost entirely through intermediaries--broker-dealers not members of an exchange and,to a much smaller extent, commercial banks--most of this business is handled on an agency basis. The Study finds that the Exchange commission schedule has also been a factor in the growth of this portion of the third market, by its requirement that non-member professionals must pay the same commission rates as public customers.

Off-board trading of listed securities takes place in many ways, according to the Study, but the great bulk occurs in over-the-counter markets for listed securities "made" by broker-dealers specializing in such trading and referred to by the Study as the "market makers." Some 17 firms were making these markets in 1961, with the largest part of the volume being transacted by only 7 firms.

The Study describes the market maker as the "core" of the third market. Free to make markets or discontinue them at will, some firms specialize in trading with institutions, some with broker-dealers, and some with both. The larger market makers are among the largest firms in the securities business generally and possess substantial resources. Some firms concentrate almost exclusively on third-market business while for others third-market activities are part of a larger integrated securities business. The market makers are said to gear their operations for dealings with professionals; they do little advertising or merchandising of securities; they stress the trading of securities and generally do not perform the various customer services rendered by the public commission houses.

The Study describes in some detail the operations of the markets for listed stocks made by the market makers. They deal for their own accounts as principals so that their customers, both institutions and broker-dealers, trade at prices net of commissions. One result of this practice, according to the Study, is that the off-board price (for listed stocks) rarely deviates from the price obtainable on the Exchange by more than the Exchange commission. Within the limits of this generalization, the market makers have developed a wide variety of trading practices to govern the operations of their markets. Another consequence, according to the Study, is that the absence of fixed commission charges on the third market permits the market makers considerable flexibility in pricing practice. Finally, it is evident that the emphasis on principal trades establishes capital resources as an important element of the market maker's ability to function. As a group, they tend to be willing and able to assume large positions, whether long or short.

The Study reports that though off-board trading in listed stocks necessarily accounts for some diversion of volume from the primary Exchange market, this diversion is relatively low in more than 70 percent of the 272 stocks traded in the third market in 1961. Furthermore, much of the trading is in large-size transactions which might create a temporary imbalance on the Exchange so that the "diversion" may enhance rather than impair "depth" in the primary market. Also, to the institutional customers of this market,the off-board market has the effect of adding to the depth of market because it makes available the benefit of the market maker's substantial resources in addition to the trading and resources available on the public market of the Exchange: Thus, from the perspective of the Exchange, the off-board market may be viewed as competitive but from the reference point of the institutional customer, it is complementary; such customers seek to utilize the resources of both markets.

The Study finds that under existing circumstances the third market has been, on balance, beneficial to investors and the public interest. By and large, the competition afforded is substantial and the impairment of depth limited. It declares "that the very existence of this market to satisfy needs not met by the Exchange market is indeed affirmation of the inherent strength and viability of a system of free markets."

The Study concludes, however, that the acute lack of data concerning this market must be corrected if the market is to be fully understood. It recommends the identification of the market makers and the submission by them of periodic reports on their trading, as well as by other broker-dealers doing a large volume of off-board business but not dealing in the markets of the market makers.

Regional Exchanges

The regional stock exchanges--the 14 exchanges located outside of New York City--are separately considered in Part E of Chapter VIII. In 1962, a total dollar volume of $3.75 billion was traded through the facilities of these exchanges, representing 6.9 percent of the total dollar volume of securities traded on all American stock exchanges during 1962. The Report considers the role of the regional exchanges as secondary or "multiple" markets for securities also listed on the New York Stock Exchange or American Stock Exchange and their role as primary markets for securities not listed on the two major New York exchanges, i.e., "sole" listings, and concludes that it is in the public interest to maintain a strong regional exchange system.

The Report points out that there has been an accelerating trend for the regional exchanges to trade stocks listed on the NYSE, as an offset to a continuing and significant loss of their business to the over-the-counter market and to the two major New York exchanges. While the proportion of dollar volume of all exchanges accounted for by regional exchanges has remained relatively unchanged in the past 25 years, the proportion of dollar volume accounted for by solely-traded issues has declined dramatically. As recently as 1948, 15 percent of regional exchange dollar volume was accounted for by solely-traded stocks; by the end of 1961 this had declined to 7 percent. Numerically, solely-traded stocks have declined from about 1,300 in 1940 to less than 500 in 1961.

Data presented in the Report show that of 1,168 common stocks listed on the NYSE in 1961, about 750 were also traded on one or more of the regionals. The NYSE stocks selected for multiple trading by the regional exchanges tend to be the most active NYSE stocks. However, there is also a tendency for each regional exchange to concentrate on the dual trading of securities of companies in its vicinity. In some of these cases the stock may first have been listed on the local regional exchange for some time prior to its NYSE listing. For regional exchanges as a group, 93 percent of dollar volume in 1961 was in multiple-traded issues. Many of the solely-traded stocks, accounting for the remaining 7 percent,are inactive stocks. The 102 solely-traded stocks having an average share volume of more than 100 shares per day accounted for 86 percent of the dollar volume for all solely-traded issues.

The Study also found a significant overlap between the regional exchanges and the NYSE and AMEX in membership as well as in securities traded. The Report notes that 238 firms are members of both a regional exchange and either or both of the NYSE and AMEX (dual members), as against 449 firms which are solely members of a regional exchange. Data analyzed by the Study indicates, however, that the dual members have the largest sales organization and constitute the most important source of business for each exchange. In examining the income sources of both dual and sole member firms the Study found that the regional exchanges provide the major source of income for neither group. When each group is taken as a whole, dual members generally relied more heavily on NYSE income than on regional exchange activities, while sole members as a group generally earned the major part of their income from such activities as over-the-counter transactions and mutual fund share sales. However, the Study also found that many sole members earn a substantial part of their income from regional exchange activities.

The Report discusses the factors which led to the decline of the regional exchanges as primary markets and observes that the major causes of the shift to multiple markets have included: (1) freedom from controls over issuers in the over-the-counter markets as compared with issuers of listed securities; (2) greater flexibility of trading, "merchandising" and pricing practices in the over-the-counter markets; and (3) improvements in communications accentuating the pull of the New York exchange markets and fostering the growth of the over-the-counter markets.

The Report points out that the structure of the NYSE commission rate schedule exerts a direct influence on the regional exchanges and their development as dual markets. Because the non-member commission schedule fails to make special provision for non-member broker-dealers, the latter are precluded from directly earning or sharing commissions on NYSE transactions for their customers, but such firms that are regional members can trade NYSE stocks for their customers on a regional exchange and retain the commission that would be lost by sending the order to the NYSE. By giving their sole members preferential access to dually-traded stocks, the Report notes, the regional exchanges help to widen the public customer's field for the selection of a broker able and willing to do business in a large spectrum of stocks.

Furthermore, according to the Report, multiple trading also serves as a medium for channeling reciprocal business to regional exchange members by NYSE commission firms and mutual funds. NYSE member firms will send commission business to regional exchange members in exchange for orders sent to New York which the regional exchange member cannot execute on the regional exchange. Mutual funds send orders to regional exchanges to compensate members of these exchanges for selling mutual fund shares. The Study observes that in some cases such reciprocal business can also be channeled through the regional exchanges to non-regional members where the regional exchange commission schedule permits commission splitting with non-members.

The Report notes that the importance of multiple trading to the regional exchanges has given rise to various trading practices on these exchanges designed to assure that the price on a regional exchange is competitive with the price in the primary market. The Report discusses some of the specific regional exchange trading devices and finds that one or two of these arrangements may raise questions of whether the customer receives the best available execution. However, the Report also points out that occasionally a better price may be available in a specific stock on the regional exchange than on the primary exchange and that by checking both the regional market and the New York market, a broker is in a position to obtain whichever price is more favorable. The odd-lot system in effect on the regional exchanges for multiple-traded stocks mechanically gears odd-lot prices to the NYSE market. The Report notes that there is no competition between the regional exchanges and the NYSE and AMEX in respect of commissions paid by the public customer since the commission schedules of all exchanges are the same, with the exception of certain professional discounts extended by 4 of the regional exchanges.

The Study also considers the impact of the multiple trading system on the primary markets and discusses the possible effects of the diversion of volume from the primary markets to the regional exchanges. The Report finds that in the typical situation, the splitting of the market does not appear to affect adversely the quality of the New York market; and to the extent that competition is afforded, the regional exchange market may work to improve the primary market.

The Report also points out that issues solely listed on the regional exchanges are traded under rules generally similar to those in effect on the NYSE and AMEX. However, since the solely-traded issues are for the most part quite inactive, with thin specialist "books," the regional exchanges are faced with continuing problems to insure adequate markets in their solely-traded issues--a problem also present on the NYSE and AMEX in inactive issues.

The Report concludes that the vitality of regional exchanges has importance not only to the economy of the regions in which they are located but also in that they serve as resistance points against what might otherwise be an irresistible and ultimate gravitation of securities markets and surrounding activities to New York. The Report notes that in the past regional exchanges have introduced various innovations and cost-saving mechanisms that demonstrate the trail-blazing potential which can be provided by competition.

Several possible courses are mentioned in the Report to encourage the preservation of strong regional exchanges. The Report notes that the pending legislation to remove the disparity in treatment accorded stocks traded over-the-counter might remove what may now be an artificial barrier to regional listings in some cases. The Report mentions other possibilities for strengthening the role of regional exchanges as competing markets; among these are the mergers of existing regional exchanges; mechanical interconnection and reciprocal membership arrangements with other exchanges; modifying trading rules to meet the special needs of solely-listed securities of less than optimum depth; and development of programs for wider publication of stock lists and quotations and programs for general enhancement of prestige and public acceptance. The Study concludes that as the stature of the regional exchanges is enhanced consideration should be given to raising the listing and delisting standards of the NYSE and possibly the AMEX and encouraging the transfer of certain NYSE and AMEX listings to other exchanges.

General Conclusions

The Special Study concludes its chapter on the interrelationships of trading markets with recommendations that the Commission improve its facilities for the continuous accumulation of data relating to trading markets and that the Commission establish a permanent Policy and Planning Unit with the responsibility of accumulating and analyzing data bearing on market patterns and practices, which are characterized as kaleidoscopic rather than static, with various important currents of change operating beneath the surface of daily business. The Report observes that there seems to have been only limited awareness of the significance of questions posed by some developments in the trading markets, and limited attention to their resolution, particularly with respect to the growth of trading in NYSE listed securities in other markets, the significance of institutions as participants in trading markets, the over-all growth of the over-the-counter market, the effects of the absence of a volume discount in the NYSE rate structure, and the effects of technology on trading markets.

The Report notes that trading in NYSE listed stocks on the regional exchanges and over-the-counter is in some instances quite high compared to that done on the Exchange. Thus, of 50 selected stocks, which included many of the most active stocks on the NYSE, 16 have a combined volume of trading away from the NYSE of at least 30 percent of the volume on the NYSE.

The growth of multiple trading of NYSE securities raises two competing considerations, according to the Report. One is the impairment of the depth of the primary market. On this point the Report states the success and quality of an auction market partly depends on a concentration of public buying and selling orders in the market, so that, solely from this point of view, any diversion to another market would have to be counted inimical to the public interest. On the other hand, notes the Study, there are the general public benefits of competition that may be provided by multiple markets. The Study concludes, not that impairment of depth in the primary markets is irrelevant or inconsequential, but that, under present circumstances, the benefits of competition by and large outweigh any detriment attributable to that impairment. The Report points out that where there is competition each market has greater incentive to improve its facilities and that multiple market places for particular securities may be responsive to differing or changing needs. The very existence of multiple markets, the Report indicates, may add to total market depth and provide incentives for better executions in each market place. The Report goes on to state that the extent of needed regulation of markets in the public interest depends, at least in part, on the effectiveness of competition in maintaining high standards of performance.

The Report also observes that competitive markets may give rise to different results in the execution of a given transaction depending on which one of the competing markets is used. Among the variables affecting executions, according to the Report, are the diffuseness of the over-the-counter markets and the comparative unavailability of price information; the possibility that the mechanisms and regulations of regional exchanges are not always such as to assure equal results in the regional market as in the primary market; the commission rate structure of the various exchanges; and the various exchange rules which tend to restrict members from transacting business away from the primary market. The Report concludes that the factors contributing to or detracting from the public's ready access to all markets and its assurance of obtaining the best execution of any particular transaction require the continuous attention of the Commission and the Policy and Planning Unit.

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