THE FLOOR DEPARTMENT
Memorandum

December 14, 1961

Yesterday, David Silver of the Market Study Group at the SEC, and Otto Lowe, Jr., Assistant Counsel of the Senate Committee on Banking and Currency, visited the Exchange.

They first met briefly with Mr. E. C. Gray, Executive Vice President, and Mr. G. Keith Funston, President, in the company of myself and A. B. Chapman.

I then showed them the mechanics of the market operation--how the orders are received on the Floor; the tube system; the various types of members (commission brokers, $2 brokers, specialists, odd-lot dealers, etc.); the functions of the clerks and our employees; our recording system; the ticker system, and the quotation system.

We then met with Henry M. Watts, Jr., Vice Chairman, who described the functions of the broker and he executed in our presence several orders in Unilever, which was extremely active.

I had Silver and Lowe to lunch in the Chairman's Dining Room where we were joined by Roger Wickers, since Mr. Chapman and Mr. Gray were involved in other luncheons.

We spent the rest of the day with Governor Walter N. Frank, who explained in great detail the specialist system and demonstrated the performance of the agency and the dealer function of the specialist.

During the course of Mr. Frank's explanation concerning the stopping of stock for a selling order against a buying order on the book, Silver questioned whether it wasn't detrimental to the interest of the buying customer, even though the principal purpose of the stop was to permit the specialist to do better for the seller. Mr. Frank explained that this is a procedure which is followed because it is felt that, over the long range, it provides the most good for the most people most of the time. He also showed how this practice narrows the spread between the bid and offer price; for example, if the stock is bid for at 50 and the offer is 50 1/2, stopping stock for a seller and offering his stock at 50 1/4 narrows the quotation spread by 1/4 point. Mr. Frank Further demonstrated that this leads to better price continuity (narrower variations between sales).

Mr. Frank also showed how the specialist may assume a position in a stock, for the purpose of making a market, and expose himself to a substantial risk and possible loss. He gave as an example the purchase of some 20,000 shares of Flintkote at around 26, and the purchase of an additional 10,000 shares on the way down to 23. The price at the time of the discussion was around 23 1/4. Mr. Frank emphasized that if demand developed for it he would be obligated to sell his position at reasonable price variations on the way up, even though the cost price of most of his stock was at the 26 level. Lowe then asked what would prevent the specialist from letting the stock rise quickly to the higher price level before disposing of any of his position, and then selling his stock at the higher prices. I stated that any such thinness of market on the way up would quickly be detected by the Floor Governors or our Staff and that certainly the buying brokers who were attempting to purchase the stock for their customers would immediately complain. I also pointed out the likelihood of such a quick runup being detected immediately by the Stock Watching Division.

Lowe then raised the question of long term positions of specialists. He posed the possibility of a specialist having a long term position and having demand develop in one of his stocks. I told him that the Exchange considered any long term position of the specialist unit as being available to the market and that the specialist must stand ready to either offer such stock or go short in his trading account against the long position. Lowe pursued the point further by giving a possible example of a specialist maintaining a reasonable and orderly market by selling stock from his trading account, but still holding stock in his long term investment account, stating that if he offered the long term stock as well as the stock in the trading account the market would be still more liquid then it would be if the specialist offered only the stock in the trading account. In answer to this I informed him that the Exchange would have no objection to a specialist retaining a long term position in the stock of a company concerning whose future he was optimistic, provided that the market he maintained during the price rise was fair and orderly and, in our judgment, in the light of the type of security and prevailing conditions, was one which had reasonable depth.

Governor Frank did an excellent job of explaining the functions of the specialist and answering the questions which were put to him.

After the close we met briefly with the Chairman in his office.

We then returned to my office and I explained in detail our methods of policing the specialists' dealings. No significant questions were asked concerning this area.

Today (December 14), Silver spent his time at the American Stock Exchange. Lowe visited me again, and before the opening we returned to the Post of Governor Frank who demonstrated the procedures which are followed in opening stocks.

I introduced Mr. Lowe to Governor John A. Coleman. Then, we spent some time with Governor John Phelan who gave some further explanations concerning the specialist functions. Thereafter, we met briefly with Governor Robert Stott who added some additional thoughts and showed Mr. Lowe some of the positions he was carrying, some of which involved losses.

We then had a brief visit in the Bond Room where Harold DeBlayker and I described how the market is conducted in cabinet bonds and in the active bonds.

We then had lunch with Messrs. E. C. Gray, A. B. Chapman and S. L. Rosenberry.

Lowe, Chapman and I then visited Lee Arning, who explained the Stock Watching procedures in some detail.

We then visited with Frank Coyle who explained the functions of his Department, with particular reference to the questionnaire system, the work of the Examiners and their yearly surprise visits to member organizations. In this connection, I pointed out that one of the things which Examiners look for during such visits is unusual activity in accounts carried, service or introduced by specialists in stocks in which they are registered. We also explained how the capital questionnaire system serves to supply The Floor Department with information concerning the capital of specialists, over and above that which is necessary for the protection of customers, and that this is supplemented by additional questionnaires from The Floor Department four times each year to those specialists who are not subject to the questionnaire system of the Department of Member Firms.

Lowe and I then returned to my office and I gave him an explanation of our policing of Floor Trading. This was a brief explanation because Mr. Lowe had to leave.

Lowe explained that he had been assigned by the Committee to the SEC investigation and it was his job to cover not only the specialist and Trading Floor aspects, but the whole broad area of the investigation, including the over-the-counter market, mutual funds, etc. He is unsophisticated concerning the stock market, but his general approach and the questions he asked indicated that he is very intelligent and that he had read many of our rules and policies concerning the Floor.

Altogether, the visit was conducted on a pleasant tone. I told both Silver and Lowe that if they had any further questions, they should not hesitate to get in touch with us.

W. K. Vanderbeck

Copies to: Mr. E. C. Gray
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