

May 19, 1967

Mr. G. Keith Funston, President
New York Stock Exchange
11 Wall Street
New York, New York 10005

Dear Mr. Funston:

This will refer to our discussion on April 11, 1967 with Messrs. William O'Reilly, Robert Walters and James Buck concerning the Office of Regulation's recent inspection of floor trading.

As indicated at the meeting, our staff found that the Exchange plan filed under Rule 11a-1 to regulate floor trading is not functioning as envisioned. The problem does not seem to be in the plan itself but rather a lack of enforcement on the part of the Exchange.

A major factor in the apparent breakdown of effective enforcement is the failure of the Exchange adequately to follow through on cases developed by the investigative division. Although the investigative division handles a large number of cases, investigations are processed in a routine manner and are readily closed out ("noted") on what appears to be superficial explanations by traders even though these explanations often deviate from Exchange data and supervisors' explanations. For example: a large number of apparent violations of the short selling rule were found; however, most of the cases were "noted" and closed upon explanations by traders that the transaction journal or their trades were either missing or out of order. Furthermore, situations of possible improper congregating by traders (Rule 110) were investigated but the unresolved problem was "noted" and dropped as the traders in question did not recall seeing one another in the crowd and the floor supervisor or specialist did not recall seeing the traders in the crowd together.

In our conference your staff confirmed that use of the term "noted" does not mean the Exchange did not find a violation of the trading rules; rather it apparently means that, faced with conflicting evidence, the investigative division closed the case rather than follow through to determine whether the registered trader had violated an Exchange rule. At the conference your staff members stated that even though no action is taken when a case is closed, they felt the investigations had a prophylactic effect since traders would realize that their trading activities were constantly being reviewed. It appears, however, that the prophylactic effect will be actually lost as traders begin to realize that very little comes of the investigation.

The failure of the Exchange to take appropriate action against certain registered traders after repeated serious rule violations have been discovered, raises a serious question as to whether the Exchange is adequately enforcing its rules. The Exchange's failure to take appropriate action evidences a failure to grasp the seriousness of these repeated violations and sharply points up the problem of this enforcement program. We request that you apprise us as soon as possible as to whether any floor traders have committed any additional possible violations of Exchange rules since the day of the inspection, and the action, if any, being taken by you.

The inspection also revealed that with regard to interpretations given to registered traders by the Floor Department staff, it is clear that not all such interpretations are thoroughly reviewed with respect to the proper or prior interpretations of the same matters. Some interpretations are contradictory; others off definitions not contemplated nor covered by the rules. For example, the Exchange's interpretation (as revealed during the course of the inspection) that a trader may buy and sell rights or low priced stock solely to raise the stabilization rate, raises a serious question as to the enforcement of the stabilization percentage required by Rule 112. Another area of questionable interpretation pertains to congregating of dominating the market (Rule 110). The supplementary material to Rule 110 provides that when establishing or increasing a position no more than three registered traders may be in the crowd for one stock at the same time. The inspection disclosed that the Exchange does not impose a comparable limit on the number of registered traders in the crowd who are liquidating. Apparently the Exchange excludes from the definition of congregating registered traders, who are liquidating unless such traders are also dominating the stock. Since there is no justification for applying a different liquidating as compared to establishing or increasing a position, the numerical definition of congregating should be clarified to include traders who are liquidating as well as those who are acquiring stock. In this connection, it should be emphasized that the Exchange's system of reliance upon post supervisors to spot congregating by traders is not satisfactory since it is difficult apparently for members or staff of the Exchange to identify traders. In view of regulatory problems raised by such Exchange interpretations given to registered traders by the Floor Department staff, it is requested that henceforth all interpretations be sent to this Division within a reasonable time after they have been rendered.

If the Exchange floor trading rules are to be effective and abuses are to be eliminated, the Exchange rules must be subject to proper interpretation and strict enforcement. The Exchange should initiate disciplinary actions against traders whose activities violate Commission or Exchange rules. These disciplinary actions should include the whole range of disciplinary actions such as censure, fine, suspension, and revocation.

On June 23, 1966 we wrote to you about certain practices which appeared contrary to the spirit and intent of Rule 11a-1 of the Securities Exchange Act of 1934 and Rule 112 of the Exchange. In that letter we pointed out that member trading subsequent to the execution of two large blocks (Boeing Co. and Ford Motor Co.) provided examples of transactions which defeat the purpose of the floor trading rule. In both instances members off-floor used their trading information from floor brokers and/or clerks prior to its public dissemination via a tape print. We pointed out that this acquisition and use of floor information by members off-floor is contrary to the spirit and purpose of floor trading rules.

Paragraph 2112.20(b) (1) (i) of the Exchange supplementary material to Rule 112 defines as on-floor trades any transaction of a member organization "which results from an order entered off-Floor following a conversation with a member of the Floor who is a participant in the same member organization." We pointed out in such letter that the members off-floor are interpreting the specific language "who is a participant in the same member organization" as permitting to acquire and use floor information prior to its public dissemination providing that the person giving the information is either a member or employee of another member organization. We suggested that the rule be amended to prohibit such and similar conduct which represents an evasion of the floor trading plan. (Such change, of course, would not be designed to prevent solicitation of quotes from the floor). Furthermore, we recommended that all orders to the floor be routed through the firm's order room to enable public and member orders to be on a parity for execution. In response, you wrote to us on January 17, 1967 and stated that the Exchange was studying the matter, that the Exchange and Commission had agreed to await the results of the Commission staff's off-floor trading study referred to below in this letter, and that the Exchange's posts were being automated with sales data being printed within 30 seconds. You concluded in your letter that in a few months the Exchange would be in a better position to evaluate the automation of data and would contact this Division in early April of this year.

The recent inspection of floor trading reviewed the Exchange's study of this problem. Our inspection revealed that your own study indicated that the dissemination and utilization of floor information by off-floor traders is a widespread practice. Our off-floor study referred to in your letter has been completed and has reached the same conclusion. As Rule 112 is now being interpreted off-floor traders enjoy significant trading advantages over the public, and automation of the posts will not eliminate these advantages. With regard to the direct wire abuse our inspection showed that off-floor traders rely heavily upon direct wires to gain advantage over the public which must use the firm's order room. We therefore suggest that you immediately implement the recommendations of our letter of June 23, 1966 through revision of Rule 112,

Paragraph 2112.20 in the supplementary material and the elimination of the discriminatory use of private wires for members' orders.

As mentioned above, Paragraph 2112.20 (b) (i) defines as on-floor any transaction for a member organization resulting from an order entered off-floor following a conversation "with a member on the Floor who is a participant in the same member organization". In our conference your staff stated that the Exchange currently construed such language to mean that a transaction following a conversation with a person who is a member of the New York Stock Exchange. Such an interpretation is contrary to the spirit and purpose of the floor trading rules. It permits evasion of the rule by the simple expedient of an on-floor employee of his organization to transmit the information to his member organization.

As we mentioned at the conference, the staff of the Commission has recently completed an exhaustive study of off-floor trading by members. We pointed out that the off-floor report indicated that there may be action at times among off-floor members designed to influence prices. In order to further investigate this problem the staff, as you know, is collecting data on member off-floor trading. Reports of all off-floor transactions in common stocks for the months of March and April, 1967 have been requested from thirty New York Stock Exchange member firms. The identity of the firms, and the questionnaire sent to them, have been forwarded to Mr. Donald Calvin.

Finally, we wish to direct your attention to the fact that another area in which the floor trading rules are not explicit is the trading from off-floor by non-registered traders who have been on the floor previously that same day. Shortly after the floor trading rules went into effect, the Exchange agreed to a recommendation of the Commission staff that once a member (other than a registered trader) has been on the floor, he should not engage in a course of dealings off-floor which could reasonably be characterized as a violation of the spirit of the floor trading rule. However, this interpretation was not incorporated as part of the Exchange's rule and it is doubtful whether the members are aware of this interpretation. The off-floor report referred to above pointed out several instances of trading from off-floor by specialists and floor brokers after having been on the floor the same day. It is, therefore, recommended that the supplementary materials on Rule 112 be amended to include a clarification of restrictions on non-registered traders after they have been on the floor and that the Exchange require regular weekly reports from members (other than registered traders) showing for any day in which they have been on the floor, their subsequent off-floor trades. As you may be aware the American Stock Exchange presently requires such reports.

If you have any questions or would like to discuss any of this further, please do not hesitate to communicate with me.

Sincerely yours,

Irving M. Pollack
Director