The Special Study concludes and recommends:

1. The purpose, nature, and significance of trading by members from off the floor remain concealed in the aggregate data reported by such members to the NYSE each week. Because this trading on occasion accounts for a large percent of total trading in individual stocks, and may therefore have a substantial impact on the trading in such stocks, the propriety of expanding the present reporting requirements of members trading from off the floor should be considered by the NYSE and the Commission.

Part H. Short Selling

Short selling not only is used by exchange members and members of the public for speculative purposes, but is used also by arbitragers, specialists, and odd-lot dealers to facilitate market operations, and is used generally for hedging and tax purposes. The practice was the subject of much difference of opinion during the congressional scrutiny which led to passage of the Securities Exchange Act of 1934, and at least after each major downward plunge of market prices, its utility and impact have been vigorously debated.

The Exchange Act made short selling subject to the full regulatory power of the Commission. The current rules governing the practice incorporate limited changes from the original. Short selling is allowed only at a price above the last different one; also, short sales must be marked "short" on the order slips. Various exemptions have been made from the price requirements, the most important of which are for arbitrage transactions. Exempt short sales are required by the Exchange, with the concurrence of the Commission, to be marked "short-exempt." The Special Study's investigations suggest that there is some laxness in the observation of the Commission's short-exempt rules, and that the records by which compliance may be checked are not adequate.

The only data regularly compiled and published concerning short sales are daily aggregate figures for all stocks on the New York and American Stock Exchanges, and monthly figures on the short positions in certain stocks of the NYSE and in all securities of the Amex. Analysis of such data permits only broad conclusions about short selling practices. In recent years, such selling has varied from a low of about 3 percent to a high of over 8 percent of total NYSE share volume, dropping to the lower percentages as stock prices reach a peak and advancing to the higher as prices approach their bottom levels. This tendency for the ratio of short sales to increase as a market decline progresses, which is attributable principally to increased short selling by nonmembers, calls into question the classic argument that short selling (because of later covering purchases) has a stabilizing influence during market declines.

Ordinarily, nonmembers' round-lot short selling in the aggregate is small compared with their total round-lot sales, especially toward the end of a sustained rise, when the ratio tends to fall below 1 percent. During market declines the ratio has risen to around 2 to 5 percent, while in the critical break of May 1962, the ratio rose to more than 4 percent and to almost 7 percent during the further decline in June. The odd-lot short sales are quite small compared with round-lot short sales during advancing markets, but rise, relatively, as the market dips downward; during the May–June decline, the ratio increased to more than 6 percent.

Specialists do the greatest amount of short selling, partly because their obligation to maintain fair and orderly markets frequently leads them to make short sales. In recent years, their short selling ordinarily has represented 40 to 70 percent of total short sales. As a percentage of their own total sales, specialists' short selling is predominantly between 15 and 20 percent, and has a tendency to decrease on market advances and to increase in market declines. Off-floor members' short sales represent 10 to 25 percent of total short selling, and range predominantly from 8 to about 25 percent of their own total sales. More markedly than specialists, they tend to decrease their short activity on advances and to increase it on declines. Floor traders' short selling accounts for only 2 to 10 percent of total short selling. However, as a portion of their own total sales, floor traders' short sales range predominantly from 5 to 15 percent, and—at least relative to other members' short sales—appear more volatile in their rising in weak markets and falling in strong ones.

The number of stocks with relatively large short positions tends to rise as the market declines and to fall as the market advances. In general, however, 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 strong concentration of short selling in a relatively small number of stocks suggests that the aggregate data used above, although useful to portray broad patterns, tend to obscure the true significance of short selling. It is well established that the price action of these stocks has a wide-ranging effect on stocks in general. Because of the concentration of short selling in such stocks, therefore, the practice has a more telling influence on the market than is indicated by the aggregate statistics. Accordingly, it is important to examine short selling with respect to individual stocks and to pinpoint this selling, as much as possible, to specific instances of time. For that purpose, reference was made primarily to short selling in eight selected stocks during 14 selected days prior to, and during the 3 days of, the market-break period in the last week of May 1962.

Most of the eight stocks experienced a declining trend during the period of the 14 selected days prior to the market break, and all of them showed a decline during the latter part of the period. Yet short selling in a number of instances rose to over 8 percent of total reported sales, and in two stocks to over 30 percent. Contributing to this large volume of short selling were varied factors, such as in the case of U.S. Steel, the dispute with the Government about steel prices, in a stock such as Korvette, a general speculative interest, and in the case of Avco, the specialized transactions of a few members.

Of the total short selling in the eight stocks during the May 28–31 market-break period, over 75 percent occurred in four of them, A.T. & T., Avco, Korvette, and U.S. Steel, with the bulk of such selling taking place on the second and third days. Nevertheless, on the day of the actual break, May 28, over 10,000 shares were sold short in each of 3 stocks and some short selling occurred in each of the remaining 5. In the cases of both U.S. Steel and Korvette, short sales constituted over 16 percent of total sales. A detailed analysis of each of the eight stocks on May 28 reveals that much of the short selling came during spells of decline. Creation of this extra supply of stock when the market already was under heavy selling pressure undoubtedly contributed to the downward movement. In addition, an awareness of this augmented supply may well have tended to cause professionals on the floor of the Exchange, including the specialists, to diminish and withdraw their buying.

This emerging picture of a substantial volume of short selling in prominent stocks during intervals of price weakness indicates the inadequacy of current rules to cope with the harmful effect of short selling which they were devised to prevent. The presence of extra selling burdens during a market which is generally weak may be a contributory factor during a period of market break. An important aspect of the inadequacy of the current rules is their reliance upon a "tick test," which goes on a "trade-to-trade" basis making short selling permissible at prices above the last preceding different price. There is need for a rule of broader perspective, focusing not upon the "trade-to-trade" situation but upon the underlying trend, so as to be an effective limitation on short selling in a security when its market is under extraordinary selling pressure. Before enactment of such a rule, its effects should be thoroughly explored to insure that it meets its intended purpose without limiting the use of short selling in other market conditions. There is need also for the Commission's rules to provide for rapid action to prohibit short selling in a particular security or in general, in emergency situations.

As has been indicated, the primary objectives of the current rules are to prevent the use of short selling either to effectuate a "bear raid" or to accelerate a declining trend. While the Special Study has not uncovered any evidence of the use of short sales to spearhead a "bear raid", it has concluded that short sales may contribute importantly to accelerating the trend of a falling market. The present up-tick limitation, complemented by one or some combination of changes such as those suggested, would preserve those features of short selling that are in the public interest.

The Special Study concludes and recommends:

1. The two series of data on short selling presently compiled by the New York and American Stock Exchanges are inadequate for regulation. The series are neither compatible nor are they useful in indicating the degree of short selling in individual issues, the effect of such selling on the price stability of a security, or whether the provisions of the Commission's rules are being observed. Accordingly, the Exchanges should initiate systems of reporting 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. Monthly data on the short interest should show corresponding information in the selected individual stocks. In addition, consideration should be given the feasibility of indicating exempt short sales and furnishing information on the other types of short sales such as "against the box," arbitrage, and hedging. The Commission also should consider the extent to which short sales data should be reported by other exchanges. The Commission should designate the information to be furnished to it on a regular basis, and should

also determine the extent and type of short selling data to be made available to the public.

2. It is difficult to determine the extent to which short sales are being made on "minus" or "zero-minus" ticks in the guise of exempted arbitrage transactions, but there is some indication that advantage is being taken of this exemption. The stock exchanges should examine current procedures for marking transactions as "short-exempts" and institute checks to insure that this marking is accurate, and thereafter the Commission should review and evaluate the procedures adopted.

3. Present rules appear inadequate to relieve the added pressure that short selling may create during a severe decline in the general market or a declining price trend in a particular security. Despite the rules, a relatively large volume of short selling occurred in particular stocks, including "market leaders" and "trading favorites," during the period of decline preceding the market break of May 28, 1962, and at critical junctures on that day, and many additional opportunities existed when short selling could have occurred. Accordingly, the present up-tick limitation should be supplemented by a rule or rules designed to cope more effectively with the potentially depressing effects of short selling during price declines. While the Special Study is not prepared to suggest the exact form of such rule or rules of general application, among the possibilities to be considered would be: the prohibition of short selling in a particular stock whenever its last sale price was below the prior day's low; or alternatively, whenever the last sale price was a predetermined dollar amount or percentage below a base price (e.g., the prior day's close or low or the same day's opening) as specified in the rule; or instead, given the circumstances of such a decline, a limitation of short sales in any particular stock to a predetermined proportion of the amount of stock available at the prevailing market. As a further precaution for times of general market distress, the Commission's rules should provide for temporary banning of short selling, in all stocks or in a particular stock, upon an appropriate finding by the Commission of need for such action.

PART I. COMMISSION RATES

Stock exchange commission rates—the fees paid to a member of an exchange for effecting transactions on the exchange—are established by rules of the respective exchanges, subject to review by the Commission. Section 19(b) of the Exchange Act authorizes the Commission to review, and—if "necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange"—to alter or supplement, the rules of registered exchanges with respect to the "fixing of reasonable rates of commission * * *." In examining the subject of commission rates the Special Study has been concerned, first, with the structure of rates and the impact of that structure on the securities markets generally and, second, with the procedures and standards involved in the setting and review of rate levels. It has not considered or evaluated specific commission rates, past or present.

The NYSE nonmember rate schedule has been followed, with few variations, by the Amex and the regional exchanges. Since 1947, commission rates have been based on the money involved per round lot. The amount of the commission per round lot varies with the value of the stock, but the schedule omits other possible differentiations: all nonmembers, whether or not professionals in the securities business, pay the same public commission rate (the Amex and some of the regionals provide important exceptions here); the rate per round lot is the same regardless of the number of round lots involved in a transaction; and the rates include the cost of various services provided by members to customers, ancillary to the basic brokerage function.

Among the consequences of these characteristics have 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. Some are aimed at special treatment of nonmember professionals. Most important are the reciprocal arrangements between NYSE members and nonmembers who are regional exchange members (i.e., sole members) which permit NYSE members to reciprocate for commission business given them by the nonmember by referring other commission business (often for stocks traded on both the NYSE and the regional exchange) on an agreed ratio, for transactions by the nonmember on the regional exchange. Of the 447 sole members of the 4 largest regional exchanges who reported to the study, 298 participated in such arrangements, 175 attributing a minimum of 20 percent of their income to this source. Nonmember professionals forwarding business to NYSE members may also receive substantial special services, extending beyond the usual services performed by Exchange members for their public customers.

The absence of a block or volume discount in the schedule has given rise to similar arrangements between NYSE members and some of their larger customers, generally institutions. Members also perform a wide variety of special services for such customers; these include special research projects, installation and maintenance of wires, and the development of sales and promotional services for mutual funds. In addition to these services, block and volume investors—chiefly mutual funds (see also ch. XI.C)—are permitted to direct reciprocal give-ups of commissions. This practice allows the mutual fund to instruct its broker to give up a portion of the commission to another broker in return for services which it has rendered to the fund or, more usually, its underwriter or adviser. The regional exchanges have been employed to channel such give-ups of commissions to their members and, in the cases of three of the regionals, to certain classes of nonmembers who are members of the NASD.

The various practices designed to ameliorate or avoid the impact of the Exchange's commission schedule have produced a variety of questionable consequences. They have greatly complicated the administration of the commission schedule, requiring subtle and shifting lines of distinction between prohibited rebates and permissible arrangements. They have involved not only the NYSE's regulation of the practices of its own members but also its relationship to other exchanges. They have, to some extent, clouded the cost data used to support changes in commission rates. Two of these practices, the reciprocal commission arrangements and the give-ups of commissions, have created delicate conflict-of-interest questions. Despite these consequences, the practices have not fully met the underlying needs, and their failure to do so has spurred a diversion of trading volume from the NYSE to other markets.[4]

Another structural characteristic of the NYSE's nonmember commission schedule is its coverage of services performed by brokers in addition to the execution and clearance of transactions. Such ancillary services are generally not charged separately, and their cost is included in the basic commission rate. The practice encourages competition among brokerage firms in the area of service, but it also aggravates the impact upon institutional investors of the absence of a volume or block discount since they often do not require ancillary services provided by brokers to other public customers.

From time to time the NYSE has considered possible solutions to these major problems of rate structure but has rejected them. In 1953 a thorough overhaul of the rate structure proposed by a special Exchange committee was repudiated by the membership (after revision by the Exchange's Board of Governors). In 1959 the Commission announced that the Exchange had agreed to initiate study of a block or volume discount, but the latter study was not commenced until late 1962. It is essential that studies of the rate structure proceed with dispatch and that attention be given to the many facets of the problem affecting competitive markets as well as the Exchange, not from the limited view of the Exchange (or groups of its members) but of the greater public interest involved.

Review of the level of commission rates presents at least equally complex problems as those of rate structure. The unique character of the security commission business precludes any blanket adoption of standards employed in reviewing rates in other industries. Factors shaping that character include (1) the multiplicity of firms (even though the total is limited), (2) an erratic and largely uncontrollable volume factor, and (3) competition with other markets and other media of investment.

The various changes in commission rate level which have taken place since enactment of the Exchange Act have been explained on the basis of a relationship, variously stated, between commission rates on the one hand, and income, costs and profits, on the other. Important questions are presented at every stage of the determination. Thus, the basic operating data for the individual firm are reported on 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 2 years earlier. The present form is a notable improvement over its predecessor but 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.

While the "profit" of the member firm from its security commission business, as derived from the income and expense report, has been considered relevant to the setting of "reasonable" rates, its significance has not been made clear: changes in the content of the term (for example, including or excluding interest earned on customers' debit balances

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[4] See ch. VIII, D and E (pt. 2).

in margin accounts) have given it different meaning at different times, and dollar amounts have been converted to percents of commission income without an indication of the significance of the result in relation to professed objectives of "fair return" or the statutory standard of reasonableness.

The multiplicity of firms complicates the determination of "reasonable" rates in relation to income, cost, and profit data. One type of question relates to whether data are to be combined in respect of all firms, "efficient" ones (however that term may be defined), or any other grouping. Another relates to the types and amounts of costs to be recognized, in a context of competition among firms and with other markets and in light of the public interest in promoting a high level of performance in the securities commission business. Further, characteristic fluctuations of volume and the relatively high proportion of fixed costs in the securities commission business add complexities to the determination of "reasonable" rates applicable to a multiplicity of firms.

Both the nature of the problem of arriving at "reasonable" rates and the manner in which the rates are initially set by exchange rule point to the importance of the Commission's role of oversight to protect the public interest in this area. Improvements appear to be called for in three respects. First, there is need for more complete data to be gathered on a continuous basis, relating not alone to the securities commission operation but to its place in the economics of the securities business generally. Unit cost and transaction data would be useful for a proper understanding and evaluation of the rate structure. The income and expense report should generally provide the information necessary for application of such criteria of reasonableness as may be adopted.

The second major desideratum is the public articulation by the Commission of such criteria. This appears to be one of those "basic matters" which calls for the "need of a more carefully articulated enunciation of * * * views * * * in the interest of clarifying policy not only to outsiders but to the Commission itself."[5] The goal is not to strive for exactitude in satisfying a specific rate formula, but to adjust divergent interests in accordance with reasonable, objective standards. A clear articulation and public expression of such standards by the Commission must be considered a major objective.

Finally, the procedure for the review of commission rates requires strengthening. Under section 19(b) of the Exchange Act, which defines the relationship of the Commission and exchanges in this area, it is possible for the Commission to be confronted by a commission rate change, without previous notice, as an accomplished fact. This has been ameliorated by agreement after the 1958 increase, but the importance and complexity of the Commission's role require strengthening of procedural arrangements with the exchanges and of the Commission's internal arrangements for fulfilling its role.

The Special Study concludes and recommends:

1. The present nonmember commission schedule of the New York Stock Exchange does not take account of important distinctions such as (a) whether the nonmember is or is not a pro-

[5] 3–B Sharfman, "The Interstate Commerce Commission," p. 764 (1931–37), quoted in Friendly, "The Federal Administrative Agencies," p. 142 (1962).

fessional in the securities business, (b) the effect of volume of a particular customer's business (whether measured by size of single orders or volume of orders over periods of time) on the cost of serving that customer, and (c) a particular customer's use or nonuse of ancillary services covered by the commission rate. Each of these aspects is far too complex in its own right and too involved with other complex questions to be the subject of specific recommendations of the study—indeed they are probably not capable of simple answers after longer study. The broad conclusion can be reached, however, that they involve important questions of public policy to which the Commission should address more positive and continuous attention than it has heretofore given.

2. Under the present rate structure of the New York Stock Exchange, members are required to charge the same minimum commissions to all nonmembers including nonmember broker-dealers, with the result that a nonmember broker-dealer has no incentive to bring business to the exchange except by resorting to one of several complicated, and often artificial, devices that have been created to provide indirect compensation. The Amex and various regional exchanges, on the other hand, have forms of associate memberships or special commission rates for specified categories of nonmembers (including non-broker-dealers in some instances); and the availability of these measures on regional exchanges has been the basis of some forms of reciprocity and the source of some business on such exchanges. 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.

3. The absence of any volume discount in the commission rate structure of the NYSE has had the effect, among others, of inducing mutual funds and their brokers to adopt various arrangements to channel a portion of commissions paid by them for portfolio transactions to other members and nonmember broker-dealers as extra compensation for selling mutual fund shares. The Commission announced in 1959, in connection with its consideration of other aspects of NYSE commission rates, that the Exchange had agreed to undertake a study of a volume discount, but it appears that such study was not begun until late in 1962. In view of the public importance of the subject and the complexity of the issues involved, the Commission itself should undertake a broad study with the aid of or in conjunction with the exchanges and other affected institutions and parties.

4. The present nonmember commission rate of the NYSE does not provide any reduction in commission for customers not desiring or using the ancillary services usually included under the commission schedule and thus gives added incentive to various forms of reciprocity. As part of its general and longer range studies in respect of commission rates, 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.

5. In relation to the brokerage business—a service business—the term "reasonable" rates cannot have the same meaning as in utility rate regulation involving a property base, yet there have been no official expressions of its significance in the present context. While the determination of "reasonable" rates of commission is an extremely complex matter at best, objective standards for measuring reasonableness could and should be more clearly enunciated by the Commission. Among other questions in need of clarification and definition of policy are: the extent to which cost and income experience of more efficient firms, as distinguished from "representative" firms, should be the basis of fixing "reasonable" rates; the treatment of commission splitting or "give-ups," when not compensating for services in connection with brokerage transactions on the exchange; the inclusion or exclusion of interest income on customers' debit balances; the concept of "fair return" and, in relation thereto, the appropriate treatment of invested capital and of partners' or stockholders' compensation.

6. The income and expense report form of the NYSE in its present form or as revised from time to time should be required to be filed by all member firms doing a public commission business and, with appropriate modification, by other categories of member firms deriving income from member or nonmember commissions. Similar reporting should be instituted by the other principal exchanges. The Commission should regularly receive copies of such reports (with or without identification of firms) and through this means and otherwise should keep advised of the economics of the securities business insofar as relevant to the fixing of reasonable rates of commission. Since volume of trading has important bearing on profitability and therefore on reasonableness of commission rates, 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. Consideration should also be given to the feasibility of establishing unit costs for various components of the brokerage function and ancillary services, as a further guide in applying the "reasonable" standard on a continuing basis.

7. To place rate review by the Commission on a more orderly and efficient basis, existing procedures should be modified to assure that proposed changes in rates will be submitted to the Commission adequately in advance of their proposed effectiveness; and consideration should be given to the feasibility of providing that, where an increase becomes effective pending the Commission's review, refund or adjustment will be made in respect of any part of the increase not ultimately approved.

8. While the odd-lot differential is theoretically an adjustment of the price charged the customer's broker rather than a commission, in practical effect to the customer it is another element of the cost of effecting a stock exchange transaction. Customers' confirmations of odd-lot transactions should be required to show separately the odd-lot differential and the brokerage commission.

PART J. AUTOMATION—ITS NEEDS AND POSSIBILITIES

Technological innovations have been utilized increasingly in the exchange markets. Some member firms have used automated techniques to transmit orders from the point of origin to the floor of the NYSE as well as in their own back office operations and in supervision. The clearinghouse of the NYSE uses electronic equipment to great advantage and the Exchange's unique "stock-watch" procedures rely on these devices for surveillance purposes. The Midwest Stock Exchange has pioneered in the development of centralized bookkeeping for its members.

However, despite the NYSE's interest in automation, as signified by the establishment of its Department of Operational Planning and Development in 1960, progress with respect to exchanges' trading mechanisms has not been impressive. The possibilities of modern technology may go beyond mechanical arrangements and involve such functional matters as the execution of some orders from off the floor. This does not mean that possible changes of this kind are necessarily desirable but it suggests that they ought to be objectively explored and evaluated. The public, through the Commission, has an interest in such exploration.

Other possibilities for the fruitful use of automated techniques may lie in the accumulation of reliable, comprehensive and current market data. At present the Exchange and member firms file many periodic reports on a variety of subjects, each of which is designed for a specific purpose. The processing of these reports does not make use in any substantial degree of modern data processing techniques. Also, since the reports cover different periods and are differently designed, the information they contain cannot be integrated to present a comprehensive picture of market trends or current transactions.

As a particular problem, improvement is needed in the reliability and completeness of volume data. Various studies have shown that such data are unreliable and incomplete under the present reporting systems. Furthermore, much information is lost at the time orders are executed which would be valuable for market surveillance and other purposes. The automated reporting procedures recently announced by the NYSE will not result in more accurate reporting or the preservation of more data than under the present system.

The Special Study concludes and recommends:

1. Automation, in the form of electronic communicating and data processing devices, seems certain to have an increasingly important impact on exchanges as trading markets and as self-regulatory agencies in various ways. For example, in connection with the handling of odd lots, reference is made to the discussion and recommendations of part E of this chapter; and in connection with surveillance of specialists' activities, reference is made to the discussion and recommendations of part D of this chapter. The potential impact of automation in these and other respects is affected with a public interest and the Commission has a present and continuing responsibility to be informed of developments and potential developments in this area.

2. The NYSE should promptly undertake to revise its floor reporting procedures so that volume data will be complete and

accurate. In this connection the Exchange's recently announced automation procedures should be restudied with the view to obtaining and preserving more market data at the time orders are executed than is presently the case.

3. The Commission and each of the major exchanges should jointly undertake studies of the periodic reports filed by member firms with the respective exchanges and by the latter with the Commission, with a view to simplifying and coordinating the reports and maximizing their usefulness. Also, they should jointly consider possibilities for developing and coordinating their automation programs in such a manner as to fulfill the needs of each with maximum effectiveness and minimum burdens, duplication, and expense.

CHAPTER VII

OVER-THE-COUNTER MARKETS

The term "over the counter" encompasses all business in securities that is not done on an organized exchange. This definition is sufficient to suggest two of the most important characteristics of over-the-counter markets: first, their diffuseness—the absence of a centralized marketplace and the resulting strong dependence on dealer participation and on communication systems; and, second, their heterogeneity—the variety of securities, participants, and practices that results from their being a residual category encompassing "all other," i.e., all nonexchange, business in securities.

The heterogeneity of the over-the-counter markets is stressed at many places in this chapter. It means, among other things, that generalities in description are difficult and sometimes dangerous, and that recommendations that may be essential in some sectors may be unnecessary or inapplicable in others. As in other parts of the report, more attention is necesarily concentrated in this chapter on problem areas than on areas of achievements and strength. Where, for example, there is discussion of diligence in obtaining best executions, it is not to be overlooked that many firms scrupulously discharge their obligations in this regard. Where there is discussion of varying costs of execution, it is not to be overlooked that within the indicated range of variations most transactions are handled on an agency basis with disclosed commissions or on a principal basis within the guidelines of the NASD markup policy. By the same token, however, there are significant deviations and problems in these and other respects, and it is to these that attention needs to be given. With the hope of bringing marginal performance closer to the level of the best performance and generally improving the functioning of over-the-counter markets in the interest of investors, a number of different types of measures are recommended below.

1. NATURE AND GROWTH OF OVER-THE-COUNTER MARKETS

In recent years the volume of over-the-counter trading has grown dramatically. In 1961, the dollar volume of stock sales in the over-the-counter markets was approximately eight times as great as in 1949. This increase in growth was acompanied by an increase in the number of issues traded in the over-the-counter markets—issues which varied widely among themselves in numerous respects.

Broker-dealer participation as principal is more conspicuous and important in the over-the-counter markets than in exchange markets. There is a significant dichotomy between the wholesale (or interdealer) market and the retail (or public) market, but with important interaction between them. The broker-dealer firms doing business in the over-the-counter markets may be broadly classified into wholesale dealers, retail dealers, and integrated firms. Wholesale dealers buy and sell selected securities for their own account, dealing with other broker-dealers. Retail firms execute purchases and sales with or for public customers by dealing with wholesale dealers. Integrated firms conduct both retail and wholesale activities. Any given firm conducting wholesale or interdealer business, whether classifiable as a wholesale or integrated firm, conducts such business with respect to only a fraction of all over-the-counter securities. Thus an integrated firm may strictly be regarded as such only in respect of securities in which it makes an interdealer market; if it does retail business in other securities, it does so in the capacity of a retail rather than an integrated firm as here described.

The professional participation of the wholesale dealer (including the integrated firm acting as wholesale dealer) is necessitated by the absence of a central location for the collection, matching and execution of orders. By announcing his willingness to buy and sell for his own account, he makes it possible for a member of the public to dispose of securities without himself attempting to locate an ultimate public buyer, and for a buyer to acquire shares without searching out the ultimate public seller. By performing this intermediary function the wholesale dealer lends marketability to securities traded over the counter; and to the extent that he purchases or sells on balance for his own account, his participation adds depth to the market.

Over-the-counter business is done by a large number of broker-dealer firms but volume is concentrated in a relatively small percentage of broker-dealers both at the wholesale level and the retail level. The retail concentration features a predominance of NYSE member firms, which account for more than half of the dollar volume in corporate stocks. Many NYSE members also act as wholesale over-the-counter dealers in corporate stocks but in this area nonmember firms do a greater volume. In fact, seven of the nine largest wholesale dealers are not members of the NYSE.

2. WHOLESALE MARKETS

Trading in the over-the-counter markets necessitates extensive communication among firms. In recent times communication facilities have been vastly expanded and improved; there now is a large network of connecting links between individual firms in the over-the-counter markets, with New York City in many cases acting as a communication center. Many of these communication links are private lines in which the firms on either end are known as correspondents of one another and have established a course of doing business with each other. Communications systems now permit dealers to keep rapidly informed of market situations and also permit facile and inexpensive contact by broker-dealers throughout the country with other broker-dealers.

The qualifications of individual traders conducting wholesale trading for broker-dealer firms vary widely throughout the industry. They are compensated in different ways, in some cases being paid a straight salary while in others receiving a percentage of the profits resulting from their trading activities. Traders may be responsible for handling anywhere from a few to more than 80 stocks. In general, supervision of traders is quite limited.

Wholesale dealers commence trading primarily because of the expectation of activity. When activity falls off, the wholesale firm may lose interest and discontinue trading unless it feels an obligation as a matter of good business practice to continue to provide a market for customers to whom the security has been sold by the firm itself, its correspondents, or other firms with which it does significant business. Some firms, particularly integrated ones, make markets in securities as an aftermath of serving as managing underwriter of a public offering, in which case a continuing obligation of "sponsorship" may be felt. 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.

Once having commenced trading, the market maker's performance is governed by competitive considerations in many situations and by general provisions against fraud and manipulation in all, but is subject to few specifically defined obligations or restrictions. Some firms feel that the function of the wholesale dealer is simply to make a profit by adjusting to supply and demand and reflecting the market's opinion. Others assert that the wholesale dealer has an obligation to maintain a fair and orderly market. Most members of the industry would regard a good wholesale market as one in which firm two-way quotations are maintained by several competing dealers, spreads between bid and asked prices are reasonably narrow, quotations are "good" for a substantial number of shares, and price fluctuations are kept to a minimum. The extent to which these criteria are met in practice is subject to wide variation, however, primarily because of the wide differences in securities and participants in over-the-counter markets, and also because such pertinent regulatory standards as exist, e.g., the NASD's standards regarding fictitious quotations or "backing away" from presumably firm quotations, have not been supplemented by adequate surveillance and enforcement measures.

The ultimate safeguard for the integrity of interdealer markets is often said to be the factor of competition among dealers. Where competition does exist among several or many dealers, as in the more prominent and active stocks, each competing dealer tends to make a closer market. Moreover, because of the diversities in positions, resources, and expectations among dealers, there may be an even smaller spread between the highest bid and lowest offer in the total market for a security. Thus, competition presents both an opportunity and an obligation for the customer's broker to obtain, upon the exercise of reasonable diligence and care, considering the kind and size of the order, the best market for the customer.

The very breadth and variety of over-the-counter markets means, however, that they include many securities for which at any given time only one or two dealers at most are actively making a market, so that the factor of competition is minimal or nonexistent. Moreover, the appearance of several dealers' active interest in a security may not be a reliable indication of a competitive market, either because most of them are in fact appearing for one and thus making a single market or because "holding hands" or similar practices may restrain actual competition. Regulatory measures appropriate for genuinely competitive markets may thus be quite inappropriate or inadequate for those where competition is lacking, whether this fact is readily apparent or is disguised under an appearance of competition. A minimum need is to provide better means for the investor and the regulatory agencies to distinguish the latter situations.

The problems of the noncompetitive market partially overlap with those arising out of the role of the integrated firm—the firm which actively engages in both wholesale and retail dealing in a security. There is considerable variation in concepts and practices as to the relationships between wholesale and retail activities in integrated firms, but there are typically two characteristic features that differentiate the integrated firm from either the "pure" wholesale or exclusively retail firm. First, the integrated firm may and often does use its retail department as an outlet for disposing of inventory positions resulting from trading; in other words, unlike the pure wholesale firm it is not limited to using its interdealer quotations and transactions to adjust positions but may conduct its wholesale trading with the expectation of disposing of positions "away from" the wholesale market through retail channels. Second, retail transactions, particularly on customers' purchases, are likely to be on a principal basis out of inventory with the customer frequently acting on the dealer's recommendation. The potential conflict of interest inherent in the dual role, although normal in all merchandising activities 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 or disclosures to retail customers at the time of solicitation and in confirmations do not appear adequate in light of possibilities of abuse.

The wholesale dealer is frequently used by institutional investors in handling large distributions and acquisitions in the over-the-counter markets. The dealer's ability to handle such transactions is partly a result of the fact that other broker-dealers may be expected to channel their inquiries to it and deal on the basis of its quotations, so that the price impact of even a large transaction often may be kept to a minimum. There is considerable flexibility in methods of handling dispositions of blocks, reflecting the fact that various merchandising and distribution methods are available in the over-the-counter markets. There is also evidence that some regulatory requirements that might 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.[1]

During the early months of 1962, preceding the severe market break at the end of May, some wholesale dealers discontinued certain of their markets, particularly in speculative issues, and there was a general tendency among wholesale dealers to reduce inventories, to quote wider spreads, and to reduce the "size" of the quoted market or quote only on a "subject" basis. During the actual market break days the latter tendencies were sharply accentuated, partly as the result of communication difficulties. The inability of many wholesalers to perform in anything like their normal fashion apparently reduced

[1] See the recommendations in ch. IV.B and C with respect to clarification of the application of rule 10b-6.

the level of liquidity in the over-the-counter markets to a substantial degree.

Wholesale over-the-counter markets are generally characterized by an absence of specific regulatory standards governing the conduct of trading. 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 import depend mostly upon the varying economic interests and business practices and standards of individual firms rather than specific regulatory standards. It is not meant to suggest that uniform or detailed standards would be feasible or appropriate for all of these matters, but it would seem that greater attention should be given to this general subject by the NASD and the Commission, in some respects immediately and in others on a longer range basis.

Wholesale dealers advertise their buying or selling interests in securities by placing quotations in wholesale quotation systems. As recognized by Congress in section 2 of the Exchange Act, there is a vital public interest in the fairness and integrity of quotation systems, both wholesale and retail. At present, there is one significant wholesale quotation system, operated privately, possessing monopoly power, and subject to no direct regulation. It is operated by the National Quotation Bureau, Inc., and consists of daily mimeographed "sheets" containing listings for each security of wholesale bid and asked quotations (or in some instances merely indications of interest on one or both sides of the market, without price) supplied by subscribing broker-dealers who elect to do so for any security. The sheets are generally available only to subscribing broker-dealers, but some banks and investment advisers are subscribers and some institutions and other sophisticated investors have ready access through broker-dealers.

The Bureau exercises final control over who may enter quotations, and thus, in large degree, over who may do wholesale business in the over-the-counter markets; what minimum capital may be needed to do such business; what securities may be listed; and what kind of listings may be made. The Bureau appears to have operated with a conscientious regard for the responsibility which its function and dominant position entail. It investigates the past business history of those who wish to insert quotations and requires that applicants have a certain minimum capital commitment to the business. It reserves the right to cancel a subscription for inserting nongenuine listings or for engaging in "any unethical business practice" and it is understood that the insertion of suspect listings has played a tacit part in some cancellations. Finally, the Bureau has cooperated with the Commission by turning over evidence of misuse of its facilities. In short, while hampered by insufficient authority and procedures, the Bureau has sought in various ways to insure the integrity and reliability of the sheets.

Experience and study indicate that scrupulous and well-intentioned efforts of the Bureau are not enough. In case after case broker-dealers have abused the wholesale quotation system through inserting fictitious quotations in connection with "boiler-rooming" worthless securities to the public.[2] Fictitious quotations have been inserted in the sheets to give an illusory value of stock to be pledged or to be distributed to the public in a registered offering. Some schemes have been utterly lacking in subtlety: quotations even of nonexistent companies have on occasion slipped by the Bureau's controls. Moreover, in significant ways the quotations published by the Bureau are not as informative as they could and should be. For example, the Bureau does not require a designation of the fact that one broker-dealer is quoting on behalf of another. This has resulted in exploitation for manipulative purposes, although there are legitimate uses also. Its significance in manipulation cases, its separability from other problems, and its ease of correction, make it a matter which should be acted upon at once. Furthermore, the quotations of the Bureau do not indicate whether a company is in bankruptcy or furnish other highly pertinent data about it, and despite the efforts of the Bureau many companies quoted have been liquidated, dissolved, or merged without notation of this fact in the sheets.

While the Bureau has acted conscientiously, it is anomalous, in markets so affected with a national public interest that it is "necessary to provide for regulation and control of * * * transactions and of practices and matters related thereto,"[3] that private hands hold such crucial powers without public regulation or review. In exercising these powers, the Bureau has inevitably had to leave much undone because of its limited authority as a private body. It is true that many of the problems that it has faced have not been merely matters of wholesale quotations, but rather, aspects of wider problems that have come in the wake of the enormous growth of over-the-counter markets. The end result, in any event, is that a crucial feature of the over-the-counter markets—indeed, their nerve center—has had inadequate controls.

Recent electronic developments leading to the possibility of competing systems, and the fact that the Bureau will eventually pass into other hands, only serve to emphasize the need for regulation. 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. There are many ways in which major harm to the integrity of the market could be accomplished by the entry of an unscrupulous operator of a quotations system, and there is no assurance that competition among private systems would be competition for higher standards of performance in the public interest.

The study of wholesale quotations points also to the necessity for a greater recognition of responsibility on the part of the NASD. As the self-regulatory agency for the over-the-counter markets, the NASD should at least maintain continuous surveillance and supervision over

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[2] In a statement to the study, the then chairman of the NASD's Board of Governors indicated that the Bureau has not been able to deal with abuses by certain broker-dealers:

"I would like to broaden your statement. You mentioned a while back certain underwriters, I think we should also include boiler shop types who have operated in New York in the last 5 years. Many of their quotations we know were not very accurate. This is a bit hard to supervise, and I do not think that Walker is able to supervise that. Sometimes these operators go in the sheets for another and quote a market 9½ to 10—but if you want to sell any stock at 9½ you can't do it. Any time that has come up we have called Walker and tried to rectify the situation."

The chairman of the National Quotations Committee also indicated doubts about the Bureau's ability to cope with the task.

[3] Exchange Act, sec. 2.

the members' use of wholesale quotation systems. The task of regulating and policing wholesale quotations might be eased considerably if the NASD itself were to operate the system. However, regardless of the role the NASD may in the future take with regard to wholesale quotation systems, such systems are at the heart of the over-the-counter markets and an appropriate regulatory scheme should be established vesting legal responsibility and authority in the operators of such systems and supervisory controls in the Commission.

3. RETAIL MARKETS

A broker-dealer may act as either principal or agent when dealing with a public customer. The study's data show that the majority of over-the-counter transactions of public customers in corporate stocks are handled on an agency basis but that institutions tend to deal on a principal basis to a greater extent than individuals. The proportion of agency transactions in individual stocks tends to decrease as one moves from less active to more active stocks. On the study's sample day there were approximately three times as many firms which acted only on an agency basis in transactions with public customers as there were firms acting only on a principal basis; and for purchases by individuals there was no tendency for small firms to act more frequently on a principal basis than large firms.

Firms with inventory positions in a stock usually act as principal when handling customer orders. This tendency appears to be more pronounced in sales to customers than in purchases from them. In general, the public has a greater volume of transactions with firms which do not have inventories in the particular security than with firms which do.

As seen above, competition in the wholesale markets tends to result in narrower interdealer spreads, while diversities among wholesale dealers may often result in differences in price for either a purchase or a sale of a given security at a given time. For the investor to receive the advantages of diversity and competition, his broker must check markets or "shop around" pursuant to his obligation to obtain the best price discoverable in the exercise of reasonable diligence. The results of diligently checking markets and negotiating for customers is apparently reflected in the generally more favorable executions received by institutions and broker-dealers who buy and sell in larger amounts and who may be assumed to expect diligent executions. While the NASD and the Commission have broadly recognized the principle of best execution, there has been little delineation through explicit standards of what it is supposed to mean in practice except insofar as individual firms have established standards for their own personnel. Less favorable executions may be caused in particular instances by a failure to check markets, by channeling of business to certain firms on the basis of reciprocal obligations or patterns of doing business, by indifference, incompetence, or venality of older clerks, or by the practice of interpositioning which in many cases involves an unwarranted payment to a third firm interposed by the retail firm between itself and the market maker.

The size of markups (or markdowns) in principal transactions and commissions in agency transactions is not governed by a fixed schedule in the over-the-counter markets. The spread between net prices paid and net prices realized by public customers appears to be largely related to whether the transactions are executed on a principal or agency basis. 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 how the firm handles it.

Principal markups ordinarily run higher than agency commissions and they are even higher in so-called riskless transactions (where the dealer sells as principal to his customer and concurrently buys the security sold), which constitute a substantial proportion of retail transactions by dealers as principal. One effect of using the principal form in what is essentially an agency execution is that the broker-dealer's cost and his markup are not disclosed. Not only does the customer typically pay more in a riskless transaction than he would in an agency execution, but he also usually pays more than he would pay in a principal transaction with a firm having a position.

The use of a higher markup in principal transactions has traditionally been justified by the fact that the firm is taking an ownership risk, but this obviously does not apply to the riskless transaction. Another justification has been that a higher markup is necessary to cover the expenses involved in making retail sales of over-the-counter securities, including both costs of solicitation and costs of research. However, where principal dealing would appear more justifiable on these grounds—namely, in the case of small, inactively traded issues—agency transactions are somewhat more prevalent than elsewhere. Moreover, as noted above, the study's data show no greater tendency toward principal executions among firms doing low volumes of business (presumably those with higher proportional expenses) than among those with higher volumes.

The retail quotation system for over-the-counter securities, sponsored by the NASD, is closely related to the problem of retail executions, both as cause and consequence. The present system involves publication of a single "bid" and "asked" quotation for each security listed, the former usually being the inside bid as supplied by a single dealer for each security and the latter being the inside offer supplied by the same dealer but adjusted upward under a "rule of thumb" generally predicated on the NASD markup policy discussed below. The inside quotations are not necessarily supplied by an actual market maker and frequently do not reflect the best inside market. As adjusted, they characteristically show a 7- to 10-percent spread between bid and asked and do not necessarily reflect the "range" within which retail transactions have actually occurred.

The NASD has stated that the supervision of retail quotations "is properly an industry obligation and responsibility." [4] Pursuant to this conviction the NASD has been successful in substantially eliminating the former practice whereby individual firms supplied newspaper quotations under their own bylines and in reducing the excessive spreads that often appeared prior to its assumption of responsibility in this area. However, the NASD has not succeeded in creating a quotations system that can be regarded as sufficiently reliable, informative or objective. 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"

[4] NASD Manual, G–53.

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 terms "bid" and "asked" mean, and ties them confusingly to a price "range" as if they related to a "high" and "low" in a trading day.

The heart of the difficulty stems from the NASD's statement that the system is "designed * * * to assist retail dealers in *selling* [emphasis in original] securities as *principal* [emphasis supplied]." Such assistance to retail dealers takes the form of showing a substantial range between the "bid" and "asked"—terms which are themselves misnomers. Within that range, sales to customers may be made on a "net" basis without guidance as to the inside trading market and without disclosure of the amount of markup or even that any markup is involved. It should be noted that, under present practices, a majority of over-the-counter purchases by individuals are executed on an agency basis and with disclosure of the cost of execution. However, the fact that a customer always has the right to purchase on an agency basis and that securities can ordinarily be bought at less than the published "asked" price is not universally understood. In these circumstances the system encourages the handling of purchase transactions on a principal "riskless" basis, with increased cost to the customer, and provides no basis for evaluating the quality of executions.

Moreover, the NASD and many of its members have consistently opposed the release of wholesale quotations to the general public, yet institutions and other favored investors have gained regular access to the sheets through NASD members. This situation has prevailed despite the policy expressed in section 15A(b)(7) of the Exchange Act, that an association's rules "are not [to be] designed to permit unfair discrimination between customers * * *."

A standard justification for the present system is to the effect that the public would misunderstand any other system, but it may not be assumed that the over-the-counter markets can function only by withholding what in other contexts is deemed essential information. The NASD and other industry organizations can and should undertake further efforts to educate the public as to the mechanisms of the over-the-counter markets, in this and other respects. While a change from the present quotation system may create special need for educational efforts, it is believed that little explanation will be needed for a system which does not hold itself out to be something more than or different from what it is in fact.

There may be various appropriate substitutes for the present system. The evolution of electronic techniques may substantially increase the possibilities but change should not be deferred. There should be a system of publishing, for the use of the general public, the best bid and the best asked price quotations of primary market makers appearing in the wholesale sheets, with an indication of the number of market makers. Such publication should be accompanied by an appropriate masthead such as:

> The following prices are dealers' (wholesale) bid and asked prices as of (the time of compilation). Retail transactions ordinarily may involve a markup, a markdown, or a brokerage commission, which may result in higher costs of purchases or lower proceeds from sales than the quoted dealers' prices.

In regard to quotations which do not appear on any national or regional list, the NASD has recently authorized closer supervision over local quotations committees. While the role of such committees may be diminished or modified in the future, to whatever extent they continue to function, the need for closer national supervision is clearly indicated. There is also need to make the Commission's responsibilty and authority over the NASD's quotations activity as clear as its role with respect to broker-dealers' use of quotations.

The markup policy of the NASD, on which principal reliance is now placed to protect the public against overreaching in retail prices, is closely related to the retail quotation system in its history and concept. While the Commission has originally proposed a disclosure approach for dealing with unreasonable markups—an approach normally considered less drastic than substantive regulation—the NASD opposed disclosure and turned instead to a regulatory solution. In the administration and enforcement of the markup policy, there appears to be considerable confusion and misunderstanding as to when the base of computation is the dealer's own contemporaneous cost and when it is the prevailing wholesale offer. Its enforcement depends on postsurveillance in the course of routine inspections of NASD member firms. Such inspections take place on an approximate 3-year cycle and include making a computation of markups on a sample of each firm's transactions.

The NASD markup policy has served an important purpose in preventing excessive spreads in retail quotations and in setting outer limits of permissible retail pricing. However, it does not meet the needs of investors for additional disclosures about the trading markets, on the basis of which informed decisions and evaluations may be made.

The Commission's regulation of over-the-counter markets has relied essentially on the fraud provisions of the Securities Act and the Exchange Act. In rules and administrative proceedings pursuant to these provisions the Commission has defined obligations inherent in doing business with public customers. This approach has been most successful in dealing with flagrant situations. It puts emphasis on disclosure in limited circumstances, expanded in recent cases, but still falls short of providing the full protection needed by investors in over-the-counter markets. The basic need of the investor in such markets, which neither the NASD's markup policy nor the Commission's use of its fraud powers has adequately provided, is for timely disclosure of information useful in appraising the quality of markets and the quality of executions—information that is needed no less than information relevant to the quality of the securities themselves.

4. AUTOMATION

Automation has only slightly touched the over-the-counter markets, present uses being largely concentrated in servicing back office operations. Recent, rapid advances in technology now offer the prospect of major new applications in over-the-counter markets, in the handling of quotations and otherwise.

It appears to be technically feasible to use a central computer to record and report interdealer quotations for some or all over-the-counter securities on a continuous basis. In addition to providing a method for instantaneously determining best quotations, such a system might provide wholly new means of matching buy and sell orders and even accomplishing their execution in some circumstances. The same system might be used for reporting and storing actual transaction information, thus for the first time making price and volume data available on a current and continuous basis.

The possibilities of automation are of great importance to the industry itself, because of the potential for improved efficiency and economy. They are of at least equally great importance to 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.

5. NEEDS OF THE OVER-THE-COUNTER MARKETS

The over-the-counter markets are large and important, they are heterogeneous and diffuse, they are still relatively obscure and even mysterious for most investors, and they are also comparatively unregulated. These characteristics are not unrelated: The obscurity stems in part from the markets' very size, variety, and diffuseness, while the relative lack of regulations 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.

An important step toward better understanding and regulation would be better identification and classification of what is involved in these markets—what securities, what broker-dealers, what practices. With appropriate identification and classification of components it should become feasible to devise substantive measures appropriate for particular categories, rather than uniform and undifferentiated measures that inevitably must be inappropriate for some categories in the total over-the-counter markets. These comments apply both to the variety of securities traded in over-the-counter markets and the variety of broker-dealer participants and their functions and practices.

Most over-the-counter securities presently live in an entirely different regulatory world from exchange-listed securities, even though many of them are quite indistinguishable from many securities in the other world and bear almost no resemblance to others in their own. To provide more logical differentiations, it is recommended in chapter IX that there be a defined group of over-the-counter securities (there referred to as "OTC listed")[5] which would be treated substantially like exchange-listed securities, rather than like other over-the-counter securities, for purposes of reporting, proxy soliciting and insider trading. By the same token, this category would be identified and recognized for various purposes relevant to this present chapter and chapter III.B (selling practices). Similarly, it is recommended in chapter X that separate categories of over-the-counter securities be recognized, and treated more like exchange-listed securities than like other over-the-counter securities, for purposes of extension of credit by broker-dealers and banks.

[5] Subsequent to the publication of ch. IX it has been suggested that the particular designation of "OTC listed" would be an unfortunate one because of possible confusion with "listed" (on a stock exchange). If this is deemed a valid objection, an alternative designation could readily be found (e.g., "OTC special," "OTC disclosure list," "OTC registered," "OTC public") without impairing the principle that there should be a special designation.

Similar needs exist with respect to broker-dealer participants in the over-the-counter markets—needs for clearer identification of those making markets for particular securities and for a degree of categorization of the markets. Some 3,300 separate broker-dealers have reported (in Questionnaire OTC-3) doing some kind of over-the-counter business (apart from those exclusively in mutual funds, municipals and governments, and other specialized categories). The study has found that in over-the-counter markets broker-dealers advertised interests in at least 14,000 corporate stock issues (see ch. IX.B), and there is little information as to the real nature, composition or operation of the market in any security at any time. It is not much of an exaggeration to say that a special study, or at least a special market quiz, is needed to find out exactly which dealers are engaging in transactions—and if so, in what volumes, at what prices, and in what manner—in any particular security during a particular period. Because of the large numbers and varieties of securities and participants involved, the nature of the market for any particular security and the reasonable expectation of investors in such security, as well as the needs and possibilities for protection of investors, are intimately related to the number and identity of dealers making an interdealer market in such security.

Establishing a continuous system of identifying "primary market makers"—those dealers who have undertaken to make an independent market for a particular security at any given time—would enable other broker-dealers, the public, the NASD and the Commission to know what kind and how competitive a market exists for such security and where to turn for active market interest, for reliable interdealer quotations and for information as to actual volumes and prices. In addition, regulatory authorities would have an established source of information as to commencement of trading in unregistered issues, as to sources of buying and selling in critical periods, as to significant long and short positions, and similar matters; and members of the industry would have more solid knowledge of where to turn for the working out of abnormal transactions, handling of limit orders, and other special situations.

Beyond this data-supplying function, a system of continuous classification and identification would serve as a basis for whatever degree of further regularization and regulation of over-the-counter markets may seem warranted, now or in the future, in what should be a continuing effort to improve and strengthen such markets generally. In order to have a reasonable basis for selectively applying and enforcing appropriate standards, the necessary starting point is a reliable means of differentiating markets according to the number of independent market makers and of identifying those market makers.

While the establishment of such a system of identifying primary market makers should be a goal of high priority, certain reforms of over-the-counter mechanisms and practices can and should be undertaken whether or not such a system is established. Likewise, although developments in automation would tend to facilitate some of these reforms and might tend to make others academic, the reforms can and should be undertaken regardless of the manner or pace of applying automation in the over-the-counter markets. These reforms are of various kinds but most of them have essentially the same objective, in response to essentially the same need. The need is one arising out of the multiplicity and heterogeneity of markets and professional participants that have been apparent throughout this discussion of over-the-counter markets. The objective is to meet this need by means of disclosure—providing more reliable and more readily available information about markets and prices than exists under present rules and practices.

It has been seen that the securities and markets constituting the broad over-the-counter category range from well-known, established companies with a substantial number of dealers making a close and competitive market at one extreme, to obscure, recent issues with a single dealer dominating the market, quoting widely spread bid and asked prices, and combining wholesale and retail trading at the other extreme, and with many variations and gradations between the two extremes. An investor's reasonable expectation when he buys an over-the-counter security necessarily depends on where in the broad spectrum the particular security falls. Just as he needs basic disclosures about over-the-counter securities themselves, he needs basic disclosures about their markets. He should be afforded information about the depth of dealer interest and the identity of the dealers making the market,[6] so that he may have some conception as to the prospect for continuous marketability. He should have access to information about price spreads in the interdealer market so that he may have some conception of the level at which a sale may be expected to occur in relation to the level at which a purchase can be made. He should have access to information about prices in the interdealer market—on which the retail market in which he deals is ultimately dependent in a most fundamental sense—so that, in addition, he may have a basis of knowing how good an execution was obtained, and what cost of execution was charged by his own broker-dealer. Such disclosures are not only needed for intelligent investment decision by the customer, however; as in all other areas of disclosure, they serve the important prophylactic purpose of silently policing the performance of the broker-dealer himself.

One such reform, or set of reforms, relates to the reliability and informativeness of the wholesale quotation system. Such a system provides information that is basic to everything else because it tells at any given time and over spans of time what dealer interest exists, the basic price levels at which particular securities are capable of being bought and sold, and the spread between these levels. In its present form, however, it fails to reveal important information that can and should be readily disclosed. In particular, it fails to differentiate in any way the quotations of an independent market maker from those of another broker-dealer who may, for convenience or with insidious

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[6] One NASD official described the importance of the identity of dealers making markets in this way:

"I had been on the Business Conduct Committee now for the past year and come to grips quite frequently in the markup cases. I do not want to sound ethereal, but I think there are several abstractions that I have looked to and I suspect others have.

"No. 1 is the security question. If I see the Bankers Trust, First National City Bank, Dun & Bradstreet, large, reputable companies, that is a factor in my judgment. I know I can trust the market. I look to the people who are making the market, if you please. Are the firms reputable; are they knowledgeable; what is the background of their interest; do they have traditional underwriting relationship, and so forth and so on; or are these firms part of a group which are known in trade as to operate on the fringe and go hand-in-hand and work in concert with each other and what not?

"These are all factors that I have tried to utilize to determine what I think is one of the pivotal things; the validity of this market."

purpose, be quoting merely a carbon copy of someone else's market. Other significant improvements in the wholesale quotation system are recommended below but unquestionably the most important single reform would be to impose a requirement for clear differentiation of quotations entered for correspondents and quotations representing multiple expressions of the same market.

Another needed change, of especial value after the quotation system has been made more reliable and informative but independently useful apart from that, is to make the wholesale quotation system publicly available. Of all the mechanisms of the over-the-counter markets it is the most crucial. It is crucial because everything else that occurs in the over-the-counter market ultimately depends on what that system most clearly and conveniently shows—the number of interested dealers and the prices at which they are willing to buy and sell. Although reflecting the wholesale level, it is the most reliable indication of what can be done at the retail level, and thus the best measure of the quality and fairness of what happens there. Some non-broker-dealers now have access to the sheets although it is denied to most, a form of discrimination that itself seems highly dubious in a fair market or a free and open one. But apart from this, under a regulatory system founded on disclosure as basic to the protection of investors, the policy of nondisclosure of the most vital single source of information about over-the-counter markets should no longer endure.

The same conclusion, for similar reasons, applies to the retail quotation system of the NASD. This system starts with a selection, out of the welter of over-the-counter securities, of those commanding sufficient public attention to be included in what must necessarily be a more selective newspaper (or electronic) listing. The present retail system provides a convenient source of information beyond what is available for most over-the-counter securities, but it has the effect of masking the interdealer market rather than disclosing it. As a result, it provides no means of testing the quality of execution or ascertaining the service charge imposed for the execution at the retail level. It may be granted that the range of variation in the handling of transactions is kept within limits by the NASD's markup policy—the variation would not ordinarily be a matter of several points but perhaps a point or two at the most—but in buying and selling securities the latter range, or even fractions of points, may be the all-important difference between a favorable and an unfavorable result. The investor should not be denied, through the retail quotation system or otherwise, the ability to perceive such differences.

Both for securities in a retail quotation system and for the larger mass of securities not so quoted, certain disclosures are so important that they ought to be regularly made in confirmations of transactions or, where practicable, at the time of solicitation. Of particular consequence, for reasonable investor awareness of what he buys and how his transaction is handled, is knowledge of whether the broker-dealer is executing a retail transaction out of its own inventory or another firm's and whether an independent market does or does not exist. Where the executing broker-dealer is in reality acting as agent as in a riskless transaction, in the sense of buying or selling in the interdealer market to accomplish the customer's transaction, the agency form should be required so that the price and commission will be disclosed. The problems of disclosure and fair dealing are more difficult where the broker-dealer has an inventory through which the customer's transaction is handled, but it is precisely here that the markup policy is most difficult of application and in greatest need of supplementation through disclosures. The investor should have the means of appraising the quality and cost of execution, even though merged in a single net price charged by the integrated broker-dealer, through knowledge of the approximate level at which the transaction might have occurred in the interdealer market if it had been executed on an agency basis.[7]

In these and other respects specified below, the full disclosure philosophy needs to be given new meaning and vitality in over-the-counter markets. It seems quite inconsistent with that philosophy that broker-dealers, whether or not making a market or having an inventory position in a security, may engage in principal transactions with public customers but not disclose whether they are dealing with their own inventory, whether and what kind of an independent market exists, or the amount of their markups in relation to the independent market.

Quite paradoxically, the NASD has resorted to a theory of direct regulation rather than disclosure in this area, in the form of its markup policy. This approach, as supplemented by the Commission's use of its fraud powers in regulating over-the-counter markets, sets important outer limits of conduct and undoubtedly precludes gross overreaching. These limits are still wide enough to be important, however, and within such limits, as in other areas of the securities markets, there is no satisfactory substitute for full and reliable disclosure to investors of facts essential for intelligent appraisal and self-protection.

The merchandising character of the securities business is recognized at various points in this report, and it is a necessary corollary that selling and other costs as well as entrepreneurial profit must be adequately provided for in any pricing system.[8] Nothing herein is intended to contravene these facts of business life or to suggest that any particular level of commissions or markups, equivalent to stock exchange commission rates or based on a "5-percent policy" or otherwise, is appropriate or inappropriate for over-the-counter transactions generally or any particular type of transactions, security, broker-dealer firm, or geographical or other circumstance. 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. It is a standard requirement, for example, that there be 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 8½ 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.

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[7] It has already been seen that many firms in the entire volume spectrum now use agency executions (with disclosed commissions) for many securities of varying degrees of activity. See ch. VII.D.2.a (pt. 2).

[8] Carrying out the recommendations of ch. IX to provide regular reporting data for over-the-counter securities should considerably reduce the dealer's burden of research which has often been cited as a reason for higher costs of doing business in such securities.

6. CONCLUSIONS AND RECOMMENDATIONS

The Special Study concludes and recommends:

In view of the heterogeneity of over-the-counter securities and markets and the need for categorization of components, as emphasized in the above discussion, the following program is put forth with recognition that the measures recommended are not necessarily equally applicable to all securities, broker-dealers or markets, so that the appropriate scope and limitation of particular measures may require a more exact definition in the process of implementation. It is also recognized that, while the following recommendations are designed as a total integrated program, the form and timing of the implementation of certain of them might have the effect of lessening the need for others.

1. In the over-the-counter markets, there is a dichotomy between interdealer (wholesale) and public (retail) markets in many important respects, but there is a close and continuous relationship between wholesale and retail markets for any particular security. Interdealer and public quotation systems are vital to the operation of these markets and, whether handled by private enterprise or by a self-regulatory agency, they are vested with a public interest and should be brought under appropriate supervisory control of the Commission. At the same time, the operator of any such system would be vested with authority and responsibility to regulate the use of its system by broker-dealers through appropriate rules and procedures consistent with the rules of the NASD and the Commission.

2. Broker-dealers, although entirely free to change their interdealer quotations in the course of trading as at present, should be positively obligated to buy or sell 100 shares (or other indicated "size") of a quoted stock at their prevailing quotations, unless clearly designated as not firm, and should be required to keep a timed record of changes in quotations. All quotations entered in an interdealer quotation system should be firm, unless otherwise designated, when supplied. The NASD should establish appropriate programs for surveillance and enforcement of these obligations. The NASD and/or the Commission should have the power and responsibility to deny or temporarily suspend any broker-dealer's right to enter quotations in an interdealer quotation system with respect to a particular security or all securities, for willful abuse of a quotation system (e.g., by entering other than bona fide quotations) or willful violation of any special rules applicable to interdealer quotations.

3. Other rules applicable to interdealer quotation systems and/or to broker-dealers using such systems should require (a) that quotations entered by one broker-dealer on behalf of another be so designated by appropriate symbols, with clear differentiation between correspondent arrangements and other arrangements involving this practice, and with clear indication where two or more quotations in different names represent a single quotation; (b) that "OTC listed" securities (see ch. IX)[9] be differentiated from all other securities by appropriate symbols, and

[9] See note 5, p. 121, above.

that securities eligible for extension of credit (see ch. X) be designated by separate symbols; and (c) that, consistent with the recommendation in paragraph 9, persons other than broker-dealers be eligible to become subscribers to interdealer quotation systems, and that broker-dealers be required to make available to their regular public customers, upon request, any quotation system to which they may be subscribers. In addition, upon establishment of a system for identification of "primary market makers" as recommended in paragraph 4, consideration should be given to a further rule providing that primary market makers for a particular security should have the exclusive right (subject to possible defined exceptions) to enter two-way quotations in any interdealer quotation system; whereas any other broker-dealer, although free to enter one-way or *OW* or *BW* quotations, should be permitted to enter two-way quotations only as correspondent for an identified primary market maker.

4. Because of the large numbers and varieties of securities and participants involved in the over-the-counter markets, the quality and depth of the market for any particular security and the reasonable expectations of investors in such security are intimately related to the number and identity of dealers making an interdealer market. As a foundation for various immediate or longer term improvements in the operation and regulation of over-the-counter markets, a system for official identification of the "primary market makers" in each security (tentatively defined for this purpose as "any broker-dealer who, with respect to a particular security, holds himself out, by entering two-way quotations in any interdealer quotation system or otherwise, as being willing to buy from and sell to other broker-dealers for his own account on a continuous basis") should be established by the Commission or the NASD as promptly as necessary mechanical arrangements can be worked out. Such a system would contemplate that each primary market maker in a particular security would file, prior to or promptly after becoming such, a data card showing the name of the security and the dealer's relation to the issue or issuers (as underwriter, director, optionee, etc.); that a primary market maker ceasing to act as such, either permanently or temporarily, would give notice to that effect; and that the Commission or the NASD would maintain, for public inspection or circulation, an official "primary market list" of those dealers who are primary market makers for each security at any given time.

5. The Commission and the NASD should 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, particularly in light of the possibilities of automation referred to below. Among other subjects for possible coverage in future rules, interpretations or statements of policy, to be applied either generally or in respect of specified categories of securities or of broker-dealers, would be: rights and obligations of primary market makers in maintaining competitive, fair, and orderly markets; the grant of "cheap stock," warrants or options to primary market makers (see ch. IV.B); standards of supervision and methods of compensation of traders; intrafirm responsibility for and supervision of the insertion of quota-

tions in an interdealer quotation system; provisions for the handling of limit orders; and possible special requirements or exemptions for primary market makers in broker-dealer capital rules, including a possible exemption from "haircut" provisions in respect of limited amounts of inventory of securities traded by a primary market maker. (See ch. III.D.)

6. While a public investor must ultimately rely upon the competence and probity of his broker-dealer for a good execution, under present rules and standards in over-the-counter markets the price paid or realized by an investor on the purchase or sale of a security may depend, to an excessive degree, on the diligence of the broker-dealer and the capacity in which he acts and/or on the identity of the investor. The NASD and/or the Commission should adopt rules and standards requiring all broker-dealers executing retail transactions, whether or not they are primary market makers in the particular security and whether the transaction is on a principal or agency basis, (a) to make reasonable effort, in light of all circumstances including the kind and size of order, to ascertain the best interdealer quotations (and to show in their permanent records the number of markets checked), and (b) 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.

7. Under present rules and standards in over-the-counter markets the disclosure of facts on which the investor may judge the price and quality of an execution depends in part on whether the broker-dealer acts as agent or principal. So-called "riskless" transactions, i.e., those in which a broker-dealer who neither is a primary market maker nor has a bona fide inventory position elects to execute a customer's purchase order by buying from another broker-dealer and reselling to the customer (or the reverse in the case of a customer's sale order) on a "net" basis without disclosure of markup or commission, are inherently susceptible to abuse and (subject to possible defined exceptions) should not be permitted to take that form; that is, a broker-dealer who neither is a primary market maker nor has a bona fide inventory position should be required (subject to defined exceptions) to execute customers' orders on an agency basis.

8. The NASD's markup policy is in need of substantial clarification and strengthening in respect of other than "riskless" transactions. In particular, an integrated broker-dealer's obligation and standards of retail pricing in relation to its contemporaneous cost or its current interdealer quotations, especially in the case of securities for which there is no independent market, should be defined, by the Commission and/or the NASD, more clearly and positively than has been done in the interpretations or administration of the present markup policy.

9. As a further basic improvement in retail over-the-counter markets the present retail quotation system of the NASD should be supplanted by a system designed to show generally (with appropriate exceptions to deal with exceptional categories of securities or situations, if any) the best prevailing interdealer bid and asked quotations that can be reasonably ascertained and the num-

ber of primary market makers for each security. Any other quotation system designed for public dissemination, including electronic systems, should be required to conform to the same provisions. By appropriate explanatory legends and by NASD-sponsored educational efforts the investing public can and should be advised that published quotations in such form are interdealer quotations rather than retail quotations and hence are subject to markups, markdowns or commissions in retail transactions.

10. The NASD should reexamine and strengthen, in a manner consistent with the above, its methods of handling "local" quotations, the functioning of its local quotations committees, and its procedures for coordinating and supervising the work of such committees.

11. The NASD should also give consideration to ways and means of improving its retail quotation system in other respects, including, but not necessarily limited to, supplying indications of dividends, ex-dividends, insolvency or reorganization proceedings, etc., in the manner of stock exchange quotations.

12. To the extent that space limitations prevent inclusion in any newspaper or similar quotation system of more than a fraction (presently about one-sixth) of all securities quoted in interdealer systems, the privilege of being included in the NASD's "national" or "regional" list should be limited to the "OTC listed" category (see ch. IX),[10] and within that category the selection should be based on appropriate rules of the NASD or other operator of the particular quotation system.

13. The NASD and/or the Commission should reexamine present requirements with a view to improving disclosures, at the time of soliciting a retail purchase or in confirmations, of essential information relevant to particular types of retail transactions. Among other possibilities that should receive early consideration in this connection would be rules of the following kinds:

(a) A broker-dealer soliciting a customer's purchase of any security for which there is no independent market other than its own, or any security out of its own inventory, or any security in which there is a spread of, say, 20 percent or more in prevailing interdealer bids and offers, should be required to disclose such fact or facts at the time of solicitation.

(b) The confirmation of a customer's purchase or sale involving 100 shares or less (or, in the case of securities priced at $5 per share or less, involving say, $1,500 or less), if handled on a principal basis, should be required to show the best interdealer quotation on the opposite side of the customer's transaction (i.e., the interdealer bid in the case of a customer's sale or the interdealer offer in the case of a customer's purchase) reasonably ascertainable at time of execution.

(c) The confirmation of a customer's purchase (but not sale), whether handled on a principal or agency basis, should provide an indication of the prevailing spread between interdealer bids and offers by showing a representative bid quotation.

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[10] See note 5, p. 121, above.

14. With an already strong communications network, there is on the horizon the likelihood of a computer system that would assemble all interdealer quotations and instantaneously determine and communicate best quotations for particular securities at any time. If such a system were established, the further possibility of using it in connection with executions and to compile actual price and volume data for over-the-counter transactions would exist. Any such automated system would clearly be affected with a public interest and should be under regulatory supervision. The NASD is the natural source of leadership and initiative in dealing with matters of automation in respect of over-the-counter markets. It should actively carry forward the very limited study of automation possibilities applicable to over-the-counter markets that the Special Study has been able to undertake and should report to the Commission from time to time as to the progress and programs of the industry in this area. The Commission and the NASD should jointly consider possibilities for developing and coordinating automation programs in such manner as to fulfill their respective regulatory needs, as well as operational needs of the markets, with maximum effectiveness and minimum duplication and expense.

15. In the absence of a completely automated system for recording transaction data, consideration should be given by the Commission and the NASD to the feasibility of establishing a reporting system designed to obtain maximum price and volume data, without undue burden, for actual transactions in over-the-counter securities or for specified categories of transactions and/or securities.

16. Interdealer or retail over-the-counter transactions in exchange-listed securities present special problems because of their actual or potential interaction with auction markets. In implementing the recommendations in this chapter for over-the-counter markets generally, appropriate exceptions and/or special requirements should be provided for over-the-counter transactions in exchange-listed securities. Other recommendations on this subject appear in chapter VIII.D.

CHAPTER VIII

TRADING MARKETS—INTERRELATIONSHIPS

[Part A (Introduction—Scope of Chapter) summarizes the contents of the remainder of the chapter.]

PART B. THE BASIC ALLOCATION BETWEEN EXCHANGES AND OVER THE COUNTER (AS PRIMARY MARKETS)

The allocation of securities among trading markets, including the determination of the primary market and the establishment of dual or multiple markets for a particular security, is determined by a number of interacting factors and forces. 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. Securities may also be admitted to trading on an exchange through "unlisted trading privileges" but this now applies primarily to securities already listed on another exchange. There is no corresponding gateway to trading in over-the-counter markets, either primary or multiple.

The most stringent listing requirements are those of the New York Stock Exchange. These include "yardsticks" as to minimum amounts of net tangible assets, net earnings, share distribution, and market value of stock. Delisting standards, while paralleling the listing standards, are far less stringent. Listing and delisting standards of the Amex and other exchanges tend to reflect similar factors but at substantially lower quantitative levels.

There is a broad tendency for securities traded in a particular market or category of markets to show generally similar characteristics; yet there are wide diversities within each category and considerable overlapping among categories. NYSE-listed stocks generally are in the highest size ranges, and stocks in the "OTC inactive" category (defined by the study as those showing fewer than four dealer quotations in the February 1962 Monthly Stock Summary) are in the lowest. The bulk of Amex issues lie between these two categories, while the "OTC active" category (stocks showing four or more dealer quotations in the Monthly Stock Summary) is spread broadly across the whole spectrum with a slight concentration below the Amex issues. Stocks listed solely on the major regional exchanges tend to fall between the active and inactive OTC groupings. Only in assets is this pattern broken—stocks in the OTC-active categories show a range of assets generally no higher than those that are inactive. Most NYSE stocks have characteristics considerably in excess of the Exchange's minimum yardsticks for original listing, but about 10 percent do not meet these requirements. While stocks not listed on the NYSE generally are smaller in relation to those yardsticks, significant percentages of stocks listed on the Amex or solely on regional exchanges and of stocks in the OTC-active category substantially meet all NYSE listing requirements.

A generally similar pattern appears in respect of trading activity. Thus, in 1961, the central two-thirds of common stocks in the NYSE were in a range higher than the Amex and considerably higher than the major regional exchanges. While no direct comparision with over-the-counter securities is possible, it would appear that the central two-thirds of OTC-active stocks show a range of trading volume higher than that of most stocks listed solely on major regional exchanges and only moderately below the range of the central two-thirds of the shares traded on the Amex. Notwithstanding these general patterns, the differences in volume within each market category are exceedingly wide, even for the NYSE (where trading activity is most evenly distributed), and there is a considerable overlapping among market categories.

For a security to be well suited for trading in a continuous auction market, spontaneous meeting of buyers and sellers must occur on a reasonably continuous basis without undue reliance on specialist participation; the market in other words must have adequate "depth." The degree of market depth in this sense is affected not only by transient variables with respect to given securities or markets but also by a number of long-range tendencies and forces. Listing and delisting standards should be designed to admit and retain securities capable of being successfully traded in the kind of market that a particular exchange is and purports to be. The wide discrepancy now found between listing and delisting yardsticks seems questionable in light of these considerations, particularly with respect to the NYSE.

The depth of buying and selling interest reflected in the auction market is directly affected by the round-lot unit of trading, presently 100 shares for most stocks, since odd-lot transactions are largely handled through dealers and not directly in the auction market. 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 and should receive consideration for all or some securities.

Since exchange markets, as continuous auction markets, are more demanding in terms of depth than are over-the-counter markets, a primary public concern is to assure that each security admitted to an exchange market is suitable, in such terms, for the kind of market that the exchange purports to conduct. Indeed, the best clue to appropriate allocation between exchange markets and over-the-counter markets may lie in the difference in warranted expectation on the part of public investors. An exchange market is generally regarded and frequently advertised as assuring a high degree of continuity and fluidity through the continuous auction process. It follows that each exchange should reasonably live up to the expectation created by its image and should not maintain listings that are incompatible.[1] There

[1] The same kind of point was made by the Commission in 1936, in relation to unlisted trading:

"Admitting a security to trading privileges on an exchange amounts to a representation by the exchange that an appropriate and adequate market for that security exists on that exchange. It does not necessarily amount to a representation that the best market from the standpoint of buyer or seller exists on the exchange, but it is a representation that an adequate and an appropriate market may be found upon the exchange."

SEC, "Report on Trading in Unlisted Securities Upon Exchanges," p. 10 (1936).

nevertheless remains room for a degree of variation and experimentation, as discussed in part E of this chapter, with certain of the regional exchanges perhaps operating under a modified set of assumptions intermediate between those of continuous auction markets in the fullest sense and over-the-counter markets.

The legitimate expectation for over-the-counter markets is quite different from that of the classic auction market. It is not and need not be the opposite; it is simply more kaleidoscopic. What the sophisticated professional expects, and the public investor is entitled to expect, is only such degree of depth, continuity, and fluidity for a particular security traded over the counter as is implied by the number of dealers making a market at any time or from time to time. This may range from 20 or more on a continuous basis to 1 or 2 on a more spasmodic basis. The over-the-counter markets have room for all of them and there need be no disappointment of legitimate expectation as to any of them, since the range of difference is ascertainable and expectation can be adjusted to particular facts. What is essential, in these terms, is that there be clearer recognition and identification for public investors of the wide variations that necessarily exist within the broad over-the-counter category, and better adaptation of regulatory measures to suit the varying needs.

For the considerable category of securities that would be suitable for an exchange or over-the-counter markets, there appears to be no reason of public policy why an issuer should not have freedom to decide, as at present, either to remain entirely in the over-the-counter sector or to seek an exchange listing.[2] This necessarily presupposes, however, that public investors in either type of market are afforded, through requirements of fair trading practices and disclosures, the maximum protection consistent with the character of that type of market. Chapters VI and VII contain both immediate and longer-range recommendations as to trading practices and market disclosures to meet this objective, and chapters IX and X contain recommendations for greater equalization of disclosure and credit requirements for securities traded in the two types of markets. Implementation of the chapter VI and VII recommendations is imperative if each type of market is to provide, within the assumption in which it operates, appropriate safeguards for investors and the public interest. Implementation of the chapter IX and X recommendations, on the other hand, will eliminate discriminations that may now affect market allocations artificially and arbitrarily.

The Special Study concludes and recommends:

1. Continuous auction markets are, by their very nature, more demanding than over-the-counter markets in respect of the depth of public interest and activity required for the degree of continuity and fluidity generally associated with them. Since various factors affecting depth are dynamic rather than static, listing and delisting standards and practices of the several exchanges require reexamination from time to time to assure that the entire list of securities being traded is in keeping with the kind of market that the particular exchange purports to provide and is capable of

[2] In this connection, see ch. IX, pp. 56–57 (pt. 3), on the recommended repeal of sec. 12(f)(3), under which proposed change all "OTC listed" issues would not automatically be eligible for unlisted trading.

providing. Present delisting standards and practices appear disproportionately low in relation to listing standards, particularly in the case of the NYSE, and should be strengthened.

2. Reduction in the round-lot unit of trading would significantly add to the depth of auction markets by bringing a portion of present odd-lot trading directly into the balance of available supply and demand. Technological advances, as of the present or the foreseeable future, may well be found to have obviated what were previously felt to be practical impediments. A Government-industry study of the feasibility and desirability of reducing the round-lot unit for all or some securities should be undertaken in the near future.

3. Over-the-counter market mechanisms are generally more adaptable than exchange market mechanisms in their capacity to provide for the heterogeneous types of securities that are traded over the counter, including some that would be suitable for continuous auction trading but a great many more that would not. On the other hand, the very heterogeneity of over-he-counter securities makes it impossible to assure markets of the same quality (in depth, continuity, or otherwise) for all such securities. Hence a pressing and continuing need 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. Reference is made to certain recommendations of chapter VII directed to this end.

PART C. INSTITUTIONAL PARTICIPATION AND BLOCK TRANSACTIONS

Although institutions are still considerably less important than individuals as holders and as buyers and sellers of stocks, their importance is increasing. In addition, institutions have special importance to the trading markets since their unit holdings and buying and selling programs tend to be larger than those of individuals; and decision-making, for the bulk of institutional holdings and transactions, is concentrated in relatively fewer investor units.

Because of the increasing importance of the institutions in the trading markets, the Special Study conducted a survey among 91 different institutions concerning their procedures for executions and their transactions in common and preferred stocks. The major specific results of this survey may be summarized as follows:

1. The transactions of the institutions sampled showed a concentration in NYSE-listed issues, with a minor amount of activity on the Amex, and negligible activity on the regional exchanges in stocks listed only on such exchanges.

2. Most of the transactions executed on regional exchanges involved NYSE-listed issues, and most of them were by the open-end (load) investment companies. The other institutions made considerably less use of the regional exchanges. Such higher use of regional exchanges by the investment companies may well be related to the investment companies' desire to give "reciprocal business" to regional exchange members and, in some cases, to nonmembers.

3. For transactions by the institutions in NYSE-listed stocks, the NYSE is the most important market channel (except for preferred

stocks), and the over-the-counter markets are the second most important.

4. Relative to the New York Stock Exchange market, the importance of the over-the-counter markets for NYSE-listed issues is greatest for preferred stocks, second greatest for public utility commons, and least great for "other" commons. This pattern no doubt reflects the relative degree of "institutionalization" of the markets for each of these categories of stocks.

5. Most transactions and "block" programs in listed common stocks take the form of a series of relatively small transactions on the exchange auction market, or involve prearranged "crosses" on the floor of an exchange.

6. The average size of individual transactions tended to be smaller on the NYSE and Amex than on the regional exchanges, suggesting that prearranged crosses (mostly in NYSE issues) are of relatively greater importance on the regional exchanges. The over-the-counter market produced the largest sized transactions.

7. For transactions on the NYSE in March 1961 and April 1962, the institutions reported using limit orders for most (about 60 percent) of the dollar volume of their transactions. They reported using discretionary orders for about 20 percent, and market orders for less than 10 percent.[3]

8. For over-the-counter transactions in the 2 months, the institutions reported using principal transactions for about three-fourths of their volume and agency transactions for the rest.

9. For block purchase or sale programs, the bigger the block, the more the time, transactions, and different broker-dealers used for its execution. Block programs in which the over-the-counter market predominated took less time, fewer transactions, and fewer broker-dealers than those in the same size class in which the exchange markets predominated.

10. Most of the institutions had no transactions in new public issues of stocks in 1961. Of those that did, quite a few, particularly life insurance companies, concentrated their new issue transactions in purchases of preferreds. In the preferred stock category, the institutions made few purchases or sales of new issues in the trading markets after the original offerings. In the common stock category, however, the institutions' trading market purchases were nearly 2½ times their original allotments, and sales were slightly in excess of one-tenth of the original allotments. The investment companies received only 17 percent of the original allotments (to the institutions) of new issues of common stock, but accounted for 59 percent of the post-offering trading market purchases. The institutions' post-offering market purchases of new issues of common stocks were, on the average, made at a premium of 33 percent above the original offering price, and their sales at a premium of 46 percent. About 60 percent of the institutions' sales of new common stock issues were made within 40 days of the original offering. The median-sized allotment of new stock issues received from individual broker-dealers, even by these institutions, was relatively small (generally 100 shares or less). Both post-offering purchases and sales, however, tended to involve larger individual transactions.

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[3] As indicated in ch. VIII.C.3.a(4) (pt. 2), however, some of the orders reported as "limit" or "market" orders may well have involved some element of discretion.

11. Virtually all of the institutions had trading or order departments which retained control over the details of executing purchases and sales of stocks. These normally had limited discretion as to price and no discretion as to the stocks to be purchased or sold, but substantial discretion as to the broker-dealers and market channels to be used for individual executions, though "approved" lists of broker-dealers, among whom the trading departments were expected to spread the business, were common.

12. Few institutions reported going directly to specialists or specialists' firms for executions in stocks in which the specialist was registered.

13. Many institutions estimated that their use of the over-the-counter markets for listed stocks had been increasing, relative to their use of the exchange markets, over the past 5 years. Few indicated that it had been decreasing. More institutions reported such an increase in the "other" common stock category than in the public utility common stock or preferred stock categories.

14. Price, cost, and volume were the factors most frequently mentioned by the institutions as factors determining use of the over-the-counter markets rather than the NYSE market for NYSE-listed issues. These factors were less frequently mentioned as reasons for using the regional exchanges.

15. "Reciprocal business" considerations were more important in the allocation of commission business among stock exchange member firms than among dealers in the over-the-counter market, where price competition exists. With respect to the unlisted stocks, several institutions indicated that they prefer to execute transactions directly with market makers.

16. Research and analytical materials were the most frequently mentioned reasons for giving "reciprocal business" to brokers. Other factors tended to vary by type of institution. Reciprocal business has been given by banks in relation to deposits and loans, by mutual funds in reward for sales of shares of the funds, by universities because of "old school tie" considerations, and by insurance companies to reward broker-dealers who bring (as agent for the issuer) desirable private placement issues to the company.

17. The institutions tend to concentrate their commission business among a relatively few firms: for each institution, its favorite 10 broker-dealers tended to account for more than 50 percent of its commission business for the year 1961. Moreover, New York Stock Exchange firms received more than 60 percent of the total commissions paid by the institutions for the year 1961. The give-up device was used principally to divert commissions from an institution's favorite 10 or 20 brokers to others. Its principal users were the open-end (load) companies.

18. Investment companies have noticeably higher stock turnover rates than other institutions. The institutions, as a whole, have lower turnover rates than the New York Stock Exchange market. While the net new purchases of stocks by the institutions as well as their turnover are presently both contributing to liquidity in the securities markets, the institutions' lower turnover rate raises questions concerning the consequences of possible further increase in institutionalization of the markets for stocks.

An important purpose of the Special Study's institutional investor survey, apart from contributing to general understanding of the institutional investors' role in the trading markets, was to supplement and throw light on data obtained through other means about various other phenomena or problems within the scope of the total study. Recommendations in those areas, reflecting the institutional survey and other data, are contained in the appropriate chapters. Certain recommendations which flow directly from the findings as to institutional transactions specifically are, however, made here.

The principal one is that the growing importance of institutional investors, the pattern of their present market activity, and the probability of a trend toward greater "institutionalization" of markets for stocks suggest the need for continuing data and attention with respect to such areas. In addition to obtaining and publishing fuller data on institutional transactions, the Commission should have programs for more continuous study of, and better lines of communication with institutional investors and others with regard to, changing needs and emerging problems regarding the handling of block transactions and their special impact on the securities markets.

While pension funds are one of the most important institutional groups in the securities markets, and are growing at the fastest rate, they are notable for the dearth of information publicly available on their holdings. Investment companies are required by the provisions of the Investment Company Act to disclose their holdings of individual stocks in their periodic reports. Insurance companies are required by various state statutes or regulations to make similar disclosures. Pension funds, however, have not been subject to any corresponding disclosure requirement. Although the Federal Welfare and Pension Plans Disclosures Act [4] applies a disclosure concept to pension funds, the act does not require that the holdings of individual security issues be revealed unless they are securities of an employer or other "party in interest," and are not securities listed on a national securities exchange or securities of a registered investment company or public utility holding company.

Recommendations have been made in the past by others that the Federal Welfare and Pension Plans Disclosure Act should require greater disclosure of individual security holdings of pension funds, with the purpose of informing, and protecting the interests of, the beneficiaries of such plans. In view of the general importance of the pension funds in the securities markets, however, there appears an independent reason of public policy favoring such disclosure.

It is apparent that any study of a possible volume or block discount in stock exchange commission rates, as recommended in chapter VI, must take into account the patterns and practices revealed by the present survey. Should a volume discount be considered, it should take a form which would be meaningful in terms of the sizes of transactions and block purchase and sale programs of the institutions. It should not, on the other hand, take a form which would have unstabilizing effects, such as giving the institutions incentives toward making larger single transactions on the exchanges than the auction markets can readily absorb.

[4] 29 U.S.C. 301–309.

The Special Study concludes and recommends:

1. Institutional participation has become increasingly important in the total business of securities markets and, since the institutions tend to deal in larger blocks and for other reasons, such participation presents special problems from the point of view of the exchanges and in relation to the public interest and protection of investors. In view of the growing importance of institutional transactions and the probability that needs and problems associated with them will not remain static, it is particularly important that there be 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 Commission should institute programs to obtain, and to publish on appropriately aggregated bases, more continuous data concerning institutional participation in the securities markets, including securities held, amounts of gross and net purchases over periods of time, and turnover rates. From time to time the Commission should hold conferences with, or otherwise invite the views and suggestions of, institutional investors, the principal exchanges and representatives of the securities business with regard to changing impacts of institutional transactions on securities markets, related needs of institutional investors, and questions of public policy involved.

2. Inasmuch as pension funds represent an increasingly important institutional group for which data on securities transactions are lacking, the Commission should recommend, from the point of view of the securities markets and independently of any other purpose, that the Federal Welfare and Pension Plans Disclosure Act be amended to require periodic disclosure by pension funds of their holdings of individual corporate securities, or that equivalent information be otherwise required to be made public.

3. Any study of possible modification of commission rate structures to provide a volume discount or lower commission rate for institutional or other large investors should take into consideration the practices of the institutions in handling large purchase or sale programs. Any volume discount or lower rate adopted should be meaningful in terms of the sizes of transactions and block programs of the institutions as they exist in actual practice, but should not create incentives toward instability in the markets such as, for example, through encouraging larger single transactions in auction markets than such markets can readily absorb.

PART D. OVER-THE-COUNTER MARKETS IN EXCHANGE-LISTED SECURITIES

The past 20 years have witnessed a striking growth in the trading off the floor of the exchanges of securities listed on the exchanges, primarily those of the NYSE. The market appears to have developed to service the special needs of two groups of customers: (1) institutional investors, which are becoming increasingly larger holders and traders of common stocks, and (2) broker-dealers not members of an exchange and therefore without direct access to the trading of listed stocks. In 1961 this off-board market in listed stocks, which may be designated as the "third market," traded an estimated volume in NYSE stocks of $2 billion, equal to 3.8 percent of NYSE volume.

While considerable off-board trading occurs in agency trades, much of it by brokers not making markets, the bulk of it is handled through firms which make markets generally similar to the wholesale over-the-counter markets described in chapter VII. The firms tend to have strong financial resources, several being among the largest in the securities business, and to stress their trading function to the exclusion of other activities. Catering almost solely to the professional securities traders of institutions and to other broker-dealers, they eliminate the ancillary services rendered for their customers by exchange commission houses.

The market makers, free to make or discontinue markets in listed securities as they see fit, have been generally expanding their lists of markets. Where formerly markets were made only in utility stocks and others of equivalent stability, the aggregate markets, at least 270 in 1961 and now numbering many more, encompass a wide variety of industrial and other equities. The major criterion employed in selecting a listed issue for an over-the-counter market is its interest to potential customers; i.e., institutions and broker-dealers representing public customers, in that order. As compared with stocks in other markets, including the NYSE, these issues appear at the higher end of the spectrum in terms of financial size of issuer, number of shares outstanding, breadth of share distribution, and, for all but a number of utility issues, volume of activity in the NYSE as well.

The twofold division of customers in the off-board market is reflected in every aspect of the market's operation. Some market makers specialize in business with institutions, some with broker-dealers, and some with a combination of both. The securities traded include not only institutional favorites but many which may be considered popular primarily with individuals (trading through broker-dealers). The range of transaction size shows a preponderance of large deals, reflecting the interest of institutions, but also a surprisingly high percent of odd lots, apparently transacted by broker-dealers for individual public customers.

Comparison of the operations of the third market and exchange market must not be construed as suggesting any equivalence in capacity to trade stocks. Though the off-board market has been growing, it is still small when compared with the NYSE's trading of its own stocks. The focus here is on the question of why even part of the trading in Exchange stocks should be effected over the counter.

The different characteristics of the negotiated off-board market and the continuous auction market of the Exchange are responsible for certain distinctions in trading practice. Institutions deal directly with the market markers on the third market and do not require the services of a broker. Their market interest and trading receive no publicity. Their transactions, which tend to be large, are not likely to affect prices on the Exchange in a way detrimental to the satisfactory completion of the remainder of a large block transaction.

The market makers closely follow the tape and quotations of the NYSE and quote prices which aim to be competitive with those of the Exchange on at least one side. Institutional customers, dealing directly with the market makers, find it advantageous to deal in the third market when the price of the stock, net of commissions, is less than the total price on the Exchange (even though slightly better than the off-board price) adjusted for commission cost. The off-board market maker is able to determine prices within the broader range permitted by the total of the commissions paid on the Exchange by both buyer and seller, since this total represents the cost of transferring shares from one public customer to another on the Exchange.

The importance of the public commission schedule of the NYSE must be emphasized. By not providing nonmember broker-dealers preferential access to trading in the exchanges, it encourages the existence of a market which will permit them to trade listed stocks profitably. It affects institutional customers in two respects: first, it provides no graduated discount for the larger transactions in which they tend to deal; and second, it is based on a cost structure which includes the cost of services other than the basic brokerage function—services often of little interest or value to an institution. The consequence of these characteristics is that the off-board market maker has considerable latitude in quoting prices to institutions net of commissions that are better than the combination of Exchange price and commission.

Depth of market, which is important to institutions in large transactions, is easily and definitely ascertainable on the third market. The market makers generally possess the capability of taking large positions. For their largest transactions they often act as agents for both parties, bringing together institutional sellers and purchasers of the same stock, generally at a commission substantially less than NYSE rates.

While the third market is competitive with the NYSE market in effecting individual trades, it is generally complementary to it in the execution of an entire block transaction. Institutional traders make optimum use of both markets, utilizing the resources of the market makers on the third market and the public trading and resources of the specialist on the Exchange. Larger trades appear to be effected off board while smaller ones, being less likely to exert an effect on price, are transacted on the Exchange.

Broker-dealer intermediaries in the off-board market are far less concerned with depth of market and far more with securing a price for the stock equivalent to the price on the NYSE, net of commissions. In odd-lot trading the practice of some of the market makers appears to be to gear the price to the last round-lot price on the Exchange, plus or minus the odd-lot differential charged on the Exchange, and differs from the Exchange practice only in that the latter gears the odd-lot price to the *next* round-lot price.

There is more question concerning the equivalence of price in the round-lot transactions because the third-market price may be determined immediately upon placement of an order while the price on the Exchange cannot be known until after the execution of an order and may well vary from the quotations and the previous tape price. Since the broker-dealer intermediaries generally charge their public customers a commission, individuals do not enjoy the price margin of the institutional customers, dealing net of commissions. It appears, however, that broker-dealers "shop" competitively among the market makers, and many utilize the NYSE when they can obtain a more advantageous execution there.

As applied to over-the-counter trading in listed securities, it appears to the Special Study that the advantages of competition generally outweigh any concern over impairment of depth in the primary market. It would appear that the third market has developed in the shadow of the NYSE only by dint of its ability to perform a useful function. Unlike the unlisted stocks traded over the counter, freedom from investor safeguards [5] is not a factor in the case of the listed stocks traded off board. Broker-dealers trade on the third market because they have no other practical access to listed securities. Institutions trade on this market only when they are able to secure better executions. 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 usefulness of the functions performed by the third market does not, of course, lessen the public interest in its operations, an interest which extends to all markets for the trading of securities. It is important that the off-board market for listed securities, taken both independently and in its relationship to other markets, operate to achieve the objectives of the Exchange Act. A minimum need, particularly for the informational purposes described below, is identification of the firms making off-board markets in listed securities in the same way as is recommended for the "primary market makers" in chapter VII. Transfer to market makers on the third market of any of the regulations governing the activity of the primary market makers generally, however, should depend on the applicability of these regulations to the special facts of the third market.[6]

Similarly, the inherent differences between the off-board market and the exchange markets preclude their being placed in the same mold. Regulations are not to be transferred from one to the other in the name of uniformity. At the other extreme, it would be difficult to justify differences in trading practice and operation, if any should develop, which may merely serve as loopholes in exchange regulation. For example, though there appears to be little short selling on this market at the present time, short sales by customers of the market makers should be identified. But the applicability of restrictive rules should depend, in each case, entirely on their need.

The rapid growth of the third market and its possible effect on other markets requires, at the very least, observation, understanding, and evaluation of its activities. The market is altogether too important, even apart from the strong indications that its growth has not necessarily come to an end, to be permitted to continue in relative and absolute obscurity. Because of its very direct impact on auction markets this would seem to be true of over-the-counter markets in listed securities even if it is not found appropriate to impose comparable requirements on over-the-counter markets generally. Specifically, there should be reporting of volumes and prices (including market makers' trading on the auction market), as well as of short sales by customers of the market makers, in each listed security. The focal point of such reporting would be the market makers, but the requirements should be broad enough to cover off-board trading, at least in transactions of size, taking place outside the established markets.

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[5] See the discussion of the reporting, insider trading, and proxy requirements of the Exchange Act in ch. IX, pp. 2–7 (pt. 3).

[6] See discussion in ch. VIII.F (pt. 2) of the question of quality of execution presented by the existence of competitive markets.

Stress on the present effects of off-board trading in listed stocks on the primary market and on the need for additional data concerning such trading points to the further question of the long-run consequences of current trends. The institutionalization of the bond and preferred stock markets has already led to a notable shift away from the auction market to a dealer or over-the-counter market in these securities. The concentration of off-board trading in the common stocks generally most active on the Exchange should not becloud the fact that a number of these stocks, mostly utilities, are of less than average activity on the principal exchange and therefore potential candidates to continue that shift. Maintenance of present trends toward increasing utilization of the over-the-counter market for the trading of these stocks by institutions—which appear to be more interested in these stocks than individuals—could result in the off-board market's becoming the dominant market in the trading of these stocks. The extension of such a development to a larger number of stocks could ultimately transform present patterns in the trading of common stocks.

The plotting of future trends in this area depends, of course, on a number of independent developments. More individuals own common stocks directly today than ever before, but a larger number is also constantly participating in such ownership through the medium of pension funds, insurance companies, investment companies, commercial banks, and other institutions serving as conduits between individuals and the ultimate investment of their funds.[7]

Much depends, too, on the capacity of the exchanges, primarily the NYSE, to adapt themselves to any shift in the nature of their customers and in the pattern of their trading. The various special plans of the NYSE for the handling of transactions considered unsuitable for the regular auction market constitute a step in this direction but, alone, represent no final answer to the challenge. The effect of the commission schedule has been shown to be of great importance. Yet the Exchange has shown little inclination in recent years to reexamine the schedule's assumptions and to measure its adequacy in light of today's market conditions.

The challenge to the primary market represented by the third market calls for imagination and statesmanship in the interest of enhancing the usefulness of each, not for measures in the direction of destroying competitive markets. Only a withering of the needs which have given rise to the third market can justify the "elimination" of that market, as recently suggested by the NYSE's president. In the competition of markets for the trading of securities, it is surely not too much either to expect that each will put forward its strongest efforts to retain and capture the largest possible trading volume or to believe that, absent unreasonable discriminations and within the necessary bounds of investor safeguards and the public interest, the best markets will be those whose performance in that interest sanctions their claim to existence.

The Special Study concludes and recommends:

1. The rapid growth in recent years of an off-board market for the trading of listed common stocks has made this an increasingly

[7] The evidence does point, however, toward a progressively larger relative participation by institutional investors. See ch. VIII.C.1. (pt. 2).

important segment of the national securities markets. Although the stocks are listed on the exchanges, the market operates as a part of the over-the-counter markets. It thus has elements of each market but is distinguishable in important respects from both (and for this reason has been designated in this part as the "third market"). As in the case of multiple markets generally, the third market requires evaluation of the advantages of competition with reference to possible impairment of the depth of the primary market. Under existing circumstances, it appears that the over-the-counter market for listed stocks has been beneficial to investors and the public interest.

2. The study found an acute lack of data concerning the third market. Correction of this deficiency is an indispensable prerequisite to understanding and evaluating this market. As a basis for the gathering of essential information concerning the off-board trading of listed securities, the broker-dealers who hold themselves out to other broker-dealers and others as being willing to buy and sell listed stocks for their own accounts should be identified. The system of identification should generally follow the pattern recommended for "primary market makers" in the conclusions and recommendations in chapter VII, but there is no need to await the establishment of mechanical arrangements for such identification; the relatively small number of market makers and securities involved in the third market should permit the institution of the necessary identification program with a minimum of delay.

3. Pursuant to section 17(a) of the Exchange Act, the Commission should, by appropriate rule or regulation, secure information concerning the third market on a continuous basis from at least two sources. The market makers (as identified under paragraph 2) should be required to file reports on their trading in listed securities in such detail as to volume and price as the Commission may find reasonably necessary. Other broker-dealers engaged in off-board trading in listed securities, but not making markets, should be required to file periodic reports of transactions in listed securities of (say) 300 shares or more; i.e., transactions effected as agent for both buyer and seller, not involving a listed market maker.

4. There appears to be no more basis for broker-dealers to engage in riskless principal transactions with public customers in listed stocks than in unlisted stocks, discussed in chapter VII. Broker-dealers trading in listed stocks for which they are not making markets officially identified under paragraph 2 or without a bona fide inventory should be required to effect the orders of public customers for listed stocks on an agency basis, in accordance with the recommendations in chapter VII.

5. Short selling by the customers of the market makers, though apparently limited in extent at the present time, contains the seeds of a problem if utilized to escape the regulations governing the exchange markets. All sales to market makers should be marked either "long" or "short" in conformance with such regulations as the Commission may issue, and the market makers should report such sales to them under paragraph 3 above.

6. The trading of market makers directly with individuals in the third market also appears to be negligible in amount. At the same time, however, expansion of this area of operation in the future contains the potential of a situation requiring regulation to safeguard the interest of investors. The market makers should be required to file with the Commission data concerning such transactions necessary to permit adequate oversight and anticipation of regulatory needs.

PART E. ALLOCATION AMONG EXCHANGES—THE REGIONAL EXCHANGES AS PRIMARY AND SECONDARY MARKETS

At present there are 14 active regional exchanges, of which 4 are exempt from registration under the Exchange Act and 3 are western mining exchanges; the remaining—the Boston, Cincinnati, Detroit, Midwest, Pacific Coast, Philadelphia-Baltimore-Washington, and Pittsburgh Exchanges—are the main subject of this part of the report.

The regional exchanges now in existence are the remainder of what at one time were over 100 regional exchanges. In the last century and the early part of the present century exchanges were organized wherever there was an active interest in trading securities; before adequate communication facilities were developed, trading could only be accomplished on a face-to-face basis and the exchanges were organized to fill that need.

While the regional exchange picture has always been changing, particularly important changes occurred beginning in the 1930's when functions and practices began to take their present form. Following the 1929 crash, volume on all securities exchanges dwindled and the effect was severely felt by the regional exchanges. The trading of stocks that were listed solely on regional exchanges declined for several additional reasons. The Exchange Act with its requirements as to disclosure, proxies, and insider trading tended to discourage new listings by issuers on regional exchanges. The distribution of new issues ceased to be a function of the regional exchanges, partly as the result of the growth in communications which permitted the over-the-counter market to perform this function. At present the stocks traded solely on regional exchanges are relatively few in number and many of them are relatively inactive.

To make up for their loss of solely traded stocks the regionals expanded their trading of stocks also traded on other securities exchanges, usually the NYSE. Although Commission approval is required under section 12(f)(2) of the Exchange Act before an exchange can trade on an unlisted basis a security already listed on another exchange, in recent years the expansion of dual or multiple trading on the regional exchanges has been facilitated by the Commission's liberal granting of regional exchange applications under this section.

As a result of the regional exchanges' loss of primary listings and their increasing reliance on dual or multiple trading, the latter has become by far the most important business of the major regional exchanges; in fact 93 percent of the dollar volume of trading on the seven major regional exchanges in 1961 was in securities also traded on a principal exchange (usually the NYSE). These securities are generally the most active NYSE stocks, with the greatest number of shares outstanding and the most shareholders. In the typical situation, the splitting of the market through dual trading 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. In some situations, however, dual trading may cause impairment of depth in the primary market.

The regional exchange markets in solely traded and dually traded stocks operate in different ways. Round lots in solely traded stocks apparently are traded in much the same way as stocks are on the NYSE and Amex, although the relatively thin markets and limited public participation in these stocks make it more difficult for a continuous auction to take place. Although there is greater need for specialist participation in inactive stocks, specialists are reluctant to take positions or make close markets in these stocks. Odd-lot trading in solely traded stocks uses the same mechanism as on the principal exchanges, with the function of odd-lot dealer and specialist combined, as on the Amex.

Trading in a dual stock is essentially based on the prices and quotations of the primary exchange. The specialist participates in most transactions and on one or more of the exchanges is required to, or does in practice, quote at least one side of the market as favorable as in New York. A variety of special arrangements have been developed on the regional exchanges by which a customer may be enabled to receive a price substantially equivalent to that in the primary market, but one or two of these arrangements may raise questions of whether customers receive the best available execution. However, by checking both the regional market and the New York market, a broker is in a position to obtain whichever price is the more favorable.

Odd-lot orders in dually traded stocks are mechanically executed based on prices appearing on the NYSE (or Amex) tape, with a time interval designed to provide the same price on the regional exchange as would have been obtained on the principal exchange. However, the degree of surveillance given to such transactions differs from exchange to exchange.

The odd-lot dealer-specialists in the course of trading odd lots and round lots in dual stocks may accumulate positions. They have several methods of liquidating a position; they can make their round-lot quotes better than the primary exchange's quote or they can sell stock off the regional exchange by trading over the counter or on the primary exchange. There is no evidence that such offsetting transactions on the NYSE have had any harmful impact on that market.

Although there are significant numbers of sole members, regional exchange members deriving the greatest portion of the income earned on the regional exchanges are dual members; i.e., members of both regional exchanges and the NYSE, but the regional exchanges do not provide the most important source of income for them. Sole members of regional exchanges, as a group, also do not receive the major portion of their income from the regional exchanges; other activities—over-the-counter activities and mutual fund sales—are larger sources of income. However, there are many sole members who receive a substantial portion of their income from their regional exchange activities.

The commission rate structure of the NYSE (see ch. VI.I) prevents nonmember broker-dealers from directly receiving or sharing in commissions on transactions in NYSE stocks. The dual trading system (together with the over-the-counter market in listed securities) permits such nonmember broker-dealers to deal in a large number of securities trading on the NYSE and retain all or part of the commissions. Dual trading also facilitates the channeling of reciprocal business to sole members who send orders which cannot be executed on the regional exchange to New York for execution. Further, it permits savings for dual members who do not have their own execution and clearance facilities in New York. The dual trading system also permits institutions such as mutual funds to channel business in return for sales of mutual fund shares to broker-dealers who are not members of the New York exchanges and in some cases to broker-dealers who are not even members of regional exchanges.

In certain areas the regional exchanges have provided technological competition with the major exchanges; one current example of this is the automated centralized bookkeeping system in effect on the Midwest Stock Exchange. In a wider sense, too, the public interest is served by maintaining and fostering competitive markets as distinguished from having excessive concentration in a very few markets. From this point of view the role of regional exchanges as primary markets is particularly significant but in practice has been progressively reduced in importance.

In general, the regional exchanges as primary markets have experienced declining importance on declining prestige. Nevertheless, strenuous efforts to secure further listings as the disparities between the disclosure requirements for stocks traded over the counter and on exchanges are removed—coupled with other measures such as modified market mechanisms and possible further mergers, interconnections and/or reciprocal memberships among exchanges—might serve to arrest and even reverse the trend.

The Special Study concludes and recommends:

1. Over recent decades, the character of most regional exchanges has markedly changed to the point where most of them are far more important as "dual" or "multiple" markets for securities listed on a New York exchange than as primary markets, and their memberships consist predominantly of "dual" members (members of a New York exchange) rather than "sole" members. The Commission's administration of section 12(f)(2) of the Exchange Act has allowed the regional exchanges substantial freedom in selecting securities in which to establish dual or multiple markets. By helping to promote the multiple trading of the regional exchanges, which has become the mainstay of their existence, this policy has encouraged competition in the securities markets. The evidence points to the conclusion that the benefits of this competition outweigh any possible effects on the depth of the existing markets.

2. Given the present dependence of regional exchanges on multiple trading, for the most part conducted as an adjunct to the New York markets rather than on an independent basis, any program for providing a volume or block discount in commission rate structures or for providing preferential access by nonmember

broker-dealers to New York markets (see ch. VI.I) should be planned and carried forward with due regard for the potential impact on regional exchanges.

3. The survival of one or more regional exchanges as *primary* markets, significantly competing for primary listings with the New York exchanges, would appear to be generally in the public interest. These exchanges should be encouraged and assisted in developing and effectuating (a) combinations, interconnections and/or reciprocal membership arrangements with other exchanges, to provide larger combined memberships, broader stock lists, and stronger resources, market facilities, and self-regulatory mechanisms; (b) trading rules and practices consistent with their character as centralized markets and with basic protection of investors, but adapted, so far as practicable, to the special needs of listed securities of less than optimum depth on a nationwide basis; (c) programs for wider publication of stock lists and quotations and for general enhancement of prestige and public acceptance.

4. An important byproduct of legislation extending the protections of sections 13, 14, and 16 of the Exchange Act to investors in over-the-counter markets (see ch. IX) would be to remove what is now an artificial barrier to exchange listing of securities entirely suitable for an auction market. To improve the stature of the regional exchanges as primary markets, to provide a nationwide market pattern of maximum strength, and to avoid excessive concentration in the New York exchanges, there is every reason to promote the attainment by the regionals of a status which invites new listings. As progress is made in enhancing the stature of the regional exchanges and in furtherance of such progress, consideration should be given to further raising the listing and delisting standards of the NYSE, and possibly the Amex, and encouraging the transfer of listings that might find more suitable markets on other exchanges.

5. Multiple exchange memberships, at least when so extensive that the membership of any one exchange may become the most important membership of others (as is now true of the NYSE in respect of most regional exchanges), tend to limit the independence of such other exchanges and their ability to compete. If and to the extent that it is realistic to contemplate some of the regional exchanges' becoming important, competitive primary markets (see 3 and 4, above), regulation of multiple memberships may be an appropriate long-range goal of public policy, although not a realistic possibility under present circumstances. In light of the present importance of multiple memberships, the Commission's continuous surveillance of rules and practices must be designed to assure the freedom of the regional exchanges from the possibility of control by the NYSE or its members in areas of potential competition.

Part F. General Considerations

The market scene is kaleidoscopic rather than static, with various currents of change operating beneath the surface of daily business. Rules and practices of the marketplace must be periodically reappraised both to determine whether they themselves are accountable for possibly unintended changes in market patterns and also to consider whether trading or regulatory mechanisms need to be adapted to new conditions.

The currents of change are sometimes in the same direction, sometimes in opposite directions, and often circular in their interaction. Though they may operate slowly and imperceptibly, they may lead to results of basic importance. Among the most significant phenomena examined in this chapter and chapters V to VII are the importance of the NYSE and its membership in other markets and the participation of other markets and nonmember broker-dealers in the trading of NYSE-listed securities. These particular phenomena and others discussed in these chapters raise fundamental issues as to, among other matters, the appropriate extent and limits of competition in the securities markets, as well as rights and obligations in respect of access to particular markets and assurances of best executions.

Broad questions of this kind should receive more positive and continuous attention in the performance of the Commission's total role and responsibility to protect the public interest and the interest of investors. Since market patterns in which these questions arise are constantly subject to change, the Commission should be equipped, in facilities, personnel, and programs to be the repository of essential information and the wellspring of public policy in these areas.

The Special Study concludes and recommends:

1. It is essential for the Commission to improve its facilities and programs for continuous accumulation of data with respect to fundamental, but often obscure, changes in the components, uses and needs of the total pattern of trading markets; i.e., the separate markets when considered in relation to each other. This need, together with others discussed in chapters VI, VII, and VIII, calls for both a reappraisal of present reporting systems, with full regard to the burden of supplying particular information in relation to its utility in the public interest, and a considerably wider perspective as to potential uses of data processing equipment in discharging the Commission's regulatory responsibilities.

2. The Commission should establish a separate, permanent policy and planning unit within its staff, having the responsibility of accumulating and analyzing pertinent data bearing on market patterns and practices generally, making special studies as the need may be indicated, and reviewing policies and regulations in light of changing circumstances.

3. Among the subjects that appear to need further and continuing attention of such a staff group and of the Commission are: (a) types and forms of competition and of limitations on competition actually or potentially existing within and among markets, and their impact on the free, fair, and orderly functioning of the various markets; and (b) 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.

CHAPTER IX

OBLIGATIONS OF ISSUERS OF PUBLICLY HELD SECURITIES

[Part A (Introduction) discusses generally the need for adequate availability and dissemination of information about issuers and the need to extend to unlisted securities the safeguards now applicable to listed securities under the Exchange Act.]

Part B. Protections for Investors in Listed and Unlisted Securities

Disclosure is the cornerstone of Federal securities regulation; it is the great safeguard that governs the conduct of corporate managements in many of their activities; it is the best bulwark against reckless corporate publicity and irresponsible recommendation and sale of securities. In light of such considerations, it seems wholly indefensible, in terms of logic and of public policy, that most investors in over-the-counter securities should be afforded drastically less protection than is provided for investors in exchange-listed securities through sections 13, 14, and 16 of the Exchange Act. It is also highly anomalous that market allocations (in the sense of selections between exchange markets and over-the-counter markets) should be importantly affected by a sort of Gresham's law whereby many issuers may avoid the protective measures applicable to all listed securities by simply electing to have their securities traded over the counter. Issues traded in over-the-counter markets are far too numerous and important—partly as a result of this Gresham's law—to permit the present anomalous distinction to continue.

Investors in all exchange-listed securities are afforded protection both by statute and by rules of various of the exchanges. The Exchange Act requires full information about an issuer to be disclosed in a publicly filed application for registration before securities of the issuer may be listed for trading on an exchange, and requires the information to be kept current by subsequent periodic and current (special) reports (sec. 13). It also requires that complete information be supplied shareholders in accordance with Commission rules when proxies are solicited (sec. 14). Finally, the Exchange Act controls the use of confidential corporate information for personal gain by requiring public disclosure of insiders' transactions in the equity securities of their corporations and providing for the corporate recovery of resulting "short-swing" profits.

Statutory protections are supplemented by the exchanges. The principal New York exchanges, for example, in their listing agreements require all listed companies to disseminate independently audited financial statements to shareholders annually, and require most