RULE 394

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[original undated]

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INTRODUCTION

This report is the result of an inquiry conducted under a Commission order issued pursuant to Section 21(a) of the Securities Exchange Act of 1934 directing a private investigation in the matter of

"Rules, Regulations and Practices of National Securities Exchanges Relating to Off-Board Transactions by Member Firms as Agent and Principal in Securities Admitted to Trading on Such Exchanges."

Pursuant to the authority granted in the order, certain designated officers of the Commission conducted a series of transcribed interviews with respect to the subject matter of the inquiry. Approximately 2000 pages of transcript were taken with a view toward fully exploring the ramifications of the inquiry. In addition, non-transcribed interviews were conducted with a variety of financial institutions and experts who were intimately familiar with the subject matter. Extensive documentary material was obtained from the New York Stock Exchange and other exchanges pursuant to a subpoena, a copy of which is set forth in Exhibit A. This inquiry was conducted privately. The individuals who were interviewed on the record were given an opportunity to obtain the transcripts of their discussions with the staff of the Commission.

The investigation and report, for the most part, concentrate on Rule 394 of the New York Stock Exchange. Although information was obtained in the course of the inquiry from other exchanges in connection with their rules relating to off-board trading by members, this material was evaluated in the context of its relationship to the New York Stock Exchange Rules and its effect on broker-dealers who were members of both the New York Stock Exchange and such other exchanges.

Chapter VIII of the Special Study of Securities Markets discussed the interrelationships between trading markets. Section D of that Chapter dealt with over-the-counter markets in exchange-listed securities. It discussed the volume and growth of this "third market," the securities traded, the size of transactions, the participants (both public and professional), the operation of the market and the relationship between exchange markets and the third market. The Special Study found that there was a conflict between the advantages of competition resulting from the existence of the third market and the disadvantage occasioned by a possible impairment of depth on the exchange market. The Study concluded, however, that on balance the advantage of the competition provided by the third market and the potential overall depth outweighed the concern over impairment of depth on the New York Stock Exchange. The Study also noted that the Commission had only sparse information with regard to the third market. The Study pointed out that the existence of dual markets highlighted questions as to whether the Exchange commission rate structure and the restrictions on members executing trades off-board might result in other than the best executions for a public customer. Finally, in view of the foregoing, the report recommended that the Commission devote further and continuing attention to "(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." This report is a partial fulfillment of that recommendation.

The problems of competition between the Exchange and the third market and the quality of executions with respect to dually traded stocks were also brought into prominence by a controversy over the listing on the New York Stock Exchange of the Chase Manhattan Bank. M. A. Schapiro & Co., a non-member dealer which had long maintained a market in Chase stock and had dealt extensively with exchange member firms, while objecting neither to the listing of bank stocks in general nor Chase in particular, objected to the application of Exchange rules which would prohibit members from continuing their customary dealings for their own account and for the account of their customers with the firm. The crux of the problem was Rule 394 of the New York Stock Exchange, the chief subject matter of this study.

I. Rationale for and History of Rule 394

The text of Rule 394 of the New York Stock Exchange reads as follows:

"Except as otherwise specifically exempted by the Exchange, members and member organizations must obtain the permission of the Exchange before

effecting a transaction in a listed stock off the Exchange, either as principal or agent."

The Rule in its present form was filed with the Securities and Exchange Commission on [blank in original] 1957, as part of an extensive renumbering and consolidation of Exchange rules. This section of the report deals with the rationale for the Rule and the background and circumstances which led to its adoption.

Exchange members state that Rule 394 is designed to preserve and maintain the depth and liquidity of the auction market and that any fragmentation of that market by permitting orders to be executed other than on the floor of the Exchange damages the primary market. This is the basic theory on which the Rule is based. While some of the terms used in this conclusion may seem somewhat vague or not subject to quantification, the general thought is simply that all orders must be brought to one place to insure an efficient, fair and orderly securities marketplace. This position is refined and explained by five basic premises:

1. The fairest market, it is argued, is a market in which all orders are entitled to an execution based on the best price available as qualified by rules concerning precedence, parity and priority of orders. This means that a public customer who places an order on an Exchange expects that he will receive an execution of that order at the price that he sets -- prior to the time that any other person obtains an execution at a price better than the one he brought to the floor. Therefore, if a customer bids $20 for a stock, no other customer who is bidding only $19-7/8 will be able to buy the security if it is offered for sale. The $20 bid is higher in the "auction" and if it is the highest bid, it will take the floor. The Exchange argues that the public customer who places an order with a member firm expects that all of the other public orders of member firms will be brought to the floor so as to increase the possibility of his order being executed at a favorable price. To the extent that the member firm is permitted to execute orders off the floor, the expectations of persons who have left orders on the floor will be frustrated.

2. A second basic principle which underlies Rule 394 is that in an exchange market the specialist should have an opportunity to participate in each transaction. While this concept is not necessarily a sine qua non for a central market, it is bottomed on the realistic evaluation that for most, if not all securities, specialist participation is required. The Exchange is not a continuous auction market in the sense of there always being available public buyers or sellers; rather professional intervention in the market is often necessary in order to assure immediate liquidity at a reasonable price. Ordinarily the specialist will look to the spread between his bid and asked -- the so-called "jobber's turn" -- as a source of profit. To the extent that the specialist is not shown each order and

thereby given the opportunity to participate at what may be favorable prices (particularly on block transactions), he will lose "one leg" of his jobber's turn and his opportunity for profit. Stated another way, if the specialist is required to maintain a fair and orderly market by taking positions and supplying securities where needed, he can only reasonably be expected to do so if he is assured that he will see all the buy and sell orders entered by the public through member firms.

3. A third premise on which the current interpretations of the Rule are based is that the exchange market depends upon and uses a tape which records and disseminates facts about transactions. The tape print has two principal purposes: First, it provides a method by which public investors are informed about the execution of the order they have placed with their broker. Secondly, the tape print is designed to attract orders to the floor for execution by openly publicizing the prices, volume and movement of each security on the board. If orders in listed securities are executed off the floor and therefore are not publicly reported, it is argued that brokers and customers may not realize the existence of willing buyers or sellers for a particular security. [Footnote: Rule 394 also can and does serve to insulate the public from information about a transaction. Sometimes, where the price of a transaction is substantially away from the market, approval for off-board trades is granted in order to avoid the disclosure of the transaction on the tape. Non-publicity is deemed desirable if the dissemination of the facts about a particular transaction will create either significant buying power or selling pressure and thereby place substantial -- and unwarranted -- burdens on the specialist. Rule 394 therefore also serves as a safety valve to avoid such pressures.]

4. A fourth justification for Rule 394 is the preservation of the minimum commission rate schedule. All non-members must pay a minimum commission on a transaction with a member, irrespective of size, business function or fiduciary relationship with a member. It is argued that if exchange members were to execute orders off-board, they might obtain one commission from their customer and deal on a net basis with a non-member to facilitate the execution of the customer's order. It is also argued that off-board trades will tend to break down the minimum commission rate schedule even if a commission, on the face of a trade, appears to have been paid by the non-member. This is because prices will be negotiated between members and non-members in such a way that the minimum commission charged will be offset by the non-member's adjustment in the overall price. Rule 394 also prevents a member firm from dealing off-board as principal and thereby executing orders without payment of a commission by a non-member. The requirement that members execute orders on the floor (and charge a minimum commission) therefore removes any direct economic pressures from financial institutions or other non-members who might wish to

negotiate the service fee if the order were executed other than on the floor of the Exchange.

5. Finally, the Exchange argues that its market is a regulated market. The so-called third market, however, with whom member firms might wish to do business, is considered by the Exchange to be an unregulated market. It is a market which does not have rules and regulations with respect to the obligations of market-makers to assure a fair and orderly market; there are no rules concerning short-selling; there is no tape print and no public reporting of transactions. Thus, the Exchange takes the position that the public interest requires that if its members act as intermediaries in executing orders, it should do so in a market which is under regulatory supervision.

The foregoing points reflect the current Exchange position with respect to rules which restrict the member firm from trading off the floor of the Exchange. It is important, however, to examine the historical precedent for the Rule, and in particular, the previous positions of the Exchange with respect to the question of off-board trading. The following discussion describes the events and circumstances which led the Exchange community to support Rule 394.

In 1939, the Board of Governors of the New York Stock Exchange became concerned with the activity of its members on regional exchanges of which they also were members. A committee was appointed to determine whether member firms were in violation of Article XVI, Section 8, of the Constitution of the Exchange which, at the time, read as follows:

"Whenever the Board of Governors by the affirmative vote of seventeen Governors, shall determine that a member or allied member is connected, either through a partner or otherwise, with another exchange or similar organization in the City of New York which permits dealings in any securities dealt in on the Exchange, or deals directly or indirectly upon such other exchange or organization, <u>or deals publicly outside the Exchange in securities dealt in on the Exchange</u>, such member or allied member may be suspended or expelled, as the Board may determine." (Emphasis added)

In 1940, the committee concluded that the Constitution was not being enforced by the Exchange. Shortly thereafter they adopted a resolution stating that any member, allied member, or member firm, acting as an odd-lot dealer or specialist, or otherwise publicly dealing for his or its own account on another Exchange in securities listed on the New York Stock Exchange, should be subject to proceedings under Section 8, Article XVI, of the Constitution.

Upon notice of the policy of the Exchange to enforce Article XVI, Section 8, of the Constitution, the Division of Trading and Exchanges of the Commission

submitted a report to the Commission which concluded that the Exchange action would be undesirable and, though apparently directed solely to its own members, would affect inter-exchange competition in a manner harmful to local industries, the general public and individual investors. In particular, it was argued by the Commission staff that since New York Stock Exchange members were the best capitalized broker-dealers in the financial community, any rule which prevented them from using their resources as specialists or odd-lot dealers on regional exchanges would seriously curtail the effectiveness and competitive element of the regional exchanges. The staff of the Commission recommended that the Commission take appropriate action to rescind the resolution of the Board of Governors, and in December 1940, the Commission, pursuant to Section 19(b) of the Securities Exchange Act of 1934, requested that the Exchange change its rules to make clear that neither the rules of the Exchange nor their enforcement should "prevent any member from acting as an odd-lot dealer or specialist or otherwise dealing upon any other exchange outside the City of New York of which he is a member." The Exchange advised that it would not comply with the request and the Commission ordered a hearing pursuant to Section 19(b) on the specific rule change recommended by the Commission. [Footnote: This proceeding, the Rules of the New York Stock Exchange, 10 S.E.C. 270 (1941), hereafter referred to as the Multiple Trading case, has been the only proceeding instituted by the Commission pursuant to Section 19(b) of the Exchange Act.] The hearings commenced in January 1941, and following a hearing, argument and submission of briefs, the Commission in October 1941, issued an order which added the following proviso to Article XVI, Section 8, of the New York Stock Exchange Constitution.

". . . provided, however, that nothing herein contained shall be construed to prohibit any member, allied member or member firm from, or to penalize any such firm for, acting as an odd-lot dealer or specialist or otherwise publicly dealing for his or its own account (directly or indirectly through a joint account or other arrangement) on another exchange, located outside the City of New York (of which such member, allied member or member firm is a member, in securities, listed or traded on such other exchange." [Footnote: Article XVI was renumbered and became Article XIV of the New York Stock Exchange Constitution, which reference shall be used throughout this report.]

It is important to emphasize the narrow issue involved in the Multiple Trading case and the emphasis that the Exchange placed on the definition of the phrase "or deals publicly outside the Exchange ..." In this connection, Counsel for the Exchange stated in his opening argument before the Commission:

"If the Commission please this is a proceeding under Section 19(b) of the Securities Exchange Act of 1934 to require the New York Stock Exchange to alter or rescind its resolution under Section 8 of Article 16 of the Exchange's

Constitution. This resolution prohibits members of the New York Stock Exchange from dealing publicly -- that is, buying and selling, as principals -- for their own account securities listed on the New York Stock Exchange, elsewhere than on the floor of that Exchange. It does not prevent any member of a regional exchange, who is also a member of the New York Stock Exchange, from executing on the regional exchange ordinary commission orders for customers. (Emphasis added).

The Chairman of the Board of Governors of the Chicago Stock Exchange, on cross-examination, recognized that the Constitutional provision at issue only involved principal dealings by members of the New York Stock Exchange.

"Q. So that in respect of agency transactions, a New York member will continue to go to the best market that there is to execute the agency transactions, and will continue to give the best service that he is capable of, will he not, in executing that agency order?

A. Absolutely. If he doesn't take care of it in time his customers will do it for him."

The point was re-emphasized in the New York Stock Exchange closing oral argument:

"I would like to make clear what the New York rule does not prohibit. It does not prohibit its members from belonging to regional exchanges or transacting any agency or order for customers on those exchanges that they want. A member of the New York Stock Exchange, who is also a member of the regional exchange, and who for convenience is called a dual member, meaning that he is dual to New York and some regional exchange, may execute his commission orders on the regional exchange or execute them on the New York Stock Exchange as he sees fit. That is a question of agency.

"He executes the order in what he thinks is the best market for his customer, and, of course, receives his commission for doing it."

The testimony and findings were concerned of course only with member trading on the regional exchanges. However, the constitutional provision at issue did not distinguish regional exchange executions from over-the-counter executions of members. It therefore seems that the apparent freedom of members to execute agency orders on regional exchanges also applied, under the Exchange interpretation of Article XIV, to executions in the over-the-counter market. The proviso added by the Commission merely prevented the Exchange from restricting the principal dealings of its members on regional exchanges.

For seven years the Exchange published the constitutional provision as expanded by the Commission without comment or amplification. On June 11, 1948, the Department of Member Firms of the Exchange issued Member Firm Circular #52 to its members. The circular noted that:

"From time to time questions are raised concerning the application of the provisions of Section 8 of Article XIV of the Constitution to transactions in listed stocks other than on a national securities exchange. The particular Section read as follows:"

Article XIV of the Constitution was then quoted. The memorandum concluded:

"Under this provision a member should first obtain the approval of the Exchange before effecting a transaction in a listed stock except on a national securities exchange."

The new requirement of Exchange approval implicitly constituted something more than a restatement of the quoted language of the Constitution. The Exchange's position in the Multiple Trading case was that the constitutional ban on off-board trading was limited to principal transactions; the new circular could be read as requiring approval of all over-the-counter transactions in listed stocks without reference to their character as agency or principal transactions.

The 1948 Circular came about as a direct result of threatened competition by a non-member firm which began to advertise making markets in listed securities. On May 10, 1948, approximately one month before the publication of Member Firm Circular #52, Blyth & Co. circulated among a number of broker-dealers, including member firms, a letter which stated that starting on that day the firm would make net over-the-counter markets in 15 listed stocks, including several utility companies and such market leaders as American Telephone and General Motors. Blyth also sent teletypes to member firms giving the names of listed stocks in which it was maintaining trading markets.

The Exchange immediately received a number of inquiries from its members concerning this competition from a non-member. One member firm noted that certain non-members had originally intended to make a market only in small blocks, but the making of these markets had apparently been so successful that the firm was now also making markets in odd-lots and 100-share lots. The member also ventured the opinion that the competition "represents a very serious threat to our floor market." An Exchange memorandum describes the situation:

"During April and May of 1948, there was a concerted effort on the part of certain nonmembers of the Exchange to develop an over-the-counter market in listed cannon stocks. There were indications that unless the Exchange took steps to

prevent it, members and member firms of this Exchange might be placed in positions of assisting in the [blank in source document] of the entire membership and the Exchange, as well as to the public interest, through the resulting dilution of the auction market."

The Exchange acted quickly to counteract the threat. The staff was urged with great "urgency" to make a compilation of the provisions in the constitutions and the rules of all registered securities exchanges restricting off-board trading. A list was also compiled of all member firms which had received exchange approval of private wire connections with one or more offices of Blyth & Co. There were 143 such firms, including most of the larger New York Stock Exchange member firms. The staff of the Exchange also prepared comparisons between the markets of Blyth & Co. and Weeden & Co., (another competing non-member) and those of the Exchange at given times during one trading day (May 27, 1948) in a number of listed securities. These timed comparisons showed that the over-the-counter quotations were generally competitive with those of the Exchange.

In June 1949, the Exchange's Directory and Guide, as supplementary information, paraphrased Member Firm Circular #52 as follows:

"Pursuant to Member Firm Circular #52 dated June 11, 1948, members and member firms and member corporations must obtain the permission of the Exchange before effecting a transaction in a listed stock off the floor of the Exchange, either as principal or agent."

This restatement of the Circular confirmed the ambiguous implication of Member Firm Circular #52 concerning the Exchange's intention to restrict both principal and agency off-board transactions of members in listed stocks.

For the first time it specifically required approval of off-board transactions "either as principal or agent." It should also be noted that the restatement omitted the exemption for members' transactions on regional exchanges. There is no evidence, however, that the Exchange has applied the off-board prohibition to member trading as agent on a regional exchange.

In February, 1950, the first two lines of the paraphrase of Member Firm Circular #52 were changed to read "Pursuant to a decision of the Board of Governors as outlined in M. F. Circular," etc. From 1950 to 1957, the Exchange published the characterization of Member Firm Circular #52, as quoted above, as "supplementary information" in the Exchange Guide. In 1957, in connection with a renumbering and consolidation of the Exchange rules related to the printing by The Commerce Clearing House of these rules, Rule 394 appears for the first

time. It does not differ in substance from the last paraphrase of Member Firm Circular #52.

II. Criteria for Approval -- 1941 to 1960

As noted above, both Member Firm Circular #52 and Rule 394 required members to execute transactions in listed securities on the floor of the Exchange unless approval was requested and granted for an off-board trade. Even prior to the publication of Member Firm Circular #52, member firms would request an interpretation of the Exchange staff with respect to the applicability of Article XIV, Section 8, of the Constitution, to transactions which the member had executed or intended to execute off the floor of the Exchange. The standards for determining whether a member could execute an order off-board are not set forth in the Exchange Constitution or Rule 394, nor were they incorporated in Member Firm Circular #52. Further, the interpretations over the years which spelled out the standards for granting off-board trades were not disseminated to the financial community or to the public. This section of the report will trace the changes that have taken place in the standards for determining whether a member firm could execute an order for a public customer off the floor of the Exchange. The changes in the standards and criteria used in considering off-board requests have been substantial and generally more restrictive.

In 1944, the Exchange staff, in response to an inquiry of a member firm requesting a statement of the duties of a broker vis-à-vis his obligation as an Exchange member, stated that the "normal method of execution" of an order in a listed security was to send it to the floor of the Exchange, but that:

[A]n exception is made that when an order may be executed to the advantage of the customer by using the facilities of the Over-the-Counter market no objection is raised because the interests of the customer must come first. If there is no such advantage to the customer then there is no general reason for the exception to the general rule.

This position was consistent with the position taken by the Exchange a few years earlier in the Multiple Trading case and set forth quite clearly the Exchange view at that time with respect to the broker's duty. On April 21, 1945, Mr. Edward Gray, now Executive Vice President of the Exchange, re-emphasized in a letter to a member firm that the prohibition of Section 8, Article XIV of the Constitution is not for "dealing outside the Exchange but for dealing publicly [emphasis in the original] outside the Exchange." The letter noted that if a member firm continued to advertise a market for its own account in its office "day in and day out," such a

course of conduct would undoubtedly be deemed to be dealing publicly. Mr. Gray continued:

"Conversely, a member firm which effected an isolated transaction in a listed security in its office after the close of the market at the direction of the customer and at a price more advantageous to the customer than the closing quotation on the Exchange would not be deemed to be dealing publicly. Somewhere between these two extremes the line will be drawn but this has never been set up by definition."

In 1947, the Exchange replied to a member's inquiry about his right to trade off-board after trading hours with the following statement:

"I am sure that if a member firm were found to be dealing publicly and regularly in listed stocks, 'making a market' in them, even after Exchange trading hours, the Exchange would feel compelled to do something about it. On the other hand, if after the Exchange is closed for business, you receive a brokerage order from a customer to buy or sell listed shares, and he directs that you execute the order to the best of your ability in the over-the-counter market, you as his broker would be obliged to try to execute the order. Lacking any such specific direction from the customer, and except under unusual circumstances, I believe it would be your obligation to the Exchange as a member, and to your customer as his broker, to execute his order on the Exchange during the next trading session. An unusual circumstance under which you might pursue a different course of action, and try to execute his order over-the-counter, would be where the size and nature of the order indicates to you in the light of factors known to you, that there might be little likelihood of execution of his order in the following Exchange session, <u>or that the circumstances indicate that you can effect a better transaction for the customer in</u> the over-the-counter market. (Emphasis added).

In 1948, the staff of the Exchange indicated that single transactions in listed securities by a member firm acting as agent off the floor of the Exchange would be appropriate and not be considered as "dealing publicly off the Exchange in a listed security," if a proper commission were charged the firm's customer. It seems clear from the Exchange records that in the period 1941-1948, the Exchange was more preoccupied with members making and advertising markets and dealing from inventory as competitors with specialists than they were with agency trades with non-member market-makers -- particularly if the customer benefited by the off-board trade.

However, in 1948, shortly prior to the publication of Member Firm Circular #52, the Exchange introduced a qualification to the member's right to execute agency orders off-board. In January, a member firm made the following inquiry of the Exchange which directly raised the question of agency orders:

"We have been told by experienced member firms that we could cross, off the Exchange, at any time a listed security, provided we had the permission of the purchaser and the seller to do so at a price acceptable to both parties. We also understand that we may sell a listed security after the close of the market over-the-counter if demanded to do so by a client. We would appreciate it if you would give us your ruling on these two points."

The Exchange responded as follows:

"As to effecting crosses off the Floor of the Exchange, Rule 620 of the Board of Governors prohibits crossing listed bonds, except (1) with the prior consent of the Exchange or (2) at the specific direction of the customers concerned. This latter provision has been interpreted to mean only at the specific unsolicited direction of the customers concerned. <u>With respect to listed stocks, the same policy applies.</u> [Emphasis supplied]

"With respect to your second point, in line with the general understanding that all orders in listed securities are presumed to be for execution on the Floor of the Exchange. We feel that in the ordinary case where you receive an order in a listed security while the Exchange is not open it should be sent to the Floor for execution at the next trading session. However, in an isolated instance, where a customer might give you such an order outside of trading hours and direct you to attempt to execute it immediately, you would be permitted to do so. Instructions of this nature should, of course, be unsolicited, since otherwise the spirit of the policy would be violated."

Thus, immediately before the adoption of Member Firm Circular #52, the Exchange permitted off-board trades at the unsolicited direction of its customer. Apparently, this standard was in addition to the right to execute off-board if the price were better. Member Firm Circular #52 was initially interpreted in a manner which, generally, permitted the member firm to go off-board if the price were better or if the customer directed an off-board trade. In this connection, during the first 11 months following the publication of Member Firm Circular #52, 705 requests for approval for off-board trades were granted of 857 applications received [Footnote: The procedures for requesting approval for an off-board trade pursuant to Member Firm Circular #52 were carefully set forth. The request was telephoned to the Department of Member Firms where an Exchange staff member made a record of the request, determined whether the proposed transaction involved a buy, sell, or cross. In addition, the staff member obtained the number of shares; the name of the security; the type of transaction (principal or agency); whether the transaction would involve a non-member dealer, institution or individual; whether the recent market activity was good, fair, poor, etc. The request was timed and taken to the floor of the Exchange and presented

to at least two floor governors who gave their decision. The decision was then transmitted to the inquiring firm.]

The membership apparently was aware of the liberality with which permission to trade off-board would be granted. In 1949, at the request of a member firm who was troubled by certain interpretations which prevented member firms from making net markets in listed securities and which might thereby result in a higher cost -- or lower proceeds -- for a customer, the Association of Stock Exchange Firms prepared a legal opinion on the subject of "best execution." The opinion of the Association of Stock Exchange Firms concluded as follows:

"It does appear under a strict interpretation of the laws of agency that a liability may exist especially in the case of an unsophisticated customer who does not know (or care) whether the broker is a member of the New York Stock Exchange and the customer is ignorant of the constitutional prohibition. Under these circumstances the broker, in order to protect himself, is obligated to advise his customer of both facts. It does not seem reasonable that a Court would require the broker to go to the extreme of telephoning non-members to determine whether a better market actually could be obtained off-board. <u>Should the broker have an actual offer of a better price off board, it would seem that his obligation to advise his customer is not only a moral one but of a legal nature.</u> In the "secret profit" cases there is sufficient authority substantiating the principle that a broker, as agent of his customer, must devote to the service of his customer his faithful and disinterested effort, untainted by adverse interests.

It is my understanding that counsel for the New York Stock Exchange, at the time the constitutional provision was enacted, and at various times since in enforcing the provision, has considered the possibility of liability of a broker under these circumstances, but has concluded that any such risk is justified in order to prevent the dilution of the auction market; and to prevent non-members from deriving benefits of New York Stock Exchange memberships. <u>The staff takes the position that members are not required to do anything illegal as permission is readily granted to trade off board in a listed security if it is shown a better market exists off board</u> .... (Emphases added)."

In 1949 the staff of the Exchange began to codify the decisions of the floor governors in granting approval or in disapproving requests made under Member Firm Circular #52 in order to minimize delay and to facilitate consistent treatment among floor governors. The staff of the Exchange suggested that a definite policy be adopted which would set forth those types of transactions which would likely be approved or disapproved by the floor governors. It was also suggested that after the codification was completed the staff be given authority to approve or disapprove certain categories of requests. Such procedure would save

considerable time and would tend to produce more consistent treatment. In a staff memorandum prepared in February 1949, various floor situations were described in which it was recommended that the staff might grant approval without floor governor consultation in order to save time and insure consistent treatment. The substance of the memorandum is reported below:

[Footnote: As agent, a purchase by a member for a customer at a price below the current bid, or a sale for a customer at a price above the current offer, by an amount at least equivalent to the regular commission.

Example: With a floor market of 27-27-1/2, 100 and 200, a member requests permission to sell 2000 shares as agent for his customer to a non-member at a net price of 27-3/4.

In this case the member is earning a commission from his customer, who also obtains an advantageous price; whereas the buyer in the transaction is paying more than the floor offering price, by at least the amount of the regular commission.

2. As agent for both buyer and seller, a cross by a member at a price equal to the bid or offer, (where the cross could not be made on the floor) or, when the market is not in session, at a price not higher than the closing offer and not lower than the closing bid.

Example: With a floor market of 27-27-1/2, 100 and 200, a member requests permission to cross 2000 shares at 27-1/2 as agent for both buyer and seller.

In this case, the member earns two commissions, and both of his customers are able to effect a trade in the full amount desired.

3. As principal, a purchase by a member at a price below the current bid or a sale at a price above the current offer, by an amount at least equivalent to the regular commission.

Example: With a floor market of 27-27-1/2, 100 and 200, a member requests permission to sell as principal, 2000 shares to a non-member at a net price of 27-3/4.

In this case, the member obtains an advantageous price and the buyer is paying more than the floor offering price by at least the amount of the regular commission.

4. As principal, the purchase and sale, where the spread between the purchase price and the sale price is at least equivalent to two commissions.

Example: With a floor market of 27-27-1/2, 100 and 200, a member requests permission to buy 2000 shares at 26-3/4 and to sell 2000 shares at 27-1/4.

In this case, the member has made a profit equivalent to at least two commissions, and both customers have been able to effect a trade which, otherwise could not have been made.]

The staff recommendation for authority to grant off-board approval for trades of the type set forth below was not acted upon, and criticism continued of the time delay and inconsistent treatment of requests. In January 1951, a memorandum from Amyas Ames, then [blank in source document] recommended again that the authority to grant approvals in certain designated areas be left to the staff of the Exchange. Mr. Ames pointed out that the members did not know the basic principles underlying the decisions and felt that they were being treated in an arbitrary way. It was again suggested that the staff review all of the decisions of the recent past and codify them into a statement of policy which would indicate exactly what type of transactions could be done off-board and which type of transactions must be done on-board. It was suggested that the statement of policy be made available to all member firms. Pursuant to this recommendation, the staff codified the decisions of the years immediately prior to February 1, 1951 as follows:

"A general policy has been evolved covering the types of transactions which usually will be approved or disapproved, subject to the discretion of the Floor Governors in special situations. These types of transactions may be summarized as follows:

<u>Generally approved</u>

Purchase as agent for a customer, or as principal, from another member acting either as agent or principal, outside of trading hours, at a price closely related to the market. (Sale on same basis).

Purchase as agent for a customer, or as principal, from another member acting either as agent or principal, during trading hours, at a price related to the market, but not possible of execution on the Floor because of the current quotation. (Sale on same basis).

Purchase as agent for a customer, or as principal, from a nonmember, during or outside of trading hours, at a price below the current or last Floor bid by an amount at least equal to regular commission. (Sale on same basis).

Purchase and sale, as agent for both buyer and seller, during market hours, at a price related to the market, but not possible of execution on the Floor because of the current quotation.

Purchase and sale, as agent for both buyer and seller, outside of market hours, at a price related to the market.

Generally disapproved

Purchase as agent for a customer, or as principal, during or outside of market hours, from a nonmember, at a price which would net the nonmember better than the Floor bid price, less commission. (Sale on same basis).

Purchase as agent for a customer, or as principal, during trading hours, from another member, at a price at which the transaction presumably could be executed on the Floor. (Sale on same basis).

Purchase and sale, as agent for both buyer and seller, during market hours, at a price at which the transaction presumably could be executed on the Floor.

There are many special situations which do not fall into the categories outlined above, on which the decisions depend on the circumstances involved.

It is suggested that service to members in this respect might be speeded up if the staff had authority to approve of certain transactions as set forth above, under the heading "Generally Approved." If necessary, such approvals could be reported to Floor Governors at stated intervals.

This suggestion merely contemplates Staff authority to approve of certain specific transactions. All other requests would continue to be serviced in the present manner of obtaining the approval or disapproval of one or more Floor Governors."

On February 15, 1951, the Board of Governors of the Exchange approved a recommendation of the Advisory Committee that:

"[T]he Department of Member Firms be authorized to give prompt approval, eliminating the necessity for approval by a Floor Governor, to requests of members and member firms for permission to make off-board transactions, provided such requests meet the tests for transactions described under the heading "Generally Approved" contained in the memorandum of the Staff, dated February 1, 1951."

This was the first (and only) time that the Board of Governors had specifically passed upon the criteria to be used in determining when a member firm could trade off-board. The document, however, was not circulated to member firms.

Mr. Harold Schutz, now an Exchange staff member in the Department of Member Firms, was directly involved in the staff decisions to approve requests pursuant to the February 1951 memorandum and testified as follows with respect to that memorandum:

Q. I would like to show you an extract from the minutes of the Board of Governors of a meeting on February 15, 1951.

* * *

Having looked at that, is it your recollection that you did have the authority to approve those five kinds of transactions referred to in the February I memo?

A. Yes.

Q. ... Do you still have that authority?

A. To my knowledge I do not.

Q. Was there any time when you did approve transactions of those five kinds without having to get the approval of the floor governor of the Exchange?

A. When I first went into the job in 1952 I approved transactions coming within these categories.

Q. Do you recollect about for how long you continued to do that?

A. I would say for about a year or so.

Q. And what happened then?

A. There was a general tightening on the part of the floor governors granting approvals for off-board trades. In view of this change in philosophy or feeling, the staff began partly the practice of referring off-board trades to the governors on the floor.

Q. ... Did somebody tell you that this was the new practice?

A. No, no one gave me any specific instructions.

Q. How did you know to stop approving them yourself and start giving them to the floor governors?

A. Well, in those areas where governors were required to give approval I found that there was a reluctance to approve off-board transactions, and since the governors were taking a somewhat more restrictive view I felt that staff and myself particularly might be in a position where I would be approving something that the governors might feel should not be approved.

Q. But you did have the authority to approve those five kinds of transactions?

A. Yes, I did.

Q. ... In other words, you gave up that authority voluntarily because you on your own feelings or on your own opinion decided that the floor governors were being more restrictive. Was this entirely a matter of your own private opinion?

A. I wouldn't say that. I believe there was this general feeling among the other people who were handling off-board trades as well.

Q. Was the February 15 Board of Governors resolution to your knowledge ever rescinded or modified?

A. To my knowledge, no.

Mr. Schutz also identified as his own a handwritten note, dated October 3, 1956, added to an extract of the Board of Governors Minutes of February 15, 1951. Mr. Schutz's note read as follows:

Note: "In view of the present attitude of the governors which looks to putting all possible trades on the floor, the staff does not approve <u>any</u> requests during trading hours, and only in exceptional cases at any other time."

Mr. Schutz explained the change:

Q. This [note] was written in 1956, but you stated earlier that the policy changed about a year after you came in, which would have been around early '53.

A. Well, it could best be explained perhaps by saying that there was an evolution in the attitude of the governors which consistently became more and more restrictive, so that by the time 1956 came along the governors were disapproving transactions which the staff had a right to approve. This was an anomalous situation.

Q. Well, why would they get them at all?

A. Because in the earlier requests, those around 1953 where the requests were sent to the governors where the staff did not have authority approve, it was evident to me at least that there was a tendency on the part of the governors to take a tighter and less liberal view of off board transactions, and in view of this I decided to send more and more requests to the floor, and I found that the governors were disapproving requests where the staff had authority to approve them.

Shortly after the 1951 memorandum was approved by the Board of Governors, Mr. Richard Crooks became Chairman of the Board of Governors of the New York Stock Exchange following a period as Governor from 1946 to 1951. [Footnote: Mr. Crooks' term as Chairman expired in May 1954. He was again elected a governor for the period 1956 to 1959 and currently serves a term which will expire in 1966.] Mr. Crooks stated that he was familiar with the requests for off-board trades; the records of the Exchange indicate that he and perhaps three or four other Governors passed upon the great majority of all requests for off-board trades. With respect to the first example in the February 1, 1951 memorandum, Mr. Crooks commented as follows:

Q. Is that kind of transaction still generally approved?

A. No.

Q. Can you tell me when the policy was changed?

A. I believe that policy was changed during the administration of Mr. Werle as Chairman of the Board, at least the initialization of the change came about that time. That is my best recollection of that.

Q. When approximately would that have been?

A. 1958, as near as I can recollect. I believe Mr. Werle's chairmanship began in 1958.

* * *

Q. Maybe I can save myself reading out each of the others by asking you this: The five kinds of transactions which were stated here to be generally approved, was this policy changed with regard to all of them at the same time or at or about the same time, in other words, 1958?

A. To the best of my recollection, they were not all changed at the same time.

Mr. Crooks commented as follows on the second "generally approved" transaction:

Q. I'd like to read the second type of situation which is stated to be generally approved in the February 1, '51 memo: "Purchased as agent for a customer or as principal from another member acting either as agent or principal during trading hours at a price related to the market, but not possible of execution on the floor because of the current quotation." Is it the present policy of the Exchange to grant a request in that kind of situation?

A. It is not.

The point was further refined as follows:

Q. Suppose the market is 50 to a quarter and the member firm ... wants to effect the cross at 49-1/2, which is below the current bid, and the parties are willing to take care of the book, if there is a book, or any orders in the "crowd" between 49-1/2 and 50. Will approval be granted under those conditions to cross the balance at 49-1/2 off floor?

A. No.

Q. What is the consideration then in that situation why approval would not be granted, since by definition I assume that the book would be taken care of?

A. Well, I think we make a distinction that is not real where we keep talking about the "book."

Q. We can say the orders in the "crowd."

A. Let's say that.

Q. Fine. Let's assume they bring the order to the floor and there is nobody in the "crowd" who wishes to buy the stock between 49-1/2 and 50, or any portion of it, and the member firm requests permission for 49-1/2 crossing his orders?

A. Because we believe that publicly recorded transactions are in the best interest of the public.

On the third category of "generally approved" trades, Mr. Crooks' hypothetical testimony also reflects the apparent change which took place after 1956:

A. Yes, I reread the paragraph and, I believe, that this ruling or this circular was put out without a proper evaluation of situations that occur on the floor of the New York Stock Exchange. These items were changed in the process of evolution after we found out that many people were being deprived of the market price by exactly this paragraph. This was a mistake originally and I think the evolution of this thing, as we received complaints from various member firms, is what caused us to change it.

* * *

Q. This memorandum of February I purports to be a statement of the practices existing at that time in approving or disapproving transactions. It wasn't a statement of what ought to be approved, it was really a statement of what was being done, is that correct?

A. That's correct.

Q. The third generally approved situation was: "Purchased as agent for a customer or as principal from a nonmember during or outside of trading hours at price below the current or last floor bid by amount at least equal to regular commission, sale on same basis;" is that one followed today?

A. No, it is not.

Q. In this situation I'd like to ask you the same questions as Mr. Rotberg did. Would two commissions be charged when that was granted --

A. One commission.

Q. Do you know when this one was changed?

A. I can't pinpoint when it was changed, but, as I said before, the evolution of this whole theory came piecemeal, as I recollect.

Q. And it was just a gradual shifting of policy over the years?

A. Due primarily to complaints by member firms that they were being shut out of the market.

Q. There was no time then when a decision was made by any individuals to make some change in the policy?

A. No. As I said before, it was a period of evolution. As we kept studying these various examples even in this memorandum, we began to see faults in this

policy we had adopted and we gradually changed it to the concept that exists today. The market conditions in 1951, I might remind you, are completely different than they are today.

Q. Could you go into that a little bit?

A. Well, your market in 1951 was a dull market, without too much depth. Institutional business was not nearly as large as it is today, nor was the whole scope of the market as large as it is today. These regulations were put in, and I think erroneously at the time, partly because of the climate of the market at that particular time.

The last two points were treated in a similar manner:

Q. Just to run through the other two: "Purchase and sale as agent for both buyer and seller during market hours at a price related to the market, but not possible of execution on the floor because of the current quotation."

A. I give the same answer as the one that was approved after trading hours.

Q. And finally: "Purchase and sales as agent for both buyer and seller outside of market hours at a price related to the market."

A. The same answer.

The slowly evolving attitude by staff members and floor governors involved in passing on requests for off-board trades continued until 1960. By that time, the criteria for approval as set forth in the 1951 memorandum endorsed by the Board of Governors and the concept of "best execution" were not considered to be appropriate standards.

III. Rule 394: 1960-1965

A. Best Execution

In the securities markets today, many investors make known to potential buyers, sellers or intermediaries their interest in a particular security. The institutional investor, the specialist on the regional exchange, the broker holding a membership on a regional exchange, the members of the major exchanges, and the third market dealer try to become aware of buying and selling interests through communicating with each other. The purpose is simply to match buying or selling interest and obtain profit through putting two parties together or to take positions and hope to profit by selling or buying at an advantageous price. As a

result, there may be available on regional exchanges or at the trading desks of institutional or professional investors indications of interest for securities which are traded on the New York Stock Exchange at prices which are competitive with those on the New York Stock Exchange.

Members of the New York Stock Exchange, however, in acting for their customers are effectively restricted by the current interpretation of Rule 394 from soliciting the interest of non-members for an "off-board" trade, irrespective of whether the quoted price is or is not better than the price on the floor of the Exchange. At the present time the fact that a customer might obtain a better execution in an off-board trade is not considered to be an appropriate justification for an off-board trade. Whatever other exceptions to Rule 394 have developed in recent years, the early position in the 1940's that "the customer's interest comes first" is now secondary to the interest of the Exchange in preserving the market as it is now constituted and preserving the minimum commission rate schedule.

It was previously noted that in the 1940's the Exchange took the position that an order could be executed "off-board" if advantageous to the customer. An Exchange floor governor directly involved in the current interpretation of Rule 394, commented on that position:

"My understanding of the present policy of the Exchange is that letter is erroneous in light of what our policies are today."

* * *

Q. When you say it's erroneous, do you mean that it did not state the policy of the Exchange at the time, or do you mean the policy has changed?

A. I think the word erroneous that I used is not the right word to use. I would say that the policies of the Exchange have changed since 1944.

The floor governor noted, however, that if the floor market was not as good as the off-board market, he would, after disapproving the transaction, suggest that the member firm advise the customer to execute directly with the non-member making the better market. If the member still wished to execute the order on the floor of the NYSE and thereby obtain a commission, though the price was inferior to that available in the over-the-counter market, the member would be permitted to do so and would not be in violation of the rules of the Exchange.

Mr. Edward C. Gray, now executive Vice-President of the Exchange, explained that the change in policy was necessary because:

"I think there is a greater appreciation of the need to keep our market -- meaning the floor market -- the best for the public, and that trading away from the Exchange when it is possible to do it on the Exchange, weakens that market."

* * *

Q. Now, granted that the policy of the Exchange has changed, I wonder whether you now reject that statement (1944 letter) as a matter of practicality, or what you will? Is that statement a foolish one?

A. Well, it may well have been a perfectly appropriate one at the time it was written. What is the date of it?

Q. June 5, 1944. What are the differences that make this an inappropriate statement today? What are the differences between then and now that make it -- this statement -- inappropriate?

A. I would say the conditions have changed tremendously. Our market has increased, has broadened. It has got depth which it may not have had in 1944 when we were under the restrictions put in in World War II.

Q. That would just make it less likely (advantageous execution off-board) that the situation described in 1944 would occur today, is that right?

A. I would say yes.

Q. Well, if it is just a question of being less likely, aren't we still posed with the underlying question of what your policy is in those few cases where it is the fact that it would be to the advantage of the customer to go elsewhere?

A. Well, I can't start on the premise it is a fact.

The floor governors who pass upon the requests for off-board trades also reject a "best market" standard in passing on requests for executions. Mr. John Phelan, a specialist and floor governor, noted the following:

Q. If First Boston was making a market at 49-1/2 for a portion of the block, which was a half a point better than the market on the floor, or the market (made) by the specialists, would you be disposed to grant approval or disapprove it?

A. I would not grant approval.

Another floor governor commented:

Q. In deciding on requests to trade off-board, do you take into consideration the possibility that there might be a better market off-board or if ... a member can get a better execution for its customer off-board, would that be a reason to give approval to the request?

A. No. It would not. There are many instances that I have knowledge of where member firms asked for approval of an off-board transaction where they state in their request for exemption that if we do not get this approval this business will be lost to a non-member firm. This happens, not frequently, but in such quantity that it is pertinent to the question.

However, one specialist, Robert L. Stott, who also was a floor governor active in passing upon requests, expressed a view somewhat inconsistent with the view taken by all other exchange governors and staff members interviewed by the Commission staff. He stated his position this way:

A. If we think he could get a better price or a different price on the floor of the Exchange, we would approve it.

Q. So, the standard is whether the customer can do better off-board?

A. Oh, definitely. If the customer can do better, we approve it. We have to. When I say we have to, I say yes, I give an approval.

* * *

A. ... In plain words, if the customer can do as well, having checked with the specialist after the close of the market, got the size of his bid and found there was a buyer there or a seller there, and the customer will do as well tomorrow, see, then I will disapprove it, see. If, after I gathered the facts, my best judgment was that he can't do as well, or he will do poorly if I push him over until tomorrow, I will grant him approval.

Mr. Stott was most concerned that the floor governors should not grant approval without thoroughly checking with the specialist in the particular security, the floor brokers and seeking out other indications of interest in the security which might facilitate the execution of a customer's order. Mr. Stott noted that if a determination was made after thorough examination of the floor that there was a better price off-board, he would not object to a rule which would permit approval for an off-board trade under such a situation.

Member firms almost uniformly reject the principle that they have a duty to seek out the best market for a customer if such activity involves trading off-floor with a non-member. Member firms state that they do not believe that they have a duty

to become aware of the existence of competitive markets in particular securities. In addition to the considerations relating to dilution of the auction market referred to above, members make a somewhat legalistic argument to the effect that the customer knows that the member is not free to execute off-board. One member firm put it this way:

A. The customer here knows that we are members of the New York Stock Exchange and are not free to shop both markets.

Q. That is a critical point. Does the customer know this?

A. Our customers do.

Q. Do they know what the rules of the Exchange are?

A. Mr. _______ nods Yes.

Q. Don't those rules say that you have the right to ask permission here, permission to go off.

A. We have asked permission to go off on many transactions, and it is disapproved.

Another major New York Stock Exchange member firm with an active retail department stated that Rule 394 prohibited them from dealing off-board. The member firm, however, would apparently change its policy and would check markets, as it does for securities traded only in the over-the-counter market, if the Exchange rules were modified.

Q. Do you think you have any kind of an obligation to your customers to find out --

A. I have an obligation to get the best price I can for the customer.

Q. From any source?

A. I will have to say from any source, so long as I live under the rules that I live under. He knows I'm not going into third market.

Q. How does he know that?

A. I am a member of the stock exchange.

Q. Does the exchange rule prevent you from going into the third market?

A. Yes; they do.

Q. What rule does that?

A. This is 394.

Q. Doesn't 394 say you could go into any market except that you first get permission?

A. To get permission?

Q. You have to get permission.

A. Yes, if you can get permission.

Q. Would you begin to trade with more frequency with non-members in ... utilities? Let's assume that the exchange put them on the exempt list simply because they were inactively traded.

A. Yes.

Q. Would you start dealing?

A. Well, if they were on the exempt list I would inquire into their markets; yes.

Q. Why would you do that?

A. Because I could trade them over-the-counter .

Member firms have a number of alternatives in obtaining the best execution for their customer on the Exchange. For example, they may thoroughly explore the possibility of a cross with a wide variety of non-members, including competing market-makers in listed securities, the depth of a specialist book, the potential participation of the specialist, the feasibility of special plans and the possibility of executing on a regional exchange. One firm explained its activities and where it believed its obligations to the customer ceased:

Q. Let's assume you get an order in size. You said earlier that you first tried to, diligently try to find a cross, assuming the Exchange floor can't absorb it.

A. And assuming our customer permits us.

Q. Do you also consider the possibility of special block bid or purchases or exchange distribution plans, or off-board secondaries? Do you consider these also?

A. Yes, we do.

Q. Do you advise your floor brokers to use the utmost discretion in handling the order on the Exchange so that he can act in a manner which gets the best price on the Exchange.

A. Yes, that is, of course, elementary with our floor brokers.

Q. So that the firm policy is to use as many of the tools or techniques to assist the customer as are at your command?

A. Yes.

Q. Do you think that as an Exchange member, you have that duty, or do you think you are just doing it graciously because that is the thing to do, but you really don't have a duty to do it?

A. Oh, no, we take our duties very seriously.

Q. Why do you think, as a broker, you have that kind of duty to explore the various areas or ramifications of the techniques at your disposal? What Is it about being a broker, do you think, that causes you to have to do that?

A. To be a successful broker, you have to produce constantly for your customer, because there are hundreds of other brokers who would be perfectly happy to do it, if your customer finds that you are not capable of doing the best job for him. We take pride in our executions, we take pride in doing business a proper way and we think that is why we have grown as rapidly as we have.

Q. I take it, therefore, it might, under certain circumstances, take a good deal of time to work off a substantial block?

A. Yes, work for several days on some of them.

Q. Do you sometimes have to use a number of different techniques to sell off a block, such as buying some yourselves, some portion on the floor, some portion crossing with, other institutions?

A. Yes.

Q. So that you often use a number of techniques in order to sell the block?

A. That is correct.

Q. Do you have any specialists in these fields who know the most efficient way price-wise?

A. Yes, we do.

Q. In view of this kind of background, and in view of what you consider to be your duty to your customer, what is it about calling up First Boston or Weeden, that you think is not your duty, that is, to obtain their prices?

A. Because we feel that concentrating our activities on the Exchange creates a better market for everybody in the country, over a long period of time, and a market that is there every second of the day.

In a very real sense, the reluctance to check the third market dealers or a non-member institution to determine their bid or offer for a net trade is because of the member firm's experience that the Exchange would not grant permission to execute such orders off-board. One firm, important in institutional block business, commented as follows:

Q. Why under those circumstances couldn't you check the market and if for example you had a 49-3/4 net bid for a portion of the block ask permission to go off floor and get permission from your seller and deal net with the third market?

A. Well, you could ask permission.

Q. Yes.

A. You could ask permission.

Q. Well, why don't you?

A. Our experience is that this would probably not be granted.

Q. Have you had this situation occur?

A. I think we have. Well, I think I am right. The rules of the Exchange [say] a member, in dealing in a listed security can only deal with another member who is charging a commission or if dealing with a non-member must charge a commission.

Q. ... are you familiar with the Rule 394?

A. Yes.

Q. Does not that rule say that you must deal on board unless you get permission otherwise to do so?

A. Well, our experience, though not recent, our experience has been that the permission will not be granted.

Q. Do you think you have a duty as a broker to ask?

A. Ask for permission?

Q. Yes.

A. Well, we have as I have said before a duty to our customer.

Q. Yes?

A. To get the best price.

Q. You can't get it unless you ask.

A. You can't get it unless you ask but on the other hand as we have mentioned before, where there has seemed to be a fairly clear cut policy in relation to Rule 394, our impression has been that it would be pointless to ask.

Q. Well, what do you think of a rule which denies you the right to get the best execution for your customer from whom you will get your same commission?

A. Well, philosophically getting back to the point you raised earlier, a customer coming to us as members of New York Stock Exchange knows we are limited by such.

Q. What does he know you are limited by?

A. Rule 394.

Q. That rule says you have the right to ask permission. What limits you?

A. We may be limited or may not be able to get off the board for a third market or principal or someone else.

Q. Are you implying that he thereby knows in coming to you that you may ask and get turned down?

A. No. I am referring to your statement earlier which brought out we are attempting to get the best price for our customer. If our experience has been -- we have not been able to get that permission and if the general rule as stated is that you may not go off the board, this comes within the concept we mentioned earlier that we will get the best price in so far as we are able, so long as it is otherwise permitted by either your regulations or rules of exchanges or associations of which we are members.

Member firms also make the point that apart from whether a market in a particular security would be better for a particular customer at a certain point in time, the better approach would be to execute the orders in the exchange market because "in general, for all 1600 stocks listed, the best market is the New York floor and in the third market."

One member firm expressed the "overall good" theory this way:

Q. You said that you wouldn't feel an obligation to go and ask permission if it was 1/8 or maybe 1/4 above that price, but if it was a whole point then you would.

Let me just ask you this: Don't you have, under law and under the traditional ethics of a broker, don't you have an obligation to get the best price for your customer regardless of all these things -- however true they may be, about the continuous auction market and so? Do you have any right to set these kinds of philosophical and general concepts against what is a very clear duty that we all know about; to get the best price for your customer? -- and I'm talking about that particular customer at that particular moment.

A. I think a broker generally is obligated to get the best price possible. And I think most brokers, or all brokers, aim to get the best price possible. Being members of the exchange we do so within the framework of the constitution and rules of the stock exchange. I am not convinced that in the majority of times the best price is the third market. On the contrary, I think in almost all the cases I have been exposed to the best market is the auction market; not just the best market today, but the best market down the line.

If I were the manager of an investment trust I wouldn't be interested in what the liquidity is for three or four of the stocks in my portfolio, I would be interested in what the liquidity of my entire portfolio is. And I might have 100 or 150 issues. And I would be -- I think I would be far less concerned if I might have to pay 1/8 more for stock than in the auction market if, in so doing, I was able to have some

assurance that I was contributing to the maintenance of a concentrated primary auction market.

A. more blunt approach was expressed in the following manner:

A. I think you can't get out of the nickel and dime department.

* * *

A. I'm trying my level best to look at the overall ballgame, not the nickel and dime department, which is so goddamned unimportant, because it is that type of thing, which, in my judgment, would destroy markets, and I'm sure that's what you fellows want, and I'm not talking about on the board, off the board, I'm not trying to put words in your mouth -- you want the best goddamned markets for the public as you can possibly get.

Another member firm put it this way:

Q. Well, how -- would you just generally describe what you believe your duty is to your customer in connection with the price that you get for them? Just the general philosophy of the firm.

A. Well, we feel we are entitled to get the best market price for our customer. However, we also feel that the Exchanges that we are members in actually constitute a broad enough market and in fairness to our customers we would get the best price on either one of -- or any one of the Exchanges we were listed in by checking the market on all three, or two -- whatever it may be listed on.

Q. A few moments ago you said that you are very careful to make sure that between the execution on the Philadelphia-Baltimore and New York that the customer gets the best execution between the two Exchanges.

A. Yes.

Q. It is little unclear to me why you think the customer is not entitled to that same condition as between the Exchange let's say and an over-the-counter market dealer.

A. Well, first of all we don't proceed to check the outside market and therefore we confine our efforts to executing the order at the best possible price on the exchanges that we are members of.

It is interesting to note that many of the member firms who were most vociferous about the inadequacy of the off-board market had the least sophisticated

procedures for determining precisely what prices were being quoted in those markets. Some member firms equated best execution with the fact that the customer has full disclosure of volume and price on the Exchange.

A. certain number of member firms indicated not only that the third market was "relatively small" but that it was not really a competitive price market with securities traded on the Exchange. In this connection, certain Exchange members believed that the third market was active only in inactively traded high-grade utilities; others believed that the third market merely served over-the-counter non-member broker-dealers who could not obtain a commission for the execution of listed securities; others thought that they acted only on an agency basis and did not take positions while still others believed they were active only in high-grade securities with substantial volume. In view of the general point made by Exchange members that on the whole the third market dealers were non-competitive (and therefore did not pose a problem of "best" execution), a sample study was made of the prices in the third market compared to Exchange transactions in the same stocks.

The six largest market-makers in the third market furnished complete details of their over-the-counter transactions of 2,000 shares or more in New York Stock Exchange securities which were effected from May 17 through May 28, 1965. Accordingly, reports were filed by American Securities Corp., The First Boston Corp., New York Hanseatic Corp., J. S. Strauss & Co. and Weeden & Co. H. S. Kipnis & Co. had no trades of 2,000 shares or more during the period.

For each transaction the broker-dealers furnished, among other details, the names of their customers, the time of the transaction and whether the firm acted as principal or agent. The times were either given in Eastern Daylight Saving Time or converted, where necessary, to EDST. The staff obtained from records of the odd-lot dealers on the New York Stock Exchange 10 minutes before and 10 minutes after each over-the-counter transaction which was reported by a third market-maker. At least 5 exchange transactions before and after the over-the-counter trade were obtained regardless of how long before or after the over-the-counter trade the exchange sales occurred.

The time shown in the odd-lot dealers' records was tape time and coincided with the print which appeared on the tape as the customer and the market-maker executed their third market purchase or sale.

Number and Types of Blocks

A. total of 123 transactions were reported. The number and type of transaction reported by each broker-dealer was as follows:

[table omitted]

Most of the transactions were between 2,000-5,000 shares. Seven of the 108 principal trades exceeded 5,000 shares with the largest transaction involving 10,000 shares. Of the 15 transactions as agent, 5 exceeded 5,000 shares and included a sale of 13,000 shares and another sale of 27,000 shares.

Comparison With Last Sale on New York Stock Exchange

The prices of each of the third market transactions were compared with the price of the same stock on the Exchange at the time that the over-the-counter purchase or sale was executed. The exchange price was taken as the last sale appearing on the tape before the transaction. The results of the comparison appear in Table 2 below.

In most cases, the stocks were active and there was an exchange sale within a 15-minute period preceding the over-the-counter transaction. However, if no exchange sale occurred within a short period of time, certain factors may have affected the market so that a comparison with the last exchange sale might not be appropriate. For this reason, comparative prices for active and inactive stocks are shown separately.

[table omitted]

Table 2 includes agency transactions as well as principal trades. In all but one of the 15 agency transactions there was an institutional customer on both sides. In only one purchase was the stock obtained from another broker-dealer. The reporting brokers charged commission on one side of the transaction only, and the commission was consistently 1/4 point. Both the purchase and the sale sides of each agency transaction were included in the table above and the over-the-counter price used in the comparison was the net price paid or received by the customer.

The above table shows that in 58 of the 68 purchases (85%), customers in the third market paid not over 1/4 point more than the preceding Exchange print. In 58 of the 70 sales (83%) customers received not more than a 1/4 point less than the price of the preceding tape print on the Exchange.

Comparison With Last Sale on NYSE After Commissions

The comparison of Exchange and third market prices in Table 2 does not take into account the fact that a New York Stock Exchange minimum commission would have to be paid on the exchange transactions whereas the market-makers dealt on a net basis with their customers except where they acted as agent.

However, as mentioned previously, the OTC price was adjusted to reflect the net price.

A. comparison of prices in the two markets, after adding or deducting commissions from the last sale price on the New York Stock Exchange, is shown in Table 4.

[table omitted]

The table indicates that 118 of 138 customers in the third market (86%) apparently paid less or received more than they would have paid or received had their purchases or sales been effected on the exchange at the last sale price or better.

Some of the largest savings were in agency crosses where the shares were crossed close to the exchange price and one of the customers was not charged a commission. In addition, 3 of the 8 transactions with savings of more than 50 cents per share involved crosses, with the market-maker acting as principal, between two customers.

Apart from these transactions, some of the largest savings were the following:

Corn Products Refining -- 5,000 shares Sold by a bank at 54-3/4, the last sale price on the exchange, with a saving of commission amounting to $2,225;

Sears Roebuck -- 7,344 shares sold by a bank at 70-3/8, 1/8 below the last sale price, but with a net saving of $2,475 because of no commission charge;

Texas Utilities -- 10,000 shares sold by a mutual fund at 62-7/8, 1/4 below the last sale price, but with a net saving of $2,030; and

Firestone Tire & Rubber -- 5,000 shares purchased by a mutual fund at 49, the last sale price on the exchange, with a saving in commission of $2,175.

Comparison With Next Sale on NYSE

In Tables 2 and 4 above, third market prices were compared with the last price on the tape at the time of the over-the-counter transaction. Table 5 makes a similar comparison for OTC trades compared to the immediately following sale on the New York Stock Exchange.

It was found that in 62 of the 138 transactions the next sale on the tape was the same as the previous exchange sale; in 32 transactions it was lower than the

previous sale; in 28 transactions it was higher than the previous sale; and in 16 transactions there were no subsequent sales that day.

A. summary of third market prices with the tape print immediately following the over-the-counter trade is shown in Table 5 below.

[table omitted]

This comparison also shows that relatively few transactions were effected over the counter at prices which were more than 1/4 point worse than the prices which customers might have received on the Exchange. Table 4 shows that only 10 purchases (16%) and 13 sales (22%) took place more than 1/4 point above or more than 1/4 point below, respectively, the next sale on the tape.

It should be noted that in comparing the over-the-counter price of the block with the price on the tape, no consideration was given to the fact that the over-the-counter trades were 2,000 shares or over and were compared to orders involving, for the most part, only a few hundred shares on the Exchange. At the least, the foregoing data seems to indicate that the prices available in the third market, even under pressure, provides a very competitive market to the Exchange floor. It is difficult, of course, to determine the effect on the Exchange market of purchases or sales of identical securities in similar size blocks. Available evidence of Exchange block transactions, however, indicates that block transactions are, with rare exceptions, not better than the previous sale. Thus, the decision of the Exchange not to permit off-board executions with a non-member, particularly in block sales or purchases, may result in an inferior execution for a portion of that block.

After the Exchange rejected the principle of best execution, from time to time member firms requested clarification of the new policy or objected to the decision by the floor governors which prohibited them from making an off-board trade. In essence their complaint concerned their obligation, as they saw it, to their customer. One member firm put it this way:

"The situation, as we see it is this; we are, as brokers, under obligation both moral and legal to use our best efforts in behalf of clients who entrust their orders to us. In this particular case we were offered 400 shares of a stock [by a non-member] which our customer was anxious to buy at a price that he was willing to pay for it, at a price lower than it had sold on the New York Stock Exchange during the previous week, and at a price we were currently bidding on the Floor of the Exchange. Had the stock subsequently sold above our limit our client would have had every reason to complain at our not having taken the stock that was offered to us on the outside. While we have not consulted our counsel in the matter, we believe that if the stock had sold on the Exchange at a higher price we

would have been legally responsible to our clients for the difference in price had they chosen to assert their claim.

* * *

We ask you to consider particularly two phases, first, the reaction of our client, which incidentally is a large fire and casualty insurance group, to a statement of that kind particularly insofar as it might effect their opinion of the regulations governing transactions of member firms and, secondly, the position in which it puts a member firm, to be obliged in the interest of fair dealing to give up the name of its client to some competing firm.

As we see it, we believe in the pursuit of good public relations and honest dealings with clients the Exchange authorities should review their attitude in this matter."

The Exchange replied as follows:

"It is not, of course, the purpose of the policy of the Exchange affecting off-board transactions to operate arbitrarily against the obligations of our member firms to execute their customers' orders in listed securities. As you know, what we seek to accomplish is to discourage, wherever practicable, any diffusion of the Stock Exchange market. You are entirely justified in the request you make that we review with you the exercise of that policy in relation to the subject instance."

Another member firm a few years later raised the same question:

"Mr. Funston, there is one very important factor that I feel the Exchange is overlooking; namely, the law of agency. If, in this instance, we had a customer's order to purchase 1,000 shares Equitable Office Building Stock at the market and had placed the order on the floor, we would have had to buy the stock at 9 7/8, as the market was 9 3/4 -- 9 7/8. Our position, or the Exchange's, if there were a complaint as a result of such a ruling, would be most embarrassing, to say the least.

In other words, as a broker, we are paid to act in the best interest of our client. It is questionable whether we would be protecting his interest by purchasing stock at 9 7/8 when it was available at 9 5/8 in the over-the-counter market.

We would very much appreciate your answering us on this whole matter."

The President of the Exchange defined the agency obligation of the member to the customer in terms of the best market available in the "recognized auction market":

"In your letter, you have referred to the law of agency and have suggested that if, in this particular instance, you had been acting as agent for a customer in the proposed purchase of the stock, the ruling of the Exchange would have precluded your fulfillment of what you deemed to be your obligation to the customer -- namely, obtaining the best price possible.

"The Exchange always has felt that except under very unusual circumstances the agency obligation is met by trying to execute the order in the recognized auction market for the security, and that it is not the obligation of the member to seek other markets elsewhere, especially in the ordinary unit of trading."

The position expressed in the above letter apparently reflects the current Exchange position.

The position of the New York Stock Exchange with respect to "best execution" is not taken by the American Stock Exchange. The American Stock Exchange rule which restricts off-board trading is interpreted to permit an off-board execution if a better execution is thereby obtained for the public customer. While the member is required to check the floor first and report its off-board trades to the Exchange, the American Stock Exchange takes the position that its rules should permit the customer to obtain the benefit of a better market. As a result, the member obtains one commission from its customer and deals on a net basis at the advantageous price off-board with the non-member. Most requests for off-board trades on the American Stock Exchange are granted. Generally, these requests involve situations where the off-floor market is better in terms of the particular customer's order. See also Section III B below for an analysis of the relationship of the minimum commission rate schedule to the American and New York Stock Exchange view of the broker's obligation to its customer.

In addition to the American Stock Exchange, most of the regional exchanges are far more flexible in permitting trades to be done off the floor. The Exchanges in Boston, Chicago, Cincinnati, Philadelphia and Los Angeles all permit executions to be done off the floor if the member's customer can thereby obtain a better price. Indeed, the Pacific Coast Stock Exchange permits its own members to make markets in securities listed thereon, and permits its members to deal net, under certain circumstances with non-member competing market-makers.

The dilemma posed by assuring that the customer can obtain the best execution while at the same time not unfairly damaging the primary market is recognized by the London Stock Exchange. That Exchange has designed rules which are intended to "protect the clients' interests when business is executed outside the

Stock Exchange and ... protect the London market from unfair competition by ensuring that business shall not be taken outside unless the Market has had a chance of competing on an equal basis." The London Stock Exchange holds that a "Broker's duty is to see that he deals at the best possible price for his client and these Rules do nothing to undermine that duty." The London counterpart to Rule 394 reads as follows:

88. Except as authorized by Rules 88(b) and 88(c) a Broker shall not execute an order with a Non-Member unless thereby he can deal to greater advantage than with a Member.

The London Rule provides for certain safeguards by requiring that the broker "be prepared to justify the transaction if called upon to do so"; keep records of the transaction; advise on the "contract" that the trade has been done between non-members; offer the business in the exchange market on the same terms as those proposed by the non-member prior to execution. The foregoing rules are intended to preserve the interest of the customer by providing the Exchange an equal opportunity to compete with a non-member.

B. The Minimum Commission Rate

This section of the report describes the relationship between the minimum commission rate, Rule 394, and the concept of "best execution." The rules of the New York Stock Exchange and all Regional Exchanges require that all trades involving a non-member must result in a commission or its equivalent being paid to a member firm who has brought the order to the floor. Thus, if a member firm executes an order for a non-member on the floor by selling the security to the specialist, for example, the member firm receives one commission from the public seller. Or, if the member firm brings the order to the floor and the security is purchased by a non-member buyer represented by a second member firm, each member firm will receive a commission from the non-member buyer and seller respectively. Or a member firm may bring both a public buyer and a public seller to the floor in which case it may cross the order and receive two commissions, one from the public buyer and one from the public seller. Finally, the member firm may bring to the floor the order of a public buyer or seller and purchase the security for its own account. Under these circumstances, if the customer is a buyer the member firm will sell from its inventory at a price which is equal to the offer side of the market plus an amount equivalent to a commission. If the public customer is a seller, the member firm will purchase the security for its own account and remit proceeds equal to the bid on the floor less an amount equivalent to a commission.

In all of the foregoing situations, the member firm obtains a commission or its equivalent in a transaction with the buyer and/or seller. If, however, approval

were given to trade off-board in a situation in which a member firm represented, for example, a seller, the non-member buyer may by negotiating the price paid neither pay a commission nor remit a commission to the member. Stated another way, the non-member buyer would simply buy at a net price from the member who was acting as agent for a seller. The member would receive but one commission in a trade involving two non-members. In the 1940's and 1950's, prior to Rule 394, the non-member buyer who was solicited by the member to purchase the security being sold by the member's customer did not normally pay a commission to the member. Thus, the question of whether an order should be executed off-floor also very directly involves the question of whether any category of non-member should be allowed to avoid paying a commission to a member if it participates in a cross of a listed security in a transaction involving the member as an intermediary. Stated another way, the practice of disapproving a transaction for execution off the floor ensured that a member would obtain two commissions if it was an intermediary in a cross transaction between a non-member public customer and a non-member dealer or financial institution. This relationship between the off-board trading and the minimum commission rate is also closely related to the question of best execution, as will be seen below.

The position of the New York Stock Exchange that all non-members are public customers who must be required to pay a full commission irrespective of the type of business, function in the market, size of order, etc., is of fairly recent origin and is not taken by all exchanges. The American Stock Exchange, for example, takes the position that if a member solicits a non-member institution to obtain a better price for a customer's order which the member holds, permission would be granted for an off-board trade (if the price were better) and the member firm would not be required to charge the institution a commission. The American Stock Exchange does not consider the member to be an "agent" of the institution in such instances and therefore its minimum commission rule is inapplicable. This significant difference between the two major Exchanges reflects a different approach toward the minimum commission rate -- one requires its imposition, through requiring trades to be on-board, irrespective of the agency relationship of members to the non-member; the other Exchange, however, considers the imposition of an agency commission only when that relationship can reasonably be said to exist in fact, and as a result is more flexible in permitting trades to be executed off-board.

In 1948, a number of the requests for off-board trading, pursuant to Member Firm Circular #52, involved the question of the commissions to be collected in event that trading went off-board. At the time most of the requests for off-board trading were granted, two commissions or a spread equal to two commissions usually were generally required when a member firm acted as an intermediary between two non-members. (See February 1, 1951 memorandum quoted in Section II above.) Thus, transactions were commonly approved where the member acted

as agent for the buyer and received only one commission though he may have bought from a non-member at a net price at least one commission below the bid. In this situation, the member received only one commission even though he was an intermediary between two non-members. Though the selling non-member did not get any better net price than if he had sold the stock (at the bid) and paid one commission, the saving of the amount of the commission inured to the benefit of the selling customer of the member and not the member firm. In a memorandum dated July 16, 1964, the Exchange compiled a list of 68 off-board transactions which were approved since 1954 and which involved the charging of less than two commissions or a spread of less than two commissions if the member firm was involved as principal. According to the memorandum, many of these trades were approved on the basis of "size of the block." Few were granted after 1960. This situation often arose in connection with a cross where a member firm sought out another party to satisfy his customer's execution.

It also appears that prior to 1954, one commission trades were even more frequent. In a memorandum dated July 8, 1964, Mr. Schutz noted that the February 1951 memorandum did not include all transactions in which one commission was paid to the member:

"There were also transactions which were not mentioned in the memorandum where the Governors approved off-boards for one commission based upon the size of the block. An early Floor Governor's Guide gave as a typical approved off-board trade the purchase and sale by a member firm as principal 35,000 West Indies Sugar for one commission based on the "size of block." There was also the sale of 500 Merck $4 Conv. Pfd. as "agent" to a nonmember dealer -- "approved on basis after the close; poor market, size of block."

* * *

Since then there has' evolved the present set of principles which, in effect, make mandatory a two commission fee when acting as agent, or a two commission spread when acting as principal, and the discontinuance of the granting of approval where the firm as agent for the buyer makes only one commission, but the seller is getting the same net price as though he had paid a commission. (Also agent for seller.)"

The practice of permitting one commission trades in connection with crosses of large blocks as well as the relationship of this practice to the question of best execution is demonstrated by a memorandum prepared by the Department of Member Firms in May of 1954. The memorandum, which summarized the practice at the time, noted the following:

"There are unusual occasions, when exception to these general principles is made, where the transaction involves a very large block in relation to the market in the stock. In such an instance, the member might receive only one commission or a profit equal to only one commission because, in order to effect the transaction at all, it apparently is necessary to make a substantial concession to the non-member on the other side. This might particularly apply on an agency transaction, where the interest of the customer naturally becomes of greater importance than adherence to the two commission principle.

On occasion, when the Exchange has disapproved an off-Board transaction because it would have given the benefit of membership status to a non-member broker-dealer, the member firm involved has objected on the ground that it was left in an indefensible position in respect of its brokerage or agency obligation to its customer whose order was left unexecuted, but which order could have been executed by effecting a transaction on a net basis over-the-counter with a non-member broker-dealer. The member firm's contention was that as an agent it was obliged to find the best possible market and that the decision of the Exchange forced it to fail in that obligation. In such cases, the position of the Exchange has been that except under unusual circumstances the agency obligation is met by trying to execute the order in the recognized auction market for the security, and that it is not the obligation of the member to seek other markets elsewhere, especially in the ordinary unity of trading."

A. notation adjacent to the first paragraph of the memorandum quoted above reads: "1956 -- No longer followed."

By 1956, the Exchange began to insist that members actually receive two commissions in a cross transaction between non-members. The method of enforcing the requirement was to restrict off-board trades with non-members and demand an on-board execution -- which necessitated a commission to be paid by all non-members. However, in July of 1964, the Exchange apparently reconsidered the question of the reasonableness of two commissions if a member was involved as broker in the execution of a large block of stock between two public customers. As noted below, the flexibility in the commission "law" could be accomplished by a more liberal interpretation of Rule 394. In a memorandum of Mr. Harold Schutz, dated July 1, 1964, he noted:

"Mr. Henry Watts, Chairman of the Board, called me today and stated that following a discussion with several of the Governors, it had been decided that a more liberal view would be taken of the two commission principles when large blocks of stock were involved in off-board trades.

Blocks of 100,000 shares or more would not be disapproved merely on the basis that less than two commissions were to be received -- one commission would be considered sufficient."

* * *

"This follows the practice of several years ago when transactions off the Floor were approved with only one commission the basis of 'size of block.'

"The staff is not to tell firms requesting approval for off Floor trades that the request will be disapproved if only one commission is received when blocks of 15,000 or 20,000 shares are involved -- Mr. Watts said it is unlikely blocks of this size would be approved but the staff should say nothing more than there is a good chance the request will be disapproved but that the Governors will have to rule on it."

The views expressed by Mr. Watts were not disseminated to the financial community and indeed certain important governors involved in the granting of off-board approvals were unaware of its existence even though the memorandum noted "it had been decided that a more liberal view would be taken, etc." As a result, there has been no discernible difference since 1964 in the granting of approvals to go off-board under circumstances where one commission would be received for a large block trade. However, Mr. Schutz explained that while Mr. Watts' comments were not accepted, the Governors, even at the present time, might approve requests to trade off-floor for one commission on crosses where exceptionally large blocks were involved.

While almost all requests involving only one commission in a cross transaction are disapproved for off-floor executions -- indeed, the staff will summarily so advise the requesting party -- there is a lack of consistent treatment. The following testimony points up the differing attitudes of the floor governors, given a particular situation to decide.

Q. I want to just tie up this situation of one commission trades for a large block. I want to direct your attention to a permission to trade off floor, which involves a cross of a very substantial block of stock, well over 100,000 shares, in which the applicant firm, William R. Stott & Company, was negotiating and had neither a buy or a sell order, later requested an exception from the commission law of requirements and the remarks read that the transaction involved the sale of a president's entire holdings to another corporation, and they wanted approval to do it for one commission.

This was on June 26, 1964.

It was approved by the floor Governors Frank, Stott, Phelan and Crooks. The decision read: "Approval for one commission on basis it is a corporation taking over control of another corporation."

I was wondering whether or not you have any recollection of why you approved a substantial transaction in view of your previous comments.

A. I recall this request. This memorandum is in error to the extent that I did not approve the transaction.

Q. Would you have disapproved it?

A. Yes.

Q. On the basis of the standards that you stated before?

A. Yes.

Q. Were you consulted on this?

A. After the permission was granted, one or two of the Governors spoke to me and I voiced my opinion at that time that I would not have approved it.

Q. Could you explain to us or comment on what Mr. Frank, Mr. Stott and Mr. Phelan don't share your view on this one commission concept?

A. Well, it was obvious from the memorandum that they don't.

Q. Well, again, then, we are faced with a very fundamental problem of which comments of yours ... reflect your own personal views or the views of the Board of Governors, or as an alternative, does each Governor make up his own mind as he sees fit without any standards from the Board?

A. I am not going to answer for the other three Governors involved. I will answer only for myself. I believe that the policy of the Board of Governors precluded the approval of that transaction. That's why I disapproved of it or would have disapproved had I the opportunity.

Despite Mr. Crook's observation concerning the policy of the Board of Governors, the fact remains that the 1951 memorandum, approved by the Board of Governors, does permit one commission trades if a member firm acts as intermediary between a public buyer and a public seller.

It also appears that one commission might be charged if it were the only way that the member firm could obtain any profit. For example, in a transaction involving a 1000 share transaction of South Puerto Rico Sugar, 8% Preferred, approval was granted for an off-board trade between a member firm's customer (buyer) and a non-member institution. The non-member institution sold at a net price and did not pay the member firm a commission. Mr. Stott, who approved the transaction, was unable to explain why the transaction was approved. He testified as follows:

A. I don't know the market at the time.

Q. What would the relevance of the market to the question of whether one or two commissions should be charged, assuming it was going off-board?

A. Very possible the stock couldn't be bought on the board at a reasonable price. This is an 8% preferred stock. That is why I say I don't know.

Q. Well, let's assume that a proper decision was made to have a trade off-board. What I am trying to get at is does that mean the minimum commission rate schedule no longer applies?

A. Well, he is getting one commission, and there are exceptions made for unusual circumstances, and X assume something like that was the case here, see.

Q. Well, could you give us some of the exceptions to the two commission policy. What are some of the concepts under which you only have to charge one commission on an off-board trade?

A. I don't think I want to try to answer that, see. I would have to know what the story was, because each and every one is so different.

The effect of generally requiring two commissions in a cross transaction is to provide the member firm with the extra commission at the expense of the public customer. For example, if a public customer of a member firm requests a sale of a listed security, the member firm, if unable to sell the block immediately on the floor or buy it for its own account, will normally try to find another financial institution as a potential buyer of the stock. It solicits the interest of these other financial institutions who in effect supplement or perhaps replace the floor market. As noted above, in the late 1940's and early 1950's, the member firm would obtain a commission only from its original customer. Thus, if the floor bid was $50 per share, the member firm would seek out a public buyer in size to absorb its customer's stock at a price no better than 49-1/2 and would "cross" the order in the office at 49-1/2. The selling customer would pay about a 1/2 point commission to the member (obtaining proceeds of approximately $49), and the

buyer would remit 49-1/2 to the member for its customer. In recent years, however, because of the difficulty of obtaining an off-board approval, the typical practice is for the member firm to bring the non-member buyer to the floor, cross the order at $49 per share and charge the non-member buyer a commission, thus making the non-member buyer's net cost the same -- $49-1/2. To the non-member buyer, it is irrelevant if he buys off-board at a net price of 49-1/2 or on-board at a price of 49 plus 1/2 point commission. However, in the latter situation, the public seller loses a 1/2 point since the on-board execution was at 49, while the member firm makes the extra 1/2 point as a commission.

Although some members may consider it their duty to advise the customer that a market exists off-board for the security at a net price which, in terms of total dollars, will be more advantageous to their customers than a cross on-board, most member firms follow the practice described above of bringing the non-member on the floor and effecting the cross at a price which makes it economically feasible for the non-member to pay a commission. One member firm describes his duties and obligations as well as the relationship of the minimum commission rate to Rule 394 as follows:

Q. Did you ever ask a non-member such as First Boston or Blyth and Weeden to take a portion of the block on the market and charge them a commission?

A. Yes.

Q. How does that kind of a trade work?

A. They are just like any other client would be, if they want the stock.

Q. Do you approach Weeden or First Boston?

A. Weeden or First Boston or whoever it might be.

Q. Yes. Now I take it in that kind of a transaction where Weeden or First Boston is participating in cleaning up the block that you get a commission from Weeden ... and from your customer.

A. Right.

Q. In that kind of a trade since the market-maker would be willing to pay the tape price plus a commission why didn't you ask approval to go directly to him and buy net at that price and charge your customer only one commission?

A. Because I happen to be a member of the New York Stock Exchange and in the commission business.

* * *

Q. Let me give you an example. Let's assume that a market-maker purchases the security on the Exchange through you at $70 a share and the tape print is $70 per share. Since it is a buyer it pays approximately a half a point commission.

A. Right.

Q. Which means that it purchased the security and laid out approximately $70.50. Can we assume that this market-maker would have been willing to buy from your client at $70.50?

A. I don't think you can assume that at all because he may not have known that the stock was even for sale.

Q. If he had known it.

A. If he had known it, why, then I wouldn't have gotten in the transaction.

Q. What I am trying to get is why do you think you should not ask permission under Rule 394 to sell it to him at $70.50, make one commission from your customer and save your customer the commission?

A. For the very reason that I told you, that I believe that the commission rule is within the framework of what I think is the discipline. I happen to be in the brokerage business. I happen to maintain a payroll and an overhead, and there is no reason why I should do business for a non-member dealer for no commission any more than I would do it for an individual customer for no commission. What could possible be the reason that I would rather do that?

Another member volunteered the following situation which demonstrates how the customer of the member obtained a questionable execution because of the relationship of Rule 394 to the commission rate schedule.

A. Here is an example, I think, which explains exactly what you are talking about. This was back in 1963. I just happened to remember this and I jotted it down.

On April 23, 1963, we received an order to sell 15,700 shares of Arizona Public Service at the market. The Exchange market was very thin. We sold 300 at 31-1/4 and 200 at 31-1/8. And then there was no market. The market was 31, maybe to 3/8 or 31-1/4. I probably offered the stock at 1/4. In the meantime I am

covering the country to find a buyer for this stock, and not having any success. There just wasn't anybody anywhere that wanted to buy this stock. The specialist, of course, wasn't that big at all.

The next thing I did, I knew that several of the over-the-counter houses were making markets in the stock. And I know the traders in these houses. So I asked First Boston if he would have any interest in it --

* * *

Well I asked First Boston if he had any interest. And I think the last sale at the time was maybe 31-1/4 or an 1/8: I'm not absolutely sure of that. Anyhow he said, "Well," he said, "I would be interested in 5000 shares a point below the market," which would be down around 30-1/4. So I said, "Well I can take that as a firm indication? And he says, "Yes."

And then I went to Weeden and he said that he could use 2500 shares. And his idea also was around a point below the market; or he might even want to buy it cheaper. And he would take 2500.

And the next one I got was American Securities. And he said he would take a thousand.

So there's 8500 shares and I've got 15,000 to go.

So then when they all indicated that they would be willing to do it at 30-1/4 -- that was the best bid indicated from First Boston -- then we went to the specialist and tried to find out what the market was all the way down. And it was very thin. We sold about 2000 shares, I believe.

Q. Down to what?

A. Down to 30-1/4.

And we said would he be interested in taking the balance, and he said yes. And he took 4400 shares. We sold 400 at 31, two at 30-7/8, five at 30-3/4, two at 30-5/8, five at 30-1/2, five at 30-3/8. That's 2300 shares there. And crossed the balance at 30-1/4.

So First Boston, Weeden, and American Securities took 8500 and the specialist took 4400.

Q. At 30-1/4? A. Yes.

Q. Now in that transaction did you charge First Boston, Blyth and Weeden a commission?

A. Yes, we had to.

Q. Now about how much is the commission on a 30-dollar stock? Is it about 3/8 or 1/2?

A. Roughly 35 or 36 dollars a hundred.

Q. So that Weeden, First Boston and Blyth in effect were buying that stock at a cost of 30-1/4 plus 3/8; is that correct?

A. Yes.

Q. Which would be a price of 30-5/8. If Weeden, First Boston, and Blyth were willing to pay 30-5/8 apparently to anyone who called of repute, why didn't you ask permission of the Exchange to go off-board to Weeden, First Boston, and Blyth, and sell it to them at 30-5/8 and charge your customer a commission, thereby getting the customer a better price?

A. The rules prohibit that.

Q. Would the rules have prohibited you asking permission to go off-board?

A. No.

The rule is that you cannot do business with a non-member firm without charging commission.

Many member firms take the position that they are entitled to the commission from the non-member market-maker because they have expended a good deal of effort in finding the non-member who completed the cross. It is often pointed out in this connection that it would be unfair to differentiate between non-member market-makers and other financial institutions such as banks or insurance companies who often are solicited to facilitate a customer's execution. From this premise it is argued that all non-members must be treated alike. However, because some of these non-members are in the business of buying and selling securities and are also in the business of advertising their indications of interest to the public, a conflict arises vis-a-vis the Rule requiring two commissions and the broker's obligation to his customer. The member firm, however, as noted earlier, takes the position that the situation involving institutional crosses is one involving very sophisticated parties who know of the existence of the third market and who often have dealt in it. The following testimony points up the problem:

A. Now, the institution obviously had a reason for engaging this transaction with Soloman Brothers.

The Regency of the University of California is a lot closer to Weeden & Company physically and possibly checks him on everything.

I am sure he knows the market as well as we.

Now, the Regents may have had a very good reason for doing this trade with Soloman Brothers which I could understand.

Q. Maybe they wanted to pay you a commission. A. That is correct.

Q. But the question is did they want to pay you in effect two commissions, because the commission you got from Weeden was at their expense.

A. That is correct. I don't know.

C. The Sophisticated Investor

Member firms state that the institutional investor is sophisticated and knows of the existence of the third market. Indeed, some expressed the view that many investors check the third market and other institutional interest prior to coming to the member firm for an execution. As a result, member firms take the position that they are relieved of any obligation to obtain the "best execution" for such customers. The member firm sometimes contends that the commission it is paid is primarily for research services or other services performed for the institution and that no institutional investor expects that the Exchange member will check elsewhere or make a request to transact business other than on the Exchange.

This argument, of course, is a qualified one. First, the member firm is a broker specializing in the execution of securities transactions for which it charges its client a commission for the service of executing an order. The argument that the institution is a sophisticated investor suggests that in the case of listed stocks the broker is justified in abdicating a large portion of this responsibility on the assumption that the client is equally capable of performing a task normally entrusted to the broker and for which the broker is paid its commission.

Apart from the duty of agent, there are certain practical facts which raise questions concerning the validity of the Exchange position. The so-called third market is not a small market where all bids and offers, and particularly bids or offers for a large block of stock, can be determined in a matter of seconds without the expertise available to member firms. It is also clear that not every

large order comes from an institution nor is every institution highly sophisticated in all the details of securities markets. Large orders may come from the liquidation of estates or from institutions not located in the primary trading centers. Institutions themselves vary in size and trading activity, and, except for the very largest among them, many do not have extensive trading desks. Thus a large member firm voiced the opinion that although institutions do not rely as heavily upon their brokers as do individuals, they did not believe that the institutions know the market as well as brokers.

The possibility of questionable expertise even by very large institutions is illustrated by one of the major New York City banks. This bank is one of the nation's largest, with over two billion dollars in deposits. It pays out approximately one million dollars per year in brokerage commissions. Yet it never executes in the third market and although its central order division is authorized to execute off-board to obtain a better execution, it does not check off-board markets to determine whether a better execution is possible even though executions on board will cost a full commission and will be absorbed by beneficiaries for whom the bank acts as trustee.

In many cases, institutions may desire to deal with particular member firms for reasons other than executions. They may, for example, have received research advice from the member firm for which they desire to pay a commission to the member firm. This does not necessarily mean that they are willing to accept an inferior execution. There may be other motives as well. For example, banks may be responsive to the fact that member firm brokers maintain deposits with them. Indeed, in this respect there is evidence that significant pressure was put on New York banks in the late 1950s to limit their executions to exchange members. According to certain of these banks, the pressure was effective and the banks did curtail their off-board executions. However, the realization of the fiduciary duty to obtain the best execution in terms of overall cost to the customer resulted in an increasing use of the third market since 1958. One exception to this is the bank referred to in the preceding paragraph, which has not executed in the third market since 1958.

Finally, a large portion of bank business consists of transactions in which the bank's customers "direct" that the bank pay commissions to particular firms. Clearly this does not mean that the banks (or their customers) would not like to see the brokerage firms have the opportunity to deal with non-members if it meant a better execution. Indeed, certain New York banks favored a liberalization of Rule 394 since there would inevitably be times when the bank would get a better execution if the member firm to which it gave an order were able to execute in the third market.

As recently as 1960 the Exchange was confronted with the decision of one important institutional investor, the Morgan Guaranty Bank, which expressed reluctance in executing orders on the Exchange at the direction of certain accounts. The economic pressure which the Exchange members can use to require the "sophisticated" investor to execute on the floor must be realistically considered. Apparently the Exchange considers that "the banks are ... obliged to see that business is given to member firms for deposits at the bank." The memorandum quoted in full below is illustrative.

NEW YORK STOCK EXCHANGE
MEMORANDUM

October 25, 1960

TO: Mr. Benjamin H. Gaylord

FROM: J. H. Schwieger

SUBJECT: Morgan Guaranty -- Proposal Not to Continue Directed Business

You mentioned that Keith had heard that the Morgan Guaranty people did not wish to continue to give directed business to specific member firms for pension fund accounts and you asked what the scope of the problem might be and whether or not Keith should become personally involved. I have quietly looked into this matter by speaking with several firms.

At the moment the problem seems to be only with Morgan Guaranty and even there it has been mentioned only to a limited extent. At one time the Chemical Bank started on such a path but did not get very far and dropped its approach.

Apparently Morgan Guaranty makes the point that it can do a better job with its large orders by placing them where it sees fit. It is my understanding that Goldman, Sachs & Co. has agreed with Morgan Guaranty to go along with the proposal. However, I understand also that several other firms expect to use informal pressures to stop the practice. The other side of the coin is that some of our member firms feel that they are entitled to receive business because of the high quality of research and other service they give to the banks. If a large percentage of the bank's business is directed, the allocation of business for services rendered becomes difficult. The banks are also obliged to see that business is given to member firms for deposits at the bank.

From the Stock Exchange standpoint a principal question is whether or not a departure from a directed business approach would result in more business going off the board than is now given to members and consequently contributes to the Exchange market place. Two of the member firms to whom I spoke indicate that they do not feel that more business will go off the Board. A third firm was of the opinion that it was possible that such an event might occur.

It would seem at this time that the Exchange might be in a better position not to take any step until the atmosphere is somewhat clearer. However, there would be no reason why the Exchange could not continue to press Morgan Guaranty to see that its business in listed securities is done on the Floor of the Exchange for all of the reasons that we have put together as good arguments for maintaining a liquid Floor market.

J. H. Schwieger

Many of the institutions executing block transactions are mutual funds. Here the desire to reciprocate is quite strong, and may account for the fact found in the Special Study that mutual funds are among the lowest proportion of direct users of the third market. In the case of mutual funds the Commission has a direct concern with the extent to which their shareholders are affected by the quality of the executions obtained by the fund. The desire to furnish reciprocal business may provide a strong motive for a fund director to relegate the quality of executions to a subordinate position and, indeed, there is evidence that this has taken place.

It may be that, to the extent that mutual funds are derelict in their duties, the problem can be dealt with in ways other than modifying Rule 394; however, the enforcement of the fiduciary responsibilities of funds, and of other institutions, is a difficult and cumbersome method of dealing with a problem which more directly concerns a broker's duty of best execution. At any rate, the "sophisticated customer" argument, suggesting as it does that there is no best execution problem, must be taken with a grain of salt, particularly in view of the economic relationships between institutions and members which inhibit "free choice" by the institutions.

IV. <u>The Duty of a Broker</u>

The question of a broker's duty to its customer, vis-a-vis its duty as it sees it to an exchange of which the broker is a member, is not a unique one. A considerable body of law has developed which spells out quite carefully the duty of a stock

broker to a customer. It is the conclusion of the staff that the present application of Rule 394 raises serious questions concerning the fiduciary duty of the broker to his customer. The following discussion relates to the legal precedents which appear relevant to that relationship.

As an agent the stockbroker's duties have been characterized as those of a fiduciary. [Footnote: I Black 499, n. 505; Meyer 251; Restatement of Agency 2d, §1, 13 (1958); Harry Marks,. 25 S.E.C. 208, 213 (1947).] Accordingly, a broker has a high duty of loyalty and must act in the "utmost good faith" with his customer. [Footnote: I Black 499. The Restatement of Agency 2d (1958) at §424 states that an agent "is subject to a duty ... to be loyal to the principal's interests and to use reasonable care to obtain terms which best satisfy the manifested purposes of the principal." §387 states that the agent must "act solely for the benefit of the principal in all matters connected with his agency." In Mechem on Agency 2d (1914) (hereinafter cited as Mechem) the broker's duty to his principal is stated as one of "utmost good faith and loyalty to his interests."] A stockbroker's duty may even transcend the ordinary agent's duty to exercise standard care and to utilize the skill which is standard in the locality for the kind of work which he is employed to perform. [Footnote: Restatement of Agency 2d, §379(1) (1958).] The stockbroker is held to a "high degree of skill and integrity," ordinary care and judgment being insufficient. [Footnote: Meyer 265.] The high degree of care and responsibility owed by one in the securities business has been viewed as so significant that even dealers who do business as a principal with the customer have been held in numerous Commission decisions to be subject to duties similar to those required of broker-agents. Thus, a dealer impliedly represents that he will deal fairly with the public by hanging out his "shingle" [Footnote: Charles Hughes & Co. v. SEC, 139 F. 2d 434 (2d Cir. 1943), cert, denied. 321 U.S. 786 (1944).] and similarly a dealer who places himself in a position of trust and confidence with his customer assumes the fiduciary duties of an agent. [Footnote: Hughes v. SEC, 174 F. 2d 969 (D.C. Cir. 1949).]

A. broker fulfills a variety of functions for his customers. For some investors the skill and care which the broker exercises in preparation of investment literature, making buy or sell recommendations, providing portfolio supervision, and rendering custodial and other ancillary services are of primary significance. In addition, fulfilling the clerical functions of order execution is an important service to all investors. However, the broker's most significant task for many investors is obtaining the best possible price in the execution of an order. When handling orders for many larger, more sophisticated investors, obtaining the best price is virtually the only area in which the broker must exercise his skill. The other services provided by brokers are either not needed by those investors or are mechanical functions which do not require the exercise of skill. Accordingly, the broker's duty to obtain the best possible execution for his customer (on either a market or limit order) is the very essence of the broker's agency duty.

The general principle that a broker has the duty to obtain the best price for his customer is widely recognized in agency law. [Footnote: 12 Am.Jr. 2d, Brokers §96 (1964) states that a broker is bound to obtain for his principal "the most advantageous bargain possible under the circumstances of the particular situation." He must "effect a sale to the best advantage of the principal -- -- that is, on the best terms and at the best price possible." 17 A.L.R. 2d 904 (1951) and 12 C.J.S. Brokers, §26 (1938) are to the same effect.] The Restatement of Agency 2d states that an agent employed to buy or sell has a duty "to obtain terms which best satisfy the manifested purposes of the principal;" [Footnote: Restatement of Agency, 2d § 424 (1958).] and that the obligation to obtain "the terms most advantageous" exists even though the principal has fixed the price at which the agent is to buy or sell. [Footnote: Id. at comment b.] In discussing an agent's authority the Restatement provides that when the price is not specified in the terms of the authorization, the agent has authority to buy or sell at the market price. When there is a definite market price, as in listed securities, the agent has apparent authority to buy or sell only at that price "or at one more advantageous to the principal." [Footnote: Restatement of Agency 2d, §61 and comments a and b (1958).]

The duty of best execution has been applied by the courts to both real estate and commodity brokers. [citations omitted] The duty of the stockbroker to obtain the best possible price has been expressed in terms similar to those applied to other areas of agency law. [Footnote: In Stutfield, The Rules and Usages of the Stock Exchange, (3d ed. 1901) the author states at p. 170 that a broker "is bound to make the best bargain that he can for his client" in executing an order on the London Exchange, rather than favoring a jobber who is a friend of his. See 12 Am. Jur. 2d, Brokers §125 (1964).] The Commission recently stated that a broker who accepts a customer's sell order on an agency basis owes "a fiduciary duty to carry out the sell order with due diligence ..." and "... to sell the stock at the highest possible price." [Footnote: Investment Service Co., Securities Exchange Act Release No. 6884, (August 15, 1962). The broker had previously sold shares of the company which was the subject of this customer's sell order to various investors through false and misleading statements. See also John Pierce, 36 S.E.C. 357 (1955); Trost & Co., 12 S.E.C. 531 (1942).] The Eighth Circuit affirmed the Commission's findings in the case and quoted the above language from the Commission's decision. In a prior Commission decision involving a stockbroker who took secret profits from customers through a fraudulent scheme the Commission stated that "as an agent, he was under a duty ... to get the best possible price for the customers." [Footnote: Harry Marks, 25 S.E.C. 208, 215 (1947).]

State court decisions have recognized and applied the same principle. In Wahl v. Tracy [Footnote: 137 Wis. 668, 121 N.W, 660 (1909)] a customer paid cash to a

broker and gave an order to purchase certain stocks for cash. The broker, who acquired the shares on margin and temporarily used the balance of the customer's money for his own purposes, was held to have violated his duty not only to "purchase in the manner directed by the plaintiff, ... but also to purchase at the best price obtainable ..." [Footnote: Id. at 661.]

As noted above, the New York Stock Exchange members generally assert that they have no legal duty to execute in the third market. Justification for this position is predicated on the theory that a person placing an order with a New York Stock Exchange member impliedly desires an execution on the floor of the Exchange. This position can be found in Meyer, The Law of Stockbrokers and Stock Exchanges:

"The broker is Impliedly authorized to execute his customer's order in the market where securities of the kind which are the subject of the order are customarily bought and sold." [Footnote: Meyer, The Law of Stockbrokers and Stock Exchanges 274 (1931).]

While the foregoing statement appears to reinforce the current exchange position, the authorities cited by Meyer do not relate to the situation where the agent has a choice of competing markets, one of which, by rule, is available only to members who are, by another rule, prohibited from executing in a competing market. Furthermore, the above rule, if it can be called a rule, (the cases cited are over 50 years old) seems to be permissive rather than mandatory or exclusive.

For example, in Rosenstock v. Tormey, [32 Md. 169 (1870).] the oldest case cited by Meyer, the broker-plaintiff sought a deficiency judgment for breach of contract. It was alleged that the defendant ordered one hundred shares of a railroad stock which the plaintiff subsequently obtained from his New York correspondents. Following the defendant's refusal to pay, the stock was sold at a loss in New York. In disposing of the defense that the New York transactions were beyond the broker's authority, the court stressed the "custom of the particular business." [Footnote: Id. at 177.] Without indicating whether the particular security was traded on an exchange or over-the-counter, or both, the purchase in New York was approved. The court stated:

"The order is general in its terms not directing the purchase to be made in any particular place or mode .... We are, therefore, of opinion the plaintiff had the right to make the purchase ... in New York, through correspondents, brokers, or sub-agents, residing and doing business in that city. He must show, however, that the stock was actually purchased ... at its fair market price ..." [Footnote: 32 Md. 169, 178 (1870)]

Similar standards were developed for the sale caused by the principal's default:

"[U]pon showing, by legal and competent proof, that it was actually sold by his agents, either at public sale in market overt, or at a sale publicly and fairly made at the stock exchange or stock board, or a broker's board, where such stocks are usually sold, at its fair market value ... he is entitled to recover from the defendants the amount, if any, of the resulting loss." [Footnote: Ibid.]

The second case footnoted by Meyer affords the New York Stock Exchange even less support than that previously discussed. Sistare v. Best, decided in 1882 [88 N.Y. 527 (1882)], examined the authority of a bank president to sell defaulted collateral on the stock exchange. After placing the sell order with a broker, the banker privately sold the retained certificates and refused to deliver equivalent shares to the purchaser located by the broker. The broker covered himself in a higher market and sued the bank president for the difference. Applying the general principles of agency law, the court found that the bank president possessed the authority to place the sell order. In holding for the plaintiff, the court, at most, established a principle that the exchange was one of several proper markets and, other things being equal, the choice of that market was properly within the bank president's discretion.

Porter v. Wormser [94 N.Y. 431 (1884).], decided by the same court two years later, is also cited by Meyer. Here the plaintiff sued the defendant-broker for alleged deviation from a stop order. The plaintiff alleged that the sale "should have been made at the Stock Exchange, whereas they (the bonds) were sold between the calls at a private sale." [Footnote: Id. at 447.] In holding for the defendant the court stated that:

"[T]he bulk of sales of government bonds were made outside of the public board, at private sale, and nothing having been shown to impeach the fairness of the sale in question, the fact that it was a private and not a public sale was not a ground of objection." [Footnote: Ibid. The court cited Pollen v. Smith, 30 N.Y. 549 (1863), which upheld a private sale conducted fairly and according to the "ordinary usage" of the trade by an aggrieved vendor. Id. at 557.]

While the agent may select the "usual market," the case does not hold that the scope of the agent's duty is restricted to the primary market. The requirement of fairness is particularly significant in view of the financial advantages which accrue to the New York Stock Exchange members under current application of Rule 394, and the possible disadvantage for the customer for abjuring the competing market.

The final and most recent case cited by Meyer relied on the Rosenstock and Sistare cases and similarly held that an aggrieved broker could mitigate his

damages by selling the shares on an exchange. In upholding the sale on the New York Curb Exchange the court stated:

"In the case of an ordinary dealing in stocks where a client orders his broker to buy or sell, the place where the sales or purchases are to be made are places where transactions of this description are customarily made, and by employing a stock broker a client impliedly authorizes him to perform the business in the manner and at the place established by local usage." [Footnote: Id. at 431.]

Although not mentioned by Meyer, one subsequent Maryland case cites Rosenstock for the proposition that either a public sale or a fair sale in the market where the stock is usually traded will satisfy the prerequisites for a deficiency judgment. [Footnote: Dudley A. Tyng and Co. v. Woodward. 121 Md. 422, 88 A. 245 (1913).] The Woodward case involved a security traded in the over-the-counter market which was privately sold to a member of the plaintiff's family following a default. The defendant, who had breached a contract to purchase the shares from the plaintiff, asserted that a public sale was necessary. The court applied the Rosenstock standard and held that there were "several ways, other than by public auction, in which they (sales) could be made." [Footnote: Id. at 431.] The case was remanded, however, to ascertain if the sale was fairly conducted.

While the quotation in Meyer superficially has a bearing on the problem currently confronting the Commission, the cited authority does not hold that an agent may look only to the customary or usual market for the security being traded. The cases did not concern the agent's duty to canvass the market in an original transaction but arose in the context of a foreclosure following either breach of contract or default on a pledge of securities. While the sole case considering the scope of the agent's duties in an original transaction held that execution in the primary market was permissible, it impliedly conditioned its holding on the absence of unfairness. The emphasis on fairness raises the inference that a transaction in the primary market might violate the fiduciary duty if a superior execution in an ancillary market were bypassed. In sum, the duty of fairness should permeate every facet of stock exchange practices and, as discussed subsequently, customary and usual exchange practices do not achieve a status elevated above the duty of fairness merely because of their imposition on the investing public.

The effect of a stock exchange's rules upon execution of a customer's order is the subject of several general rules of law. The basic rule is that a customer who engages a broker to execute an order on an exchange confers authority on the broker to conduct the transaction according to the established rules and customs of the exchange. The customer may be bound by those rules and customs even though he doesn't know of them. [Footnote: Clews v. Jamieson, 182 U.S. 461,

481 (1901); Bibb v. Alien, 149 U.S. 481, 489 (1893); Gettys v. Newburger, 272 F. 209, 215 (8th Cir. 1921) (cotton brokerage contract held not to be an illegal gambling contract in that N.Y. Cotton Exchange prohibited such contracts); Wilhite v. Houston, 200 F. 390 (8th Cir. 1912) (grain brokerage contract to be executed on boards of trade on which gambling contracts prohibited held to be binding); Cisler v. Ray, 299 P. 62 (Cal. 1931) (customer who had expressly agreed to be bound by rules and customs of exchange on which order executed held bound by San Francisco Stock Exchange's rules and customs which prohibited his attempted cancellation of stock purchase order); Eddy v. Schiebel, 112 Conn, 248, 152 A. 66 (1930) (customer bound by purchase in spite of slow delivery); Winslow v. Kaiser, 313 Pa. 577, 170 A. 135, 137 (1934); Lynch v. Maw, 3 Utah 2d 271, 282 P. 2d 841 (1955) (custom that member firm has first lien on stock in correspondent's omnibus account held binding against customer who claimed his stock was in account, noting contra English case which found same to be an unreasonable custom); Hodgkinson v. Kelly, L.R. 6 Eq. 496, 501 (1868) (Exchange custom of adding names of principals later approved); Restatement of Agency 2d, §36 (1958); 79 ALR 592-608 (1932); I Black 158-64; 2 Mechem 1961, 1963; Meyer 153-60.] Normally, in cases stating or following the general rule, the customer has either designated the market to be used or has agreed to be bound by its rules.

If the customer is shown to have been unaware of the rule or usage and if the equities are in his favor, a host of exceptions apply. The United States Supreme Court listed those exceptions when it stated that a rule or usage is applicable

"when such usage is known to the principal, and is fair in itself, and does not change in any essential particular the contract between the principal and agent, or involves no departure from the instructions of the principal; provided, the transaction for which the broker is employed is legal in its character, and does not violate any rule of law, good morals, or public policy." [Footnote: Bibb v. Alien, 149 U.S. 481, 489-90 (1893).]

The Court in an earlier case quoted a House of Lords decision which stated that the general rule of following exchange usages would be adhered to "provided they are such as regulate the mode of performing the contracts and do not change their intrinsic character." [Footnote: Irwin v. William, 110 U.S. 499, 515 (1884) quoting with approval Lord Chelmsford's opinion in Robinson v. Mollet, L.R. 7 H.L. 802, 836. Eddy v. Schiebel, 112 Conn. 248, 152 A. 66, 68 (1930) and Hall v. Paine, 224 Mass. 62, 112 N.E. 153, 158 (1916), are to the same effect.] Accordingly, if the rule or usage contradicts an expressed agreement between the customer and the broker [Footnote: Leviten v. Bickley, Mandeville & Wimple, 35 F.2d 825 (2d Cir. 1929); Eddy v. Schiebel, 112 Conn. 248, 152 A. 66, 67 (1930).], is unreasonable, illegal, contrary to public policy or otherwise alters the basic intent of the brokerage relation, it is not binding upon the customer.

[Footnote: Kernahan v. Wallace, 263 Mich. 572, 248 M.W. 904 (1933) (customer may cancel order after tender of undeliverable stock notwithstanding subsequent good tender even though not permitted to do so by stock exchange rules when contract not made in reference to those rules) j Hyman v. Sachs, 194 Misc. 69, 86 N.Y.S. 2d (Sup. Ct. 1948) (NASD order not defense to broker against customer); Ford v. Snook, 205 App. Div. 194, 199 N.Y.S. 630, (4th dep't 1923), aff'd 2^0 N.Y. 624, 148 N.E. 732 (Ct. App. 1925) ,(where no evidence that customer knew that broker was a member of particular exchange or that sale was to be made in a particular market, market rule on ex-dividend dates not binding between customer and broker); Newman v. Lee, 87 App. Div. 116, 84. N.Y.S. 106 (1903) (broker may not use as defense against customer an exchange rule which restricted normal agency powers where customer had no knowledge of the rule) ; Harker v. Edwards, 4 T.L.R. 92, 93 (C.A. 1887) (an illegal rule is never binding on the principal, an unreasonable rule is binding only if the principal didn't know of it); Smith v. Reynolds, 66 L.T.R. (n.s.) 808 (C.A. 1892) (same); Perry v. Barnett, I T.L.R. 580 (C.A. 1885) (custom which is illegal not binding on customer). See also I Black 160, 2 Mechem 1961, Meyer 162, 436-37.]

In essence, a broker may thus not use the rules of an exchange "as a shield against his own irregular acts" [Footnote: Newman v. Lee, 87 App. Div. 116, 84 N.Y.S. 106, 107 (1903).] nor may he attempt to bind the customer by a custom "which works a substantial and material change in his rights." [Footnote: Ford v. Snook, 205 App. Div. 194, 197, 199 N.Y.S. 630 (4th dep't 1923), aff'd 240 N.Y. 624, 148 N.E. 732 (Ct. App. 1925).] The Restatement of Agency adopts a similar view. It states that relevant usages of a business do not apply if they contradict the specific terms of authorization, contradict the known desires of the principal, operate unfairly against the principal or involve doing illegal acts. [Footnote: Restatement of Agency 2d., §36, comment b, f (1958).] The Restatement further provides that authorizing an agent to act in a particular market does not include the principal's assent to a custom of the market "in disparagement of the fiduciary relation." The reference is to the agency maxim that an agent cannot deal as an adverse party with his principal without disclosure. An example states that although a stock exchange permits the broker to sell his own shares to the customer rather than executing the order as an agent and the customer knows of the custom, the transaction is nevertheless voidable unless the exchange rules adequately protect the customer's interests. [Footnote: Restatement of Agency, 2d, § 389, comment d (1958).]

The Commission noted an exchange's duty in regard to a customer obtaining the best execution in a decision which involved extension to N. Y. Curb Exchange of trading privileges in a security listed on the Boston Stock Exchange and traded solely over-the-counter. In approving the application, the Commission answered the argument that better execution might be obtained over-the-counter. It stated

that "a well governed exchange recognizes limits to its operation as an automatic auction market" and should "recognize and enforce the duty of a broker to get the best price for his client, even though that price is only obtainable off the floor of the exchange ... ." (Emphasis added). [Footnote: Edison Electric Illuminating Company, I S.E.C. 909, 913 (1936). The NYSE in the early 1940's stated that the interests of the customer come first and that orders may be executed off-board in order to obtain the best execution.] The Commission in that and subsequent decisions has recognized the significance of competition between the exchanges and the over-the-counter market. [Footnote: See, e.g.. Id. at 914, Providence Gas Company, 4 S.E.C. 395, 399 (1939); City and Suburban Homes Company, 2 S.E.C. 3, 6 (1937). Permitting each market "to develop in accordance with its natural genius" was held desirable by the Senate Committee on Banking and Currency, S. Kept. No. 1739, 74th Gong. 2d Sess., p. 3 (1936).]

The London Stock Exchange and English courts have recognized the same duty. Union and Rhodesian Trust (Ltd.) v. Neville concerned a member broker of the London Stock Exchange who obtained shares ordered by his customer directly from the underwriter at a cheaper price than would have been obtainable from an Exchange jobber. The customer sought to defend an action by the underwriter for the purchase price of the shares on the ground that he had not authorized purchase off the Exchange. The court rejected that defense, holding that purchase off the Exchange had been to the customer's advantage and that such a purchase was authorized by Exchange Rule 83 which permits a member to execute an order with a non-member if "thereby he can deal for his principal to greater advantage than with a member." [Footnote: The Union and Rhodesian Trust (Ltd.) v. Neville, 33 T.L.R. 245 (K.B. Div. 1917). Rule 83, as of 1945, had been redrafted and renumbered Rule 88(b)(1).]

V. Uncertainty of Standards

Requests for permission to trade off-floor under Rule 394 are made on an almost daily basis by member firms. The requests are transmitted by a member firm to the staff of the Exchange by telephone. The staff member obtains certain information as shown in the attached Exhibit B and takes the request to the floor of the Exchange. He then submits the information to a floor governor and the floor governor makes an on-the-spot decision as to whether or not to grant an exception to the Rule. The floor governor may or may not consult the specialist or the book. The staff member then communicates with the member firm making the request and advises the member of the floor governor's decision. If the request is denied the staff makes a follow-up inquiry to determine the disposition of the order. The floor governors often consult each other before making a decision. Since the Rule on its face does not flatly prohibit off-board trades, it is important to determine the criteria by which the floor governors make decisions and the

extent to which such decisions are consistent with each other and follow the rationale for the Rule as set forth in Section II above.

As noted above, one of the considerations on which the Rule is based is the desire of the Exchange to report all trades on the tape. Therefore, if a member firm requests permission to trade off-board because it doesn't wish to have a "tape print," the floor governors generally disapprove the transaction on the grounds that the Exchange is a public institution committed to public reporting of trades. As noted above, this in turn is partially based on the theory that the tape attracts further orders to the floor and thus broadens the depth and liquidity of the Exchange market. Nonetheless, the Exchange does permit requests for off-board trades to be done if, in the judgment of the floor governors, the tape print would "upset" the market. A recent example was found where a member firm wished to effect a cross of 13,800 shares of stock at the current market price. The member firm was to obtain a commission from both parties. The buyer did not wish a tape print. The staff advised the floor governors that the principals to the transaction had already traded between themselves in the past without using a member firm. They noted that if approval was not granted, the block would be done directly between the buyer and seller without the member firm's participation. The trade was approved by Mr. Crooks and Mr. Phelan. In the instance described, the member firm went directly to the floor governors to obtain their approval. Mr. Phelan explained his actions on the grounds that the cross was going to take place off-board if the request were denied, so there was no point in denying the request. He stated that in his opinion "the publicity on the tape would be meaningless, would not mean anything." The staff of the Exchange wrote a memorandum describing the approval which concluded as follows:

"Had the staff been consulted it would have recommended disapproval since this argument can always be raised (the member would lose commissions if the trade were done between the parties) and had been raised in the past. A precedent by the governors has been to disapprove where this is the sole reason."

It is interesting to note that a similar request had been made at the same price, in the same security, about two months previously. A different broker was used and he too was to obtain a commission from the two parties. He requested approval for an off-board trade on the same grounds that "buyer wants 'no print' trade -- unless approved, buyer and seller will deal directly with each other without benefit of (name of broker)." Floor Governors Stott and Phelan disapproved the trade.

In another recent transaction, a member asked permission to go "off-board" specifically so he could avoid the publicity of a large cross. The publicity attendant to operating in a goldfish bowl was the very reason why the trade was done off-board:

Q. Well could you give us, in a general way -- or, maybe, if you like, by an example -- the kind of case where you have gone and asked for permission?

A. Yes. I had one yesterday. I had one on -- I think it was Monday, the 19th, where I went to the Committee of Member Firms and requested an exemption from Rule 394 in respect to a block of 90,000 shares. The market in the stock was very, very thin. A registered secondary was on file with the SEC, expected offering date within about ten days. If this had been crossed, if the block had been crossed on the floor of the Exchange the mere crossing of a block of that magnitude would have attracted such interest in the stock that it may well have affected the market price level, either up or down depending upon the trend of the market at the time, and thereby jeopardize the price at which the offering might have been made ...

I went to the Committee of Member Firms and told them that we could develop a buyer and a seller charging each a commission; we would trade it at approximately the market, or a very reasonable discount from the market. They looked into the size of the trading each day, the size of the block we had, the impending secondary, and decided that this would have too much effect on the market, and gave me permission to trade it off-board: which we did.

Q. This was a rather special kind of a situation and doesn't really resemble this one too much.

A. But it is showing you that the Committee of Member Firms was flexible in their thinking. It wasn't anything rigid. Where they saw an imbalance would be created with respect to supply and demand it didn't take more than a very few minutes for them to say "Go ahead and do it off-board."

Q. There was no imbalance in this case between supply and demand.

A. We were getting the other side.

Q. That's right: so there would be a perfect match.

A. There would have been a recording of an order of disproportionate size to the ordinary market.

Q. So that the whole purpose of your not wanting this transaction done on-board was really only one: you Just did not want a tape print.

A. That's right. A tape-print might have adversely affected the market.

Q. You were not doing it so as to avoid a few orders that might have been on the book at the time?

A. No; not at all.

Q. By the way, were there any orders on the book, do you know?

A. A very small number, a very small volume of trading.

Q. Now those orders were not taken care of. Do you have any feeling as to your responsibility, as a member, for the orders on the book which --

A. In this case the think was utterly insignificant in relation to the 90,000 volume. There may have been 200 shares on the book. Very minor.

Q. And I take it the specialist did not object to the transaction?

A. No. Usually the specialist gives his opinion; and apparently he saw the merits of doing this off-board.

Q. Was this at a slight discount from the last sale?

A. Seven-eighths of a point.

Q. Was that below the bid?

A. Below the bid.

Q. So that any orders on the book between that price and the bid would have been just ignored?

A. Ignored.

Q. And I take it the specialist did not want to participate at that low price?

A. He did not ask for participation.

In another example, an off-board request in June 1964, involved a cross between two non-public customers one of whom was bidding for control of a company. At the time of the request the stock was 32-1/8 bid and 32-1/4 asked. There were 1700 shares in the specialist book between 32-1/4 and 33. The staff noted the following on the request form:

"(1) the buyer does not feel obligated to take all stock offered up to 33; (2) [redacted] feels this block would upset the market if crossed and it was in public interest to cross over-the-counter; (3) [redacted] states that unless no print treatment was approved, buyer would not make a dime."

The cross was approved at $32 per share for an off-board trade; the broker received commissions, there was no publicity given to the trade.

The typical situation in which a member firm requests an off-board trade to avoid a tape print is where the order -- usually a cross -- is at a price which is not close to the current price for a security. These cases have not been decided in a consistent manner; some orders away from the market are required to be done on-board while others are not. A critical factor which appears to be determinative is whether or not the specialist does or does not desire a tape print at a price which is away from the market. It must be recognized that if approval is given to go off-board at a price away from the market, any orders on the book between the last sale and the cross price are bypassed and the expectations of the parties on the book are frustrated. Although one of the rationales for requiring on-board approvals is to prevent that very situation from occurring, approvals to go off-board and avoid the book are not uncommon, and the overriding consideration of the specialist's desire to be protected often is made paramount.

Another interesting trade occurred in connection with the request of Ladenburg Thalman to cross off board 31,035 shares of a listed security at 27-1/2 with the buyer and the seller each paying a full commission. The buyer intended to purchase 30,000 shares and the member firm would buy the remaining 1035 shares. The current quotation was 28-1/8 -- 3/8 and the last sale was 28-1/4. The buyer would not pay more than 27-1/2. At that price, however, the orders on the book of customers who wished to buy between 27-1/2 and 28-1/8 would be bypassed. On this basis the transaction was originally disapproved with a notation to "fill the bids to 27-1/2 and cross the balance on floor." At that point, however, the buyer expressed interest in purchasing the entire block of 31,035 shares at 27-1/2 and no higher on an all or none basis. This meant that the buyer was unwilling for the seller to sell his stock down to 27-1/2 in order to take care of the book before selling him the balance. The floor governor involved reversed the previous decision and approved the transaction, despite the bids on the book.

In another off-board request, a buyer wished to seek control of a listed company. The member firm, on behalf of the buyer, requested permission to cross 10,000 shares as agent for buyer and seller at a price approximately 6-1/2 points above the market. The staff noted that the buyer had already purchased several blocks from non-members. In addition, some of the stock to be purchased by the buyer would be sold by the member firm who held it in inventory. The floor governor approved the transaction and apparently no consideration was given either to the

existence of the book or to the failure to provide a "goldfish bowl" for potential buyers or sellers.

In another recent transaction, a member firm wished to cross up to 250,000 shares of a listed company. The staff noted that the buyer had already bought approximately 240,000 shares on the floor of the Exchange during the preceding year. The buyer was prepared to pay approximately 4 points above the market. There were 3500 shares on the book between 31-1/8 and 35, the cross price. The off-board cross was approved; the book was bypassed and no publicity given to the print. The floor governor noted the following: "In view of the amount offered, no large selling interest, and size of deal, [redacted] believes off-board trade justified."

In another transaction, a member firm was prepared to buy 17,000 shares of a listed security for its own account from a public customer at a price about 1-1/4 points below the current bid. However, the customer did not want to execute the trade on the floor because it wanted a net price. The member firm was willing to take a risk position to accommodate the customer. In this connection it should be noted that the discount from the current quotation was more than the amount of a commission. The staff noted "(member) firm in competition with third market." The request for approval to go off-board was granted.

It should be recognized, of course, that at the same time that these transactions were being approved, other similar transactions were being disapproved by the same or different floor governors. For example, in one transaction involving a cross of Sun Chemical 4.5% preferred at 5-1/2 points above the offer, the staff noted that the company wished to buy the stock for its sinking fund and it was restricted by its indenture to the purchase of 1200 shares per year. The company stated that the publicity of a print at a price of 5-1/2 points above the current market would nullify the chances of the company to purchase the remaining shares of the sinking fund. The transaction was disapproved. One of the floor governors involved in the trade, who had previously approved some of the trades mentioned earlier, concluded that the print of a price 5-1/2 points above the market did not appear to preclude their being able to buy the remaining shares for their sinking fund. The same floor governor also disapproved a transaction 8 points above the market with a notation that there were "8000 shares offered on the specialist book up to 23." He testified that this was the main reason for the disapproval of the transaction. In reconciling these disapprovals with a prior approval, he explained the approval as fellows:

"This is an isolated transaction and in my opinion had we disapproved this transaction this would have created on the floor of the NYSE a great many problems that we wished to avoid at the time."

The apparent lack of consistency in approach is pointed up by the following colloquy which related to an approval of an off-board trade between a member and a non-member:

Q. You have given us this morning a number of reasons which fit the particular situation: the position of the member firm, his risk and a number of other things, but it seems that your two primary considerations, that is protection of the "crowd" and the book and the desire for the goldfish bowl are theories which disappear somewhat arbitrarily.

A. I don't think that is the case. You have taken here some 10 or 15 isolated cases.

Q. I can take three dozen. I am trying to get your philosophy of when the standards you set forth earlier this morning are going to be complied with and when you are going to ignore them ....

A. ... I talked to Tom Fagen, who is a Specialist in [redacted], and he told me -- and here again this is just recollection -- that the arbitrage had either terminated or the Department of Justice had interceded at some time where it was very tenuous as to whether this merger or sale of [redacted] to [redacted] would go through.

Q. Why is that a reason for approving an off-board trade?

A. Because the market couldn't have accommodated that type of stock.

Q. This is a cross. Couldn't the market always accommodate a cross?

A. Not necessarily.

Q. This is a cross between a member firm and a non-member, why couldn't it have been put on the tape?

A. I would have to check this out much more thoroughly before I could give you a concrete answer.

Q. Is it fair to say every time you have a cross where there is an agreed price between two parties, that by definition the market could absorb it?

A. The market is the determining factor.

Q. And if there is a cross, an agreed price, is that not the market?

A. Yes.

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Q. Shouldn't that always be on the tape?

A. It should.

Q. So what is the reason for your not approving the off-board cross?

A. Well, there are certain things in this situation which I would like to explore, if I could.

Another floor governor who approved a transaction of a 13,000 share cross at 2 points below the market explained his reasoning as follows;

Q. You approved a trade of a couple of points below the existing market on the floor.

A. Sure. Because the chances are, the reason for this, approving it, is because the market wouldn't take that amount of stock.

* * *

Q. What happened to the book?

A. The book remained the same. This is a block transaction.

Q. Well, don't you think that the book deserves to be protected?

A. No. Not at all times.

Q. What situations should the book be ignored or avoided?

A. When you get a large transaction, such as this, 13,000 shares of preferred stock, I would have to go back, now, and look at it.

* * *

We approved it because I assume 13,000 shares of Radio preferred is a big piece of stock. The market as such would not take that amount of stock. If it would have taken that amount of stock, it would not have been approved.

Q. What do you mean, the market would [not] have taken it?

A. The book.

Q. Why shouldn't the book be cleared and then a cross done on the floor?

A. Well, the buyer, it is very possible that the buyer said if you sell down to and print the price of 70, I won't buy the stock at 70 because you have destroyed my ability to probably try and sell the stock.

Q. So the buyer wants a no print so that he will have a cost which is lower than the print appearing on the tape?

A. That is correct.

* * *

Q. But there are a number of cases here which are considerably against the market in which approval has been given. Is it fair to say in those transactions, whatever might be your reasons for it, the book is being bypassed?

A. Yes.

Q. Is it fair to say that the tape, for some reason or other, you have just forgotten about your philosophy of, concerning the importance of having everything on the tape?

A. No, I think there are exceptions in all cases, and I think this is one of them.

Q. Because he (buyer) doesn't want a tape print?

A. He doesn't want the print. He won't make the bid under those conditions, see. It is no different than block purchases and block sales.

Q. So that in a situation, then, of this sort, and it has come up, by the way, in the Pennsylvania Railroad situation, the Buckeye Pipe, it has come up with some of the Loeb Rhoades requests, in A.V.C., it has come up with Youngstown Spring and Wire, where there have been substantial differences between the agreed cross price and the floor price, that in those situations you feel that it is justified not to print, and is also justified to ignore the book?

A. You have got to take each one on its own. It has to stand on its own legs.

Q. Well, what are the legs?

A. The legs in this case, I assume, was that the customer could not have sold that amount of stock down to and including a price of 70. He could have sold a thousand or two thousand down, and the customer would still be standing there with another eleven or twelve thousand. There was a buyer who was willing, under the conditions he stated, to pay a price of 70, and I see he is an agent for both, and pay a commission.

Q. Well, in a number of cases I have seen you disapprove transactions, according to the records, which are at prices above or below the market on the grounds ... take care of the book and cross the balance on the floor.

A. Sure. That could happen.

In this kind of situation it seems that the guiding consideration influencing the floor governor's decision is that the buying customer has convinced the member and the floor governor that it will not engage in a transaction if there is a tape print because a low tape print would hurt his chances of disposing the security at a profit. Again, this reason poses the curious anomaly that the very reason for the off-board approval is to avoid the kind of publicity which the Exchange claims is necessary and proper to advise all the investors about what is happening in the marketplace. It should be noted that no approval was found for 1962 and 1964 in which the Exchange permitted a broker to effect a cross below, at, or above the marketplace in an off-board trade with a non-member competing market-maker.

In another interesting case, a request was made by Dillon Reed & Co. to cross 1910 shares of Superior Oil of California, at $1200 per share. Dillon Reed was to obtain a commission from both parties. The last sale was at 1235. A request for approval to trade off-board was denied with the notation that there were 100 shares on the book and "the specialist needed 110 shares." It was therefore recommended that the bids be filled down to 1200 and the balance crossed on the floor. The floor governors who disapproved the trade noted that the specialist was probably short and therefore it was important to have the trade done in a manner which would permit him to participate, i.e., on-board.

The testimony of floor governors who pass upon the requests for off-board trades point up by their testimony the lack of standards or consistency with the rationale for the Rule. For example, Mr. Crooks noted the following:

A. The second consideration would be whether the transaction was at a price variance that was fairly wide from the going transaction in the security mentioned.

Q. Which way would that cut?

A. Either up or down at a variance from the last sale of the auction market as it existed at the time.

Q. What I meant was: Would there be more chance of your approving the off-board transaction if there was a variance or less chance?

A. Generally speaking, I would say less chance.

Q. There would be less chance if the proposed off-board transaction was away from the market?

A. Correct.

Q. In other words, the closer to the market, the greater the possibility of an approval?

A. Oh, no, I wouldn't put it that way. But I would think that the price at which the transaction would be accomplished with a great variance from the going market the chance of approval would probably be less ... this is one of the facets you would explore for either granting or disallowing.

Mr. Crook's position that the further away from the market the less chance for approval might be compared to the position of Mr. Phelan and Mr. Stott, who stated that the further away from the market the requested cross the greater the possibility of an approval for an off-board trade. In this connection, of course, it should be noted that the greater the variance from the market price the greater the possibility for orders on the book to be bypassed.

It appears from the testimony given that one of the stated reasons why the book is avoided and why the goldfish bowl theory is ignored is simply the belief that a print might cause what is deemed to be too much pressure on the specialist. It is argued by floor governors that "the disruption of the market by the publicity attaching to the cross on the tape ... could [be misinterpreted as] a tremendous buying interest in the stock [and] cause distortion in the market temporarily." In fact, the tape would be reporting a "tremendous buying interest" which did exist, and which might or might not be fully satisfied. The views of a specialist and floor governor points up the problem:

Q. In that connection, you said before, that actually to require a print might be misleading.

A. Right.

Q. Because it might lead people to believe there is a large buying interest in the stock.

A. Right.

Q. In fact, it is there, a large interest.

A. It is an interest that has already been satisfied.

* * *

A. The stimulation of that print, a print of enormous size, carries with it a connotation, ... that there is an interest that exceeds a one transaction deal.

Q. Isn't this a subjective type of judgment that has to be made?

A. I think it is subjective in the sense that I said before, knowing that a man would be damaged or not damaged. I don't believe this can be wholly objective.

Q. Doesn't your comment about the large block and a print apply to every large block cross?

A. Well, certainly a block like Consolidated Coal made on the market, which is almost a history making cross, affects nobody, because it is on the market, and if it does have an effect, it will be from the existing market. If you allow crosses [on board], two or three dollars up or down, then the returning to the existing market is a painful process.

The fact that the specialist may be required to purchase or sell substantial quantities of securities subsequent to a tape print away from the market places him in a difficult position. On one hand the buyer (or seller) may not be willing to permit the specialist to participate at the advantageous price in which case the member firm might lose the entire order. On the other hand, the specialist may not wish to participate because of either a lack of inclination, capital or stock. As a result, both possibilities are avoided by letting the trade go off-board and unpublicized.

Another reason given in connection with an off-board approval is that the public parties to the transaction know each other and/or one of the parties does not want to be subject to a "weekend" or overnight risk. Ordinarily, these transactions are disapproved. However, again there is no consistency of treatment. In one transaction in 1964, Goodbody & Co. requested permission to cross 10,000 shares of Lykes Steamship Co. at the current market, as agent for buyer and seller. Two floor governors approved the transaction. The staff noted on the

request sheet "buyer wants to trade tonight. Unless Goodbody & Co. gets approval they lose trade since principals know one another." Mr. Harold Schutz explained that the floor governor may well have approved the transaction because it was not "an actively traded stock" and secondly, because "the two principals do know each other." It was also suggested that perhaps the reason for the approval was because it was after hours, which apparently sometimes is also used as a standard. On this latter point the following colloquy points up the uncertainty of treatment:

Q. Are most of your requests after hours approved or most disapproved?

A. That is difficult to say because -- I can't say offhand. It would depend on the individual transaction. I would say in relationship to the number of approvals versus disapprovals there are possibly more transactions that come in after the close that are approved than would be approved if they had come in during trading hours.

Q. I didn't ask you that. I asked you whether with respect to transactions which do come in after trading hours most are approved or disapproved. You may not know.

A. I wouldn't know without looking up the records.

Q. Would you have recommended approval of that transaction based on the information on the sheet?

A. Well, this is a problem of market judgment, I don't know whether I would have approved it or recommended it or not, I have no way of knowing, of exercising any judgment in the market.

Q. The second answer you gave in connection with this particular approval was that the parties know one another.

A. That is correct.

Q. Would you explain that?

A. Well, the buyer and the seller -- the buyer was aware of who the seller was and the seller was aware of who the buyer was, and as we sometimes find , , . the principals get together and make the transaction directly between themselves without the member firm participating.

Q. Is it fair to say that that is one of the standards that are used in connection with approvals, -- that parties know one another?

A. It might be in some cases. It might be in this one.

Q. Well, how does that particular standard comport to your understanding as to the reason for the rule in the first place?

A. Would you rephrase that?

Q. Certainly. How does that standard in your judgment tie into or relate to the reason for the rule 394, the existence of rule 394?

A. Well, rule 394 is basically a rule which would require that every transaction possible be executed on the floor. These people, since both the principals, the buyer and the seller, know each other, they are not required to go down to the floor if they want to trade with each other. If they make the transaction between themselves we have no authority over them.

In another trade, a member firm wished to cross an order between two parties, one of whom was a large buyer of the security onboard during the day. A request was made for an off-board approval after closing hours on the grounds that the seller, who was offering the stock after the close, might not offer it the following morning if the price changed in his favor. The staff noted on the information sheet that "if disapproved, the member firm might lose the trade." Two floor governors approved the trade. A third floor governor, who was questioned about the transaction during our inquiry, simply stated "I would not have approved it." The floor governor who approved it explained his position on after hours requests:

Q. Well, let me give you another example of another trade, I have a trade of Goodbody, of a 10,000-share cross where the price was right between the bid and the offer of 10,000 shares of Likes S. S. Company, and the buyer wanted to trade tonight. Unless Goodbody gets approval, they lose the trade, since the principals know one another and you approved it. Can you tell me why?

A. This was not during market hours, I can assure you. I haven't looked at it, but it wasn't during market hours.

Q. Does that make a difference?

A. It makes a tremendous difference.

Q. So if a member firm comes to you with a cross after hours, between the bid and offer, you will approve him?

A. Depending upon the circumstances, and what surrounds it. Not automatically, the answer is no. If I thought tomorrow the man could have sold the stock on the floor of the Exchange, see, the chances are we would have disapproved it, see.

Q. In that case, did you think that the market could not have absorbed it?

A. I don't know. Let me take a look at it.

* * *

A. He is agent for both.

Q. That is right. He is getting his commissions.

A. I don't see that anybody is harmed here. I mean the buyer and seller was paying commissions, see.

Q. And nobody was harmed by it?

A. And my market wasn't being destroyed.

The inconsistent treatment for requests for off-board trades raise a number of important questions. First, of course, is the discriminatory treatment which results from standards being applied in certain cases and not in others. As a result, cases which appear to be indistinguishable on their face from the member firm's point of view, or even after analysis of the market situation, are decided in different ways. Secondly, the granting of approvals in situations where the book is bypassed, the tape print is rejected, etc., flaunts the basic rationale for the Rule itself. This alone would be most troublesome. However, it appears that the exceptions occur most often either to assist a member firm in making a commission, to assist the specialist in his activities, or to prevent the public from knowing about the transactions. Against this situation it must be recognized that exceptions are not granted on the grounds that the customer will get a better execution. Rather, that standard is not used on the grounds that it would impair the depth and liquidity of the market. That particular standard is not one which is balanced against the rationale for the Rule. It is regrettable that neither the interest of the customer in the particular transaction nor the importance of competition between markets is considered a circumstance which would permit Exchange officials to grant exceptions from their rules, while situations which inure to the direct benefit of the member do allow for exceptions to the theory and rationale of the Rule.

VI. Exceptions to Rule 394

Apart from the ad hoc criteria described in the previous Section, there are a number of institutionalized exceptions to Rule 394. For example, control stock, charitable trades, error trades, and foreign odd-lots are exempted from the Rule on a routine basis as a matter of administrative practice. Furthermore, an exempt list for certain designated securities specifically exempts them from the operation of Rule 394. In addition, all bonds, whether convertible or not, in units of ten or more are treated as exempt from the Rule, as are certain foreign transactions, specialist block purchases or sales, off-board secondaries, etc. Some of these exceptions are discussed below.

A. Control Stock

Sale of control stock under circumstances which would require the giving of an investment letter by the buyer are exempt from Rule 394. The reason for this exemption is that if the seller's order were taken to the floor of the Exchange, it would not necessarily be crossed with the particular buyer who was willing to give an investment letter. The rules of the Exchange require that the best bid take the floor and in case of identical bids, the bid which is placed on the floor prior in time would be entitled to the execution. Since a buyer who had priority would be unknown to the seller ordinarily would not be prepared to give an investment letter and since the seller could not deliver the security without one (without violating the Securities Act of 1933), the Exchange automatically grants an exemption from the Rule as a matter of administrative practice.

B. Charitable Trades

For federal income tax purposes a donor may sell appreciated property to a charitable institution at his original purchase price (or other basis price) and receive a deduction equal to the difference between the sale price and the current market without realizing a taxable gain on the appreciation. Where an individual wishes to make a sale through a member firm to a charitable institution, the sale price often is very substantially below the existing market. Under such circumstances the Exchange does not believe it appropriate that orders on the book be filled between the last sale and the low cost price at which the donor sells to the charitable institution.

C. Error Trades

These trades are normally exempt from operation of Rule 394; the situation usually arises in connection with a member firm error in failing to execute the order in the manner or time specified by the customer. If the market has changed and it is impossible to bring the order to the floor at the price specified by the

customer the member firm may wish to participate in an off-board trade with its customer at a price away from the current market to rectify its previous error.

D. Odd-lots

Recently foreign odd-lot transactions have been exempted from operation of Rule 394 because of the interest equalization tax. This exemption is based on the premise that:

[Notation in original: "Odd-lot material to be supplied."]

It should also be noted that all domestic odd-lots must be done "on the exchange under Rule 394." It is interesting to note that odd-lots do not involve a tape print, they do not have any direct effect on the book and only indirectly go to the floor on occasion when the odd-lot firm desires to offset their purchases or sales. Nonetheless, the Exchange insists that all member firms take odd-lot orders to the odd-lot member firms who are making markets in odd-lots and to no other firm and execute their orders with these firms. All customers of all member firms are charged the same odd-lot differential. Mr. Crooks commented as follows:

Q. Does Rule 394 apply to odd lots?

A. I think it states completely any security listed on the New York Stock Exchange, so therefore it should apply to odd lots.

Q. From time to time we have seen in years past that in small quantities of odd lots some of the members sought permission to cross them in their office.

A. I believe this -- if you would look over those memoranda again, I think you will find that this probably occurred in December.

Q. I am sorry.

A. In December, when tax considerations are in effect, and I think some of the approvals were given with the idea that the public should not pay a premium or a discount of an eighth or a quarter percent to effect the transaction. I believe you will find that most of these requests have arisen in December, and in some cases have been approved.

Q. Do they hurt the liquidity of the auction market?

A. Not on the cross because there would just be a pair-off.

Q. Would you suggest that Merrill, Lynch might do all their pair-off in odd lots off the board because they don't hurt the auction market?

A. They do not hurt the auction market.

Q. Do they hurt the "crowd"?

A. No. You are dealing in round lots.

Q. Are they reported on the tape?

A. They are not.

Q. There is no problem of precedence or priority or parity with an odd lot?

A. No, not at all.

Q. So why should they be done on the floor?

A. Publicly arrived at transaction.

Q. ... , the question is why should they be subject to Rule 394?

A. The way the rule is written, it makes no exception for odd lots.

E. Unsuccessful Secondaries

Exceptions from Rule 394 are also granted in connection with requests by member firms for approval to trade off-board securities remaining after an unsuccessful unregistered secondary distribution. [Footnote: It is practice of member firms on certain occasions to use special plans to dispose of large blocks of securities for their customers. These plans provide for techniques to distribute the securities to the public investor with or without a tape print, depending on the type of plan used. The plans generally involve the vendor paying an amount in excess of the normal commission rate. The public buyer, however, does not pay any service fee for the execution since it has been absorbed by the vendor. The spread between the price paid by the customer and the price obtained by the member firm is sufficient to pay the salesman an amount greater than the normal profit in selling listed stocks. On occasion, however, the offering on certain of these plans is unsuccessful and the securities remain in the hands of the syndicate which arranged to make the distribution.]

In particular, in so-called off-board secondaries the managing underwriter for the syndicate may find that the syndicate has been unable to dispose of the shares which the syndicate has purchased from the non-member seller. Under such circumstances the syndicate manager may request an exception from Rule 394 to dispose of the shares which remain in the syndicate account. If approval is granted, three main effects result: first, the off-board sales will bypass any orders which might be on the book; secondly, the transactions prices will not be reported publicly; thirdly, the shares will be sold directly from the accumulated inventory at a net price without adding an amount equivalent to a commission. The syndicate manager hopes to dispose of the unsuccessful portion of the offering and thereby extricate the members from a potential loss greater than they may already have incurred from the unsuccessful distribution.

Though the decision to request an off-board trade under these circumstances seems inconsistent with the rationale for the Rule, member firms have defended their requests on the grounds that they have already lost money on the offering and are trying to "get out" as best they can and minimize their loss. One member firm described the situation as follows:

Q. That (the request for approval of an off-board trade) is when the member firms are stuck with a very substantial position?

A. Correct.

Q. Isn't that inconsistent with the theory of directing everything onto the floor?

A. What effect it has, it gives you time. In the first place, you found you couldn't do it in the normal mechanism of the Exchange. You ... try to stabilize. But, suppose it goes badly? And, at 10:30 in the morning you got your 10% or 20%, ... but this does not do the stabilization. It is obvious that the deal is flat. So you withdraw stabilization, and you own a lot of stock. You and other underwriters are unloading a lot of stock. So, in order to get additional time to work it out, without hurting the primary market pricewise, by forcing you to dump your stock, they give you permission, normally, for some period of time to try to induce institutions or other type of customers to buy the stock.

Another member and floor governor testified as follows:

A. Let's assume you have a secondary at the price of 70 -- to my knowledge, this happens mostly to new issues. If stock has been offered at $70 a share and the syndicate is dissolved, the only place he can sell the stock is at 60, he is going to be reluctant to sell the stock at 60 because every bit of stock he disposes of at the 70 level he is going to have letters written from everybody in the United States as to who did what to whom.

Q. In other words, he is going to do it off the board so as not to have a tape print?

A. Correct.

Q. Was that [also] because there were competing sellers on the floor?

A. It would be in many cases.

Q. If he is going off board to avoid competing sellers, aren't these the competing sellers we are talking about in the "crowd"?

A. This is the managing underwriter of the syndicate trying to dispose of the stock, I think that makes the difference.

Q. Why?

A. Because he is trying to get out of a bad situation.

Despite the fact that the member firm may negotiate with institutions or even the third market to dispose of their inventory on a net basis, they will not do so for the benefit of a public customer's inventory. One member firm described the situation as follows:

Q. After the syndicate is terminated and assuming you get approval for the unsold block, would you have any qualms about taking the block and selling it to a mutual fund or to Weeden or First Boston?

A. If they had the best bid?

Q. Yes.

A. No, I don't think so.

Q. Why is it you have no qualms about asking for permission to go off floor to sell your own stock to Weeden or First Boston, but you wouldn't do it for a customer?

A. Because you are just asking about an isolated instance.

Q. That is right.

A. As opposed to the broad spectrum of the general market.

Q. But you indicated that you would be willing to go to Weeden or First Boston and ask permission to do it, if they had the highest bid for your own stock, but not for that of a customer. I am trying to get a feel for what it is about that kind of impairment of the auction market which you think is justified but not justified for your own customer.

A. I think it is a matter of the way you say it. If you just say it slightly differently and say ... that conditions change and that really, what is happening is not that you are asking for permission to go to Weeden, or to go to anybody else, is that you are asking permission to extend for a short period of time past the syndication termination the distribution of that stock. And perhaps what you are saying is that for better orders the syndicate should not be terminated until all of the stock is sold and maybe that would be the answer to it.

Q. Mr. Schwieger, you are probably familiar with the rules with respect to the unregistered secondary. Am I not correct that the book must be taken care of before the secondary is effected at a particular price?

A. Are you talking about current situation?

A. Yes.

A. Again, it has been a long time, but I am not sure. It used to be. I know what the situation is, I think. You have to go to the broker who has the order in and ask if his customer wishes stock at that specific price you are offering.

Q. And all those in between that price --

A. Yes.

Q. Am I also correct you must charge an equivalent of at least two commissions on your discount of the unregistered secondary?

A. That is correct.

Q. Do these conditions apply with respect to the request for off-board trading in connection with the unsuccessful amount which remains?

A. No, they do not.

Again, it is a curious anomaly that the member firm seeks to obtain the best execution for itself even if it means ignoring some of the fundamental rationales

for the Rule, but will not do so if the situation involves a customer who is in the same situation trying to dispose of securities.

F. Exempt List

At the time the Exchange issued Member Firm Circular 52 requiring Exchange approval for off-floor trading, the Board gave temporary permission to those member firms which had been making over-the-counter transactions in "high grade preferred stocks" to continue this practice without prior approval. This action of the Board was taken at the request of the approximately 35 firms engaged in this type of business.

The interested firms represented by William Beckers, a partner of Spencer Trask & Co., argued that:

"for the most part, high grade preferred stocks are held by institutions which are interested primarily in the investment character of the securities and therefore considered them only on a yield basis; that it would not be realistic to expect such institutions to effect all of their transactions on those stocks on the Floor rather than to buy or sell through negotiation. Member firms who engage in this highly specialized field are willing to take risk positions in these securities inasmuch as their low yield and investment character reduce considerably the possibility of large fluctuation and because of the member's specialized knowledge, obtained through experience and effort, of the type of customers, generally institutions, who are potential buyers and sellers of such issues. It is stated that the continuance of member participation in the over-the-counter market for such securities will not be adverse to the interests of the public as well as of the individual member firms who deal in them."

Following the issuance of Member Firm Circular 52 the firms dealing in the temporarily exempt stocks were required to furnish weekly transaction reports so that the Exchange could ascertain the scope of the practice and arrive at a permanent procedure. The list itself, which initially comprised 194 stocks, was a compilation of those stocks which the specialty firms traded and was furnished by the Exchange only upon the specific request of a member.

Beckers and the Exchange staff were assigned the task of devising a formula and procedures for administering the list. An outline of a draft plan was prepared in August 1948 which incorporated a formula for defining "high grade preferred stocks," and set forth a requirement that all such issues be transferred to Post 30 (inactively traded securities) with the "expectation" that the specializing firms (i.e., Spencer Trask, et al.) would "participate to a greater degree than at present in the Floor market" for these securities. Following discussions with the interested

firms, specialists and Floor Governors, a comprehensive plan was presented to the Board in May 1949. The pertinent recommendations to the Board were:

(1) that permission to trade off-board in high grade preferreds be extended to all members;

(2) that periodic reporting be discontinued;

(3) that the list of stocks to which the permission is applicable be printed in the Directory and Guide and be periodically revised; and

(4) to qualify for the exempt list the security meet 3 out of 4 stated tests.

The formula, which was suggested by Beckers, who had examined various state requirements for trust and insurance company investments, consisted of the following tests:

(1) Yield not more than 2% above Moody's average for AAA corporate bonds;

(2) A market equity percentage exceeding 60% (market equity being the market value of all equity junior to the pertinent security, divided by the total capitalization, at market);

(3) An unbroken record of dividends earned and paid in every year since 1929 or date of issuance whichever is later; and

(4) Average coverage of dividends on the preferred issue and all prior charges on an overall basis of at least 2-1/2 times for industrials and 1-1/2 times for public utilities, since issuance or 1929, whichever is later.

According to Beckers and the staff, this formula was almost ideal since it included virtually all the stock on the existing list (considered "high grade" by consensus), while excluding all others.

Along with the proposed plan the Board of Governors received a detailed memo from Beckers presenting various arguments for permanently exempting high grade preferreds from the off-board trading restrictions. The main points of Beckers' argument were that the business is almost exclusively institutional and as such it was "absolutely necessary" to carry positions arid trade net and it would be "absolutely impossible to limit the rights of member firms to sell their long positions or cover their short positions outside of the current quotations on the Exchange." Beckers also asserted that the off-floor trades directly created on-floor transactions via the dealers' offsetting of positions and that the activity of the dealer firms stimulated preferred stock business of other member firms and

enabled the other firms to execute their orders on the floor since the dealer firms continuously kept bids and offers on the floor for positioning purposes.

The Board considered this memorandum and the staff recommendations at its meeting of May 12, 1949 and adopted the entire package except for the recommendation that the list be published in the Directory and Guide. As an alternative the Board determined to retain the existing system of only furnishing the list upon specific request. The Board apparently came to this conclusion on the theory that it would be poor public relations for the Exchange on one hand to invite issuers to list on the Exchange while on the other hand publishing "an invitation to deal publicly off the Exchange in securities which had already been listed." Several months later the Board, over the strenuous objection of the Stock List Department, reversed itself and authorized publication of the list in the Guide.

An early problem in administering the list concerned the, treatment to be accorded convertible preferreds. The staff of the Exchange felt it was desirable to recommend that convertible preferreds be deleted when they are actively convertible and returned to the list when the conversion is not active. The staff solution was to prohibit off-board trading when the convertible preferred was selling within a one-point conversion price range of the common. This was effectuated by marking each convertible on the list with an asterisk and adding an explanatory statement that "where the current Floor offering price, divided by the conversion ratio, equals a figure within one point or less of the bid price of the security into which it is convertible, the exemption ... is not available." Subsequently the problem was compounded by the question of the treatment to be accorded trading in rights to subscribe to convertible preferreds. Ultimately the Board voted to delete all convertible preferreds from the list.

The objective statistical standards for qualification on the list have remained constant, but in 1952 the Advisory Committee added three important subjective tests: is the market institutional in character; is there a constant floor market; and is the issue selling on an investment basis. These standards were apparently added as a result of a specialist's complaint that a stock had been placed on the Exempt List when there was allegedly a good market on the floor. Thereafter the form used to process requests to place an issue on the Exempt List contained a caption "Specialist's Comments." The staff obtained the answers to the three questions solely by oral inquiry of members (i.e., Beckers and the pertinent specialist) until November 1960 when it was decided to prepare a chart showing weekly volume and price ranges for a 12-month period for submission with the statistical detail and specialist's comments.

It should be noted that in 1949 all new issues were screened by the staff to ascertain whether they qualified. In 1953 Edward C. Gray and Frank Coyle of the

staff decided that the staff would henceforth only recommend those qualified stocks for which a request for exemption had been made by a member firm.

As stated above, during the "temporary" period from June 1948 to May 1949, the time when the Board adopted the formal list, members were required to check the floor market before executing an off-board trade in an exempt stock. In October 1955 a meeting was held between several Governors, the staff and Beckers and another partner of Spencer Trask to discuss "methods of protecting and improving the Floor market in Exempt List securities." Various suggestions were made at this meeting including requiring on-floor trading of all odd-lots, blocks under 200 shares (with narrow exceptions) and trades between member firms. It was ultimately agreed that the staff would prepare a proposed preamble to the list --

"to express <u>in broad terms and without definitive language</u> the philosophy of the Exchange that the Exempt List

(1) Was designed primarily to enable members to meet non-member competition in high grade preferred issues.

(2) Was not intended as an unrestricted license to trade over-the-counter in those issues.

(3) That member firms should effect off-floor trades in Exempt List issues only when it is essential to do so in the light of the relation of the transaction to the Floor market and price, and to all other factors, and only when it is not possible to put trades on the Floor." (emphasis in the original)

Pursuant to the instructions of this meeting the staff published a new preamble which stated:

"Though the following guaranteed and preferred stocks have been exempted from this ruling, it is a basic concept of the Exchange Constitution that all transactions in listed stocks be executed on the Floor. Consequently, every proposed transaction in these securities should be reviewed in the light of the factors involved, including the market on the Floor, the price, and the size so that wherever possible, the transaction may be effected on the Floor."

The virtually identical language is incorporated in the present material in the Directory and Guide of the Exchange.

During the course of the Special Study the validity of maintaining an Exempt List was re-evaluated by the Exchange staff. Harold Schutz, in a memorandum to

then vice president Frank Coyle, presented the question of abolishing the list and delisting all its stocks. The memorandum concludes as follows:

. . . the Exempt List is an anomaly; the Exchange says every stock must be traded on the Floor, and then it provides a list of stocks which may be traded off the Floor provided they comply with a certain formula; the market on the Floor is too small to provide an active market, and the Exchange lists issues on which the number of shares is too little to provide a reasonable market; we say we are making a public market when in fact most of the shares are held by institutional investors, and perhaps 10-12 member firms at most are active in the Exempt List stocks."

Mr. Walter Coleman, in a memorandum of the same date, was more definite in his opinion that the List should be retained because "the same conditions which inspired its adoption still exist today." He also commented that although the Exempt List issues only "barely" meet the Exchange's listing requirements, actual delisting would, "in the often expressed opinion of our Stock List Department," bring strong protests from the issuers "accompanied by threats of withdrawing from listing other issues of those companies who want listing on an 'all issues or none' basis."

There have been relatively few requests for additions to the List. Their disposition is summarized below:

Three of the requests for admission were approved -- all in a routine fashion. The pertinent details and staff comments on the remaining eleven requests are summarized below:

1. Corn Exchange Bank (common) -- request made by Laird, Bissell & Meeds on August 10, 1949 because better OTC market. Disapproved August 23, 1949 without comment.

2. Public Service Co. of Indiana, 4.32% Cum. Preferred -- submitted to Advisory Committee September 9, 1952. Disapproved on the ground that "there is a continuing good market ... on the Floor." No supporting detail attached.

3. Pacific Western Oil, 4% Preferred -- submitted September 9, 1952. Disapproved because "the stock is deemed to be non-institutional in character." No supporting detail.

4. Vulcan Materials 6-1/4% and 5-3/4% Cum. Preferred -- submitted January 23, 1958 by Goldman, Sachs. Each satisfied 3 of 4 tests (but far exceeded yield maximum). Securities were deemed non-institutional because the issues were held by 5,400 and 3,750 shareholders respectively; Beckers of Spencer Trask

opposed their admission to the list. With the consent of Goldman, Sachs the request was placed in abeyance.

5. RCA $3.50 Preferred -- submitted by Salomon Bros. & Hutzler -- May 5, 1960. The specialist objected because there was an "adequate market" on the Floor. The staff characterized the volume as "steady and good -- 6 months totaled 54,200 shares." Harold Schutz was instructed to tell the firm that the staff thought there was a good market on the floor and the stock would not be admitted.

6. Sunray Mid-Continent Oil 4-1/2% Preferred -- submitted by Eastman Dillon on September 20, 1960. The stock met all formula requirements; a partner of Spencer Trask said it was definitely institutional in nature. The specialist objected, claiming there was a "wonderful market" in the stock. Total volume for September 1960 was 14,600 shares; however, 11,300 of these were done on two days and on six days the stock did not trade at all. Mr. Harold Schutz advised Eastman Dillon of the specialist's objection and the volume for September and the firm said to disregard the request.

7. Atchison, Topeka & Santa Fe Preferred -- submitted by Merrill Lynch on October 25, 1960. The stock met 3 of 4 tests and the specialist had no objection. Total volume for the previous year was 815,500 shares -- an average of about 68,000 shares per month and there was 1/8 spread between bids and offers. A floor governor was consulted; he did not feel that the volume justified putting the stock on the list. Mr. Schutz contacted Mr. Beckers who said that volume indicated it was non-institutional and that "this does not sound like what we had in mind when the Exempt List was established." Mr. Beckers noted that the list was aimed at stocks trading on a yield basis in which there was an inability to trade on the floor due to wide spreads in bids and offers. Ultimately the request was withdrawn even though the firm felt that exempting the stock would add substantial floor business.

8. National Distillers and Chemical Corp. 4-1/4% Cum. Preferred -- submitted by Salomon Bros. & Hutzler on September 26, 1961. The stock met all formula requirements but the specialist opposed because he felt there was good volume and an adequate market on the Floor. Schutz advised the firm of the specialist's comments and "the fact that if the request was formally presented to the Advisory Committee it would probably be disapproved." Accordingly the firm withdrew the request. There was no supporting detail.

9. U. S. Industries 2-1/2% Cum. Preferred -- submitted by Hentz & Co. circa April 4, 1963. The stock qualified on 3 out of 4 tests but "barely" met the dividend coverage requirement. A Spencer Trask partner was consulted and did not feel that the stock was either a high grade preferred or institutional in nature. The

specialist had no objection since volume was very poor. Disapproved without comment.

10. Tri-Continental $2.70 Preferred -- requested by Spencer Trask on April 8, 1963. The $2.70 stock was being called with an option to exchange for $2.50 stock and an underwriting group was obligated to take any non-exchanged $2.70 stock. The request for addition to the list was made to facilitate lay-offs of the stock accumulated by the underwriters. The specialist objected because of the special purpose and because of active volume (12 month average of 2000 per week except for several weeks each year, around April 1, when about 10,000 shares traded per week), Beckers said it is "in the public interest to put the called stock on the Exempt List in order to reduce the risk to the underwriters..." The request was disapproved on the grounds that the floor market was adequate, the request was for a special purpose and the stock was non-institutional since it was being immediately called.

11. Tri-Continental $2.50 Cum. Preferred -- submitted July 12, 1963 by Spencer Trask. The stock met all formula requirements but the specialist objected because there was a "good market on floor with 1/2 point spread on his book." Volume averaged 1300 shares per week except for the week immediately preceding the request when 8000 shares traded. Beckers. was advised of the specialist's objection and advised the staff to hold the request pending further word, which was not forthcoming.

The only safe conclusion that can be made concerning the administration of the Exempt List is that the specialist has an almost complete veto over admitting qualified stocks to the list. It also appears that this veto can be arbitrarily exercised since there are no ascertainable standards as to what constitutes an adequate floor market. It should be noted that in some of the instances where the specialist claimed that a good floor market existed, the volume figures indicated a very shallow market with infrequent trades. This was evident in the request to exempt the RCA issue where the volume figure averaged out to slightly better than one round-lot every hour and a half and was particularly evident in the Sun Ray request where the month's volume was almost completely based on two days' trading. In addition, there are many securities on the Exchange which are fully subject to Rule 394 but which are less active than securities on the Exempt List. Yet, primarily because member firms do not generally have a propriety interest in such securities or do not hold institutional interests in such securities, they are not exempt from the restrictions of Rule 394.

As may be seen from the foregoing, the exempt list permits member firms to make competitive markets with the specialist in designated securities. It is not clear why securities which are "institutional" in character can trade in a different manner from non-institutional securities, or more significantly, from other inactive

common stocks on the Exchange. The Exempt List also provides for an exemption from the minimum commission rate schedule for member principal trades with non-members, i.e., members need not add an amount equal to a commission over the offer price on the floor, as they must do on principal trades on the floor. However, the Exchange takes the position that though a member may execute an agency order off board in an exempt list stock, (with either a member or non-member) , it must charge the initiating public customer a full minimum commission as if the order were executed on board. It need not charge the non-member dealer a commission however in executing the customer's order with such dealer.

The Exchange recognizes that, with respect to exempt stocks, most of the transactions are done off-board. Some Exchange members were asked whether, in line with their theory about erosion of the primary market, on-board trading of such issues should be terminated. These members indicated that this would not be appropriate since the Exchange was still the "primary" market and there was still an opportunity for the specialist to profit. One non-floor governor commented as follows:

Q. I take it, in the case of most exempt issues, and most bonds, that there are more active and better markets off the board than on the board, as a rule?

A. Yes, that is true.

Q. In line with your views on erosion of the primary market, would you recommend that those issues which do have more substantial markets off board be delisted and not traded at all on the New York Stock Exchange?

* * *

A. No, I wouldn't recommend that these issues be delisted, because there is some business in them, because there is no harm to the public. ... As I also pointed out, these things move by interest rate and changes in the market, not by changes up or down in earnings or other factors that go into moneymaking investments.

Q. How does that factor affect the harm to the public on execution?

A. I said there is no harm to the public in this particular thing, because the markets don't change, except infrequently.

Q. That may be so, but isn't there some detraction from the liquidity and depth of the off-board market?

A. Not in these high grade issues, because the prices are determined solely by the interest rate, and unless the institutions run out of money, banks and insurance companies, and what not, they will always want it.

Q. What you are saying is for the high grade bond or high grade preferreds --

A. Right.

Q. -- that since they are governed by the money market --

A. Correct.

Q. -- they are subject to less fluctuations and, therefore, even though the market is somewhat fragmented, it does not cause an erratic market?

A. That is correct.

Q. Isn't that just about the situation that exists with respect to high grade common stock utilities?

A. No. You can watch the paper every day, and you will see they go up and down, just like a top.

It is, of course, impossible to determine whether the relative stability of the preferred securities is due to the mere flexible approach which permits both on and off-board trading or to the relative stability of "money markets." Similarly, it is difficult to evaluate why high grade utilities, which are institutional in nature and fully subject to Rule 394, "go up and down, just like a top."

G. Bonds

While Rule 394 prohibits a New York Stock Exchange member from trading listed securities off the floor of the Exchange without permission of the Exchange, bonds are exempt under Rule 396, the so-called "nine bond rule." "Fragmentation" of the bond market is justified by three principal arguments: (1) the price of the securities is a function of the interest rate rather than a function of those factors which are normally considered in making an investment decision; (2) the buyers and sellers are primarily institutions; and (3) there is insufficient activity to justify trading them on-board.

The market in convertible bonds went off board with the bond market generally. Thus, exchange members deal as principal in the convertible bond while the

correlative common is traded on the floor fully subject to Rule 394. An anomalous situation develops when the price of the bond is related to the common stock rather than to the interest rate. Under such circumstances, member firms generally agreed that there was little, if any, distinction between the trading of the common on-floor and the trading of the bond off-board. Under such circumstances the factors enumerated above which are said to justify off-board trading in bonds cease to apply. First, the price of a convertible bond fluctuates more when it is no longer solely dependent on the interest rate. Secondly, the character of the investors similarly changes from institutions to individuals, and finally, the activity of convertible bonds under such conditions sometimes exceeds that of the less active listed common stocks.

When asked to justify the bond exemption, John Schwieger, of Paine, Webber, Jackson and Curtis replied:

"I don't have a good answer for that because I think that if you were to follow it through logically, and if you tied the convertible bond market into a common stock market and said that the bonds were trading based on the common stock, it would be difficult to justify an exemption in that one and not an exemption in the common stock."

On the other hand, several witnesses defended the off-board trading both on the grounds of increased liquidity for on-board trading in the common and through arbitrage profits, both of which are interrelated and result in increased income for the Exchange member. Under such circumstances, certain firms which wished to develop arbitrage profits by dealing "net" with institutions (who would be unwilling to pay full commissions) have resisted any changes which would place bonds on the Exchange and subject to Rule 394. One member firm described the situation as follows:

Q. As a frank matter, though, if your firm, and many other member firms, are dealing in convertible bonds which are selling at premium, with offsets for common ... doesn't this detract from the convertible bond market on board?

A. Oh, yes, it does.

Q. There is no question about it, it does detract from the liquidity, under your theory, of the primary market on board?

A. We are switching now from bonds to stocks?

* * *

Q. Do they have an effect on the convertible bonds being traded on the floor?

A. Yes, they do. It does. I personally don't think that is too important.

Q. We are trying to get, again, your philosophy. It would seem, just from talking this over, that if a convertible bond trades on the floor, and if a convertible bond trades off the floor, for you to be consistent, I would have though you would have said this does detract from the market in the convertible bonds.

A. I said it does, but it is not very important in this particular case. I thought I said that. I mean to say that, if I didn't.

H. <u>Foreign Transactions</u>

The approval requirement for off-board trades under Rule 394 would appear to apply to foreign as well as domestic transactions in listed securities. Nevertheless, members are permitted to make overnight bids and offers abroad in accordance with paragraph 381.13 of the Exchange Directory and Guide and to engage in joint international arbitrage under Rule 437 without obtaining Exchange approval for each transaction.

The text of Rule 381.13 (underlining indicates major additions since the original ruling: parentheses indicate deletions) is quoted below:

"<u>No member or member organization shall make firm bids or offers, off the Exchange, without the prior consent of the Exchange.</u> The practice of a member or member organization (acting either as a broker or principal) making firm bids or offers, or giving orders, <u>as principal</u>, in listed stocks, during the hours that the Exchange is open or otherwise, to a nonmember (customer outside the continental United States from whom such member or member firm receives commission business, with the intent of giving such customer an undue advantage) <u>either within the continental United States or elsewhere</u>, is contrary to Article XV of the Constitution and is therefore forbidden, unless the bid, offer or order is at a price less or greater than the last bid or offer on the Exchange as the case may be, by an amount equal to the appropriate nonmember commission and taxes; <u>except that this ruling shall not apply in the event of news or circumstances which become known after the close of the Exchange. A separate record must be maintained by members or member organizations of any bids, offers or orders made in the light of such unusual news or circumstances.</u>"

In 1956-57, the Exchange staff made a survey of those members believed to be engaged in the practice of making firm bids and offers to foreign brokers and foreign banks. Only Bear, Stearns & Co. stated that it was "a rather common practice" for the firm to make such bids and offers. The remaining members

stated that it was "very rare" for them to engage in the practice. However, White, Weld & Co. indicated that the practice of making bids and offers abroad fluctuates depending upon monetary conditions abroad:

"At the present time not much is being done because there is little demand for stock; the foreign exchange controls prevent the acquisition of any large amount of U. S. dollars. There is little interest in selling stock now. Formerly there was a great deal of this type of trading, and if conditions change, there will be again a great deal of trading."

Again, in 1960, a similar survey was conducted. The staff concluded:

"The new survey confirms the essential facts of the 1957 survey, namely, few firms make bids or offers abroad and then only sporadically except for Bear, Stearns & Co. In all cases most of the bids and offers are not accepted; of the firms recanvassed there has been a diminution of such bids and offers."

The members canvassed in 1956-57 and 1960 reported that what bids and offers abroad were being made were almost without exception overnight bids and offers, i.e., "good overnight until the next opening of the Exchange." According to members, the reason why foreign brokers are desirous of having members give them firm bids and offers when the Exchange is closed is that the New York Stock Exchange is the primary market in many securities traded abroad. When the New York Stock Exchange is closed (and the European stock exchanges are open) the foreign broker or dealer will not be willing to increase a long or short position unless he can feel assured that the position can be immediately offset by acceptance of a firm bid or offer originating in the United States. According to a staff memorandum:

"With reference to ... bids and offers abroad overnight, the primary reason for making such bids and offers is the time differential. There is a five hour difference between London and New York. 3:30 p.m. N.Y. is 8:30 p.m. London, and 10:00 a.m. London is 5:00 a.m. N.Y. ... If the foreign broker or dealer wants stock to trade in his market within the following normal business day he must have a bid or an offer on which to work. Since this Exchange is the primary market in dually listed American securities, the foreign jobbers and dealers do not want to go out on a limb while this market is closed."

An important issue in recent years has been the impact of the commission requirement of 381.13 on the ability of members to compete with non-members. It appears that following World War II, members for the first time found themselves competing in the foreign market with non-member dealers located within the United States. This development is reflected in a comment by a member:

"A lot of non-members are now going into the business of offering listed stocks to Europe. This is a comparatively new development, since before the war almost without exception member firms were the only brokers in the United States making European bids and offers .... Consequently, they are now offering more and more competition to member firms."

The member also noted:

"One of the foreign banks told Mr. Stamm the last time he was abroad that they had a list of United States stocks which had been given to them by a non-member firm who would accept either buy or sell orders up to 500 shares in any securities upon receipt of a cable from the bank."

In 1956, a member suggested that Rule 381.13 should be revised to allow members to base their overnight bids and offers on last sale rather than closing bid or offer. One reason given by the member was that non-members were making bids and offers based upon the last sale:

"One of the competitive problems facing our members is the fact that non-member dealers in the United States will make bids and offers based on the last sale. The foreign brokers and banks consequently ask the member firms to make the same type of bids and offers."

The member gave as a second reason:

"The foreign news agencies and newspapers quote the last sale on the Exchange and everyone abroad would be happier if they could tie up the price to some definite figure which they had before them."

The member suggested that if the Exchange was concerned that use of last sale might not protect the commission schedule, the solution might be to require the bid or offer to be 1-1/2 commissions away from the last sale.

The available evidence indicates that the commission requirement has hindered the ability of members to compete. The 1956-57 and 1960 surveys showed that only Bear, Stearns was regularly engaged in the practice of making overnight bids and offers to Europe. The 1960 survey showed that Bache & Co., Stamm & Co., and White, Weld had discontinued the practice "primarily because of our policy of requiring the bid or offer to be less or plus a commission away from the closing bid and offer." In the first 6 months of 1960, Bear, Stearns made 268 overnight bids and offers, but only 11 were accepted. Bear, Stearns made this comment:

"These bids are very seldom accepted -- 90% of the time nothing is done -- because the commission kills the trade."

A second major issue has been whether 381.13 is in conflict with the off-board trading rules. At the time of the 1947 revision, Mr. Frank Coyle, then Vice President of the Exchange, expressed doubts as to whether the practice of making overnight bids and offers abroad did not violate Section 8 of Article XIV of the Constitution which prohibits members from making a public market in listed securities off the floor of the Exchange. Mr. Coyle stated:

"The staff of the Department of Member Firms at this juncture can see no more reason for permitting regularized bids or offers to trade in listed securities after the close of the market in respect of Holland correspondents than we can for local correspondents, because such a practice comes close, at least, to making a public market in contravention of Section 8 of Article XIV of the Constitution."

The Exchange continued to permit the practice despite the doubts expressed by Coyle. When the matter was given further consideration after the issuance of Member Firm Circular #52 in 1948, the Exchange determined that the approval requirement of Member Firm Circular #52 should not apply to overnight bids or offers made in accordance with 381.13. The minutes of a meeting of the Advisory Committee on September 20, 1949 provide:

"The Committee considered the matter of requests received from member firms for permission to make firm bids and offers abroad after the close of the Exchange good until our next opening. It was determined that member firms making such bids and offers should be permitted to do so without obtaining our prior approval provided they conform to the provisions of paragraph 1381.13]."

In the ensuing years the Exchange reversed its position on several occasions. A 1952 staff memo points to the "apparent conflict" between 381.13 and the off-board restrictions. However, the following handwritten notation appears at the bottom of the memo:

"[P]revious policy reaffirmed for the present at staff meeting 6/17/52."

In 1955, Mr. Coyle expressed his view that the approval requirement of Member Firm Circular #52 applied to bids and offers made pursuant to 381.13:

"By inference it could well be assumed that if a member observed the required terms he had freedom at any time to make such a firm bid or offer. I think this is an erroneous conclusion and should be borne in mind on the occasion of next amending the buff page material, to clarify the point.

My reason for feeling that it is an erroneous conclusion is that the referred to item ... has been in existence substantially in its present form since long before World War II, and was a policy developed by the Committee on Foreign Business. However, a much later and more inclusive ruling was encompassed in Circular MF 52, reference to which is made on page E-373, which drew the attention of members to the fact that pursuant to Section 8 of Article 14 of the Constitution no member could effect an off-board transaction in a listed security without getting specific approval of each transaction from the Exchange."

A few days later there was a staff meeting at which Coyle's views were adopted as Exchange policy. The following handwritten note appears at the end of a memo:

"... 8/15/55 Staff Meeting -- approval required on all off-board transactions except int'l joint account and Nostro-Vostro jt. account."

Nevertheless, in 1956 Stamm & Co. and Herzfeld & Stern were given permission to make firm bids and offers abroad without compliance with Member Firm Circular #52. The Exchange stated:

"This decision is merely part of the operational procedure pending a complete study of previous procedures and rulings involving bids and offers abroad."

At about this same time, Mr. Harold Schutz of the Department of Member Firms expressed his opinion that Member Firm Circular #52 was meant to apply only to transactions within the United States:

"There is no indication that Member Firm Circular #52 was considered applicable, or intended to apply, to transactions outside the United States. The available evidence indicates that it was intended to stop member firms trading with nonmember dealers in the United States who were making a market in listed securities in competition with the Exchange."

Sometime between May 1957 and May 1958 paragraph 381.13 was amended. The amendment added the first sentence providing that members may not make firm bids or offers off the floor without the prior consent of the Exchange. The actual language of the amendment leaves some uncertainty as to its exact meaning. A finding made in connection with the 1960 member survey showed that the staff understood the amendment to require specific approval of each transaction; whereas the members believed the amendment called only for blanket permission:

"All of these firms have spoken to the Exchange in the past about such bids and offers and are under the impression they have a 'blanket' approval -- especially since they were engaged in this activity before the revised rule specifically called for approval as an off-board trade."

After the 1960 survey the Exchange determined to permit members to make overnight bids and offers abroad without obtaining specific approval for each transaction. The minutes of a staff meeting, August 11, 1960, provide:

"6. Rule 394 -- overnight bids and offers -- review shows no need to change policy which permits firms, on application, to continue without specific approval in each case, to make overnight bids and offers abroad provided it is at closing bid or offer minus or plus commission (as case may be) and provided they keep a record of it. Survey shows only one firm (Bear, Stearns currently so engaged -- 268 cases since January 1, 1960 -- only 11 accepted. Report made to the Vice-Chairman, who had inquired, and he is satisfied that no change is needed."

An important consideration behind the 1960 staff decision was undoubtedly the discovery that the practice of making overnight bids and offers abroad was of only minor significance. However, an equally important consideration appears to have been the fact that the decision to make such bids and offers is often made after the close at a time when there is no one at the Exchange to grant approval. A staff memo states:

"Since to the Foreign Arbitrageur and the foreign business-minded man, the opportunities to profit from market differences, or from news abroad, or here, during the hours between the close of the New York market on one day and its opening on the next day, occur during a time when it is impossible to obtain the prior Exchange approval essential in any off-board trade in listed stocks, and not wishing to put our members at a complete disadvantage, in competition with nonmembers, certain firms, upon specific application, were given the right to make overnight bids and offers to Europe ... ." [Footnote: While the quotation includes a reference to arbitrageurs, there is no evidence to indicate that members making overnight bids and offers abroad were doing so through the medium of arbitrage accounts registered under Rule 437.]

The 1956-57 and 1960 surveys indicated that members almost never made daytime bids and offers abroad, i.e., during the hours the Exchange is open. This may be partly caused by the fact that the Exchange does not permit members to quote definite prices in making daytime bids and offers. All that members are permitted to state is that the stock is being bid or offered at the current bid or offer on the Floor (whatever these may be at the time of acceptance by a foreign party) plus or minus a commission. The reasoning of the Exchange is that use of a definite price grants an unfair advantage to the foregoing broker:

"During the hours of trading, bids or offers on the Floor may change before the foreign correspondent accepts the firm's bid or offer. Consequently, the Exchange has felt that bids or offers made while the Exchange is open could not be at a specific price but merely on the basis of bid less commission or offer plus commission and tax without an indication of a fixed price."

In addition, the available evidence indicates that the Exchange takes the position that Rule 394 is applicable to daytime bids and offers. The minutes of the 1960 staff meeting mention only overnight bids and offers and there is no reason to assume that a broader exception was intended. However, rule 381.13 on its face specifically permits members to make bids or offers outside the continental limits of the United States during trading hours.

It appears that members generally have not expressed the same interest in making daytime bids as they have in the case of overnight bids. As Bear, Stearns stated:

"When the Exchange is open bids and offers are very seldom made as there is no sense to it. The stock can be traded on the Exchange on a commission basis."

Nevertheless, in 1956 Stamm & Co. sought permission to make daytime bids and offers at definite prices based upon the current floor quotations, that it be time stamped and that an immediate answer be required, which would mean within 10 minutes, by the foreign broker or bank. A staff memo states:

"In answer to my suggestion that he make his bid or offer at the bid or offering price on the Exchange less or plus a commission without stipulating a definite price. Mr. Stamm stated this was not a practical solution since the parties on the other side wanted a definite price. "

At about this time Harold Schutz discussed the Stamm request with a governor. A staff memo states:

"With regard to bids and offers made during trading hours Mr. Bleibtreau feels that orders should be executed on the Exchange and that there is no reason for granting approval for off-board trades."

Stamm renewed his request in 1957 after he was given temporary approval to make overnight bids and offers without compliance with Member Firm Circular #52. At the time of the second request he proposed to engage in a reverse operation, i.e., buy stock on the Exchange as principal and offer it at the purchase price plus commission, and his major concern was no longer the

restriction on quoting a definite price but the approval requirement of Member Firm Circular #52. Stamm's argument was as follows:

". . . The foreign brokers want to make net trades because under these circumstances they can charge their customer a commission for executing his order ... If the order is executed on an agency basis then the foreign broker has to give his customer a confirmation which says that he is charging an overriding commission. Customers are reluctant and object to paying such commissions in addition to the commission charged by Stamm to the foreign broker."

It appears that members sometimes give foreign brokers commission orders to be executed for the member's own account. For example, in the 1960 survey Burnham & Co. reported that although they did not make overnight bids and offers, they did give commission orders for their own account to be executed on the Geneva Stock Exchange.

It appears that the restrictions of Rule 394 and 381.13 do not apply where the order is executed on a foreign stock exchange. The question of the application of Rule 394 arose in 1952 when a member requested permission to accumulate an inventory in London, after the close of the London Stock Exchange, through a foreign broker acting as agent for the member. A staff memo states:

"Unless made on the London Exchange would be subject to off-board policy."

The question of the application of 381.13 arose in 1961 when the Exchange received an inquiry from a member who wanted to sell in Switzerland through a Swiss broker 1,000 shares of Universal Match at 51 5/8 when the market on the floor was 51 3/8 -- 5/8. A notation on a staff memo reads:

"OK if it is done on a recognized foreign bourse. No, if over-counter here or abroad."

The staff memo also states the theory behind the exception:

"In the past we have permitted commission orders to be executed on foreign exchanges for firm a/c even though the buy order was not a commission below the bid, or the sell order a commission above the offer because they were not firm bids or offers."

In conclusion, there seems to be a basic conflict between the purposes underlying Rule 394 and the policy which permits members to make overnight bids and offers abroad without obtaining specific approval. The purpose of Rule 394, as defended by the Exchange, is to preserve the auction market on the floor by prohibiting members from effectuating transactions off-board in NYSE listed

securities unless the prior permission of the Exchange has been obtained. Accordingly, the restrictions of Rule 394 must, to be consistent with the stated purpose, apply broadly to all transactions in such securities and at any time of day. While justification for the exception may be argued on the ground that such bids and offers do not take place domestically or on the ground that they occur during a time when the Exchange is closed, neither of these grounds has been viewed by the Exchange as justification for an exception. In deciding whether to grant approval for off-board trades, under Rule, 394 the Exchange has usually not regarded as anything more than a minor factor the fact that the request may have been made after the close. In denying requests made after the close, the member generally has been instructed to bring the trade to the floor in the morning. In short, the proprietary interest of the member firms in maintaining markets abroad seems to take precedence over the theoretical justification for the basic prohibition against off-board trading.

I. Regional Exchanges

Any member of the New York Stock Exchange who is a member of a regional exchange may execute an agency order in a dually listed security on that exchange without requesting permission of the New York Stock Exchange. Although such exception from Rule 394 is not set forth in the rule itself (the exception was once spelled out in Member Firm Circular No. 52), as an administrative matter, the practice is permitted.

Member firms execute orders in dually listed stocks on regional exchanges for a variety of reasons. First, under certain circumstances a member firm may obtain a better execution on a regional exchange for his customer. This may be due to a buying or selling interest which has been left on a regional exchange by members of that exchange (for their own account or for the account of others) who may or may not be members of the New York Stock Exchange. Or, buying or selling interest may exist on a regional exchange such as the Pacific Coast Stock Exchange or the Midwest Stock Exchange because of the availability of capital and/or interest on those exchanges from non-member market-makers such as First Boston Co. or Weeden & Co. or American Securities, a member of Pacific Coast who makes markets in securities listed on that exchange. These exchanges have rules and/or practices which permit member firms to engage in transactions with certain nonmember firms in order to facilitate customer executions without payment of a commission by the nonmember to the member.

Similarly, a New York dual member firm might execute a cross on a regional exchange simply to save payment of clearing charges which might substantially cut into their commission were the order executed on the New York Stock

Exchange. If they are a member of a regional exchange, such charge might be avoided. One member firm stated the situation this way:

Q. Could you give us an example or describe the kind of situation in which you have in the past made requests to go off-Board?

A. Well, here again, it comes about, because as I stated we have run into areas in the last few years where we are dealing in larger blocks. Previously, to use a figure of 500 shares or possibly 1000, why we would just go through the normal procedure of putting the order on the Board (New York) and have it executed. When we come up to blocks of 10,000 and 25,000 shares we begin to think of the profit and how much commission we are giving up to our clearing correspondent, and the fact that we originated the order on both sides, we felt we were entitled to full commission and charge a commission on each side in compliance with the rules. . . .

Q. This question which you brought up in connection with executions on the Philadelphia Exchange; namely, the problem of having to share your commissions with a correspondent firm in New York. Does this constitute -- what you say -- an important motive for going off-Board?

A. It is the only motive.

Another reason why member firms might cross a transaction on a regional exchange rather than on the New York Stock Exchange is to avoid either the book or the specialist on the New York Stock Exchange. In order to avoid this situation, a member firm may, on its own initiative or at the direction of its customer, execute on a regional exchange of which they are a member. One member firm described the situation as follows:

Q., Now if the buyer or seller has an all or none order, have you had occasion under those circumstances to go to a regional exchange to either avoid the book or the possibility of specialist participation ... ?

A. Yes.

Q. Why do you do that?

A. In order to effect the transaction, because you couldn't effect it on the big board.

Q. And you consider that, I assume, appropriate justification for going to a regional exchange?

A. Yes.

Q. Well, in going to the regional exchange, in those circumstances, would you not thereby be ignoring the book [on New York], if you will?

A. That's right.

Q. Let me direct your attention -- Strike that. You would also be avoiding the possibility of specialist participation -- New York specialist participation.

A. That's right, yes. Another member firm described it this way:

Q. When you execute a cross let's say of a fund and/or a bank or two banks, let's say you execute it all on Philadelphia/Baltimore. As a practical matter isn't that really an execution in your office in which you are charging both sides a commission, or do you have to pay for brokerage?

A. We pay for brokerage; yes. Then it goes through the Exchange and cleared. The order is phoned to the Exchange and it is actually recorded on their books to the specialist and is cleared through the clearing room.

Q. Does the specialist have the right to break up the cross in that kind of transaction?

A. Yes. He could break it up. He might have another order in there that would interfere with it.

Q. Could he buy it himself, do you know, or has he ever done it?

A. He has never done it but he could in part do this. He would have the privilege of taking a part of the order himself.

Q. But to your knowledge that's not --

A. Not normally; no.

Q. -- a normal practice.

A. We ordinary don't have a break-up in Philadelphia.

Another reason which accounts for member firms' executions on regional exchanges, perhaps the most significant reason, is simply the economic pressure placed on them by open-end investment companies who, not being members of the exchange themselves, wish to make better use of the commission dollar they pay out. They therefore often request member firms to execute on regional exchanges and require the member to "give-up" a part of the commission to a category of broker-dealers which is less exclusive than the membership of the New York Stock Exchange. The more liberal give-up permitted by certain regional exchanges permits open-end investment companies to compensate certain non-NYSE broker-dealers for services rendered the investment adviser or for selling fund shares. One member firm put it this way:

Q. Which regional exchanges is the firm a member of?

A. All of them, I think, except Boston. Let me specify them -- Detroit, Philadelphia-Baltimore, Pacific Coast, Midwest.

Q. When did you join Detroit?

A. I think we joined them, Detroit, Pacific Coast and Midwest, about a year ago. And just recently -- we only joined Philadelphia-Baltimore recently.

Q. What were the major reasons for joining Detroit?

A. Primarily at the request of clients.

Q. A client or clients?

A. Clients.

Q. A particular one?

A. No, several of them.

Q. Were the clients open end investment companies?

A. Yes.

Q. Can you tell us whether your executions on Detroit-just to name one--will be primarily in dually listed stocks rather than solely listed stocks?

A. Practically 100%.

Q. Taking just your commission business, about what percentage would you say is done on New York, as compared to the regional?

A. I guess about 90%.

Q. It is slightly peculiar as to why a firm, which is mainly an institutional type of firm like yours would join Detroit.

A. We have an office in Detroit. We got an office in all the cities where we are members.

Q. Did you have an office before you joined?

A. Yes, we had it.

Q. But your business on Detroit wouldn't be primarily generated out of the Detroit office?

A. That is a correct statement.

Q. What is it that caused the firm to accede to the wishes of your clients?

A. The clients are always right.

Q. Basically, is it because the clients wanted to bring your business on to Detroit rather than to New York in dually listed stocks?

A. No. The reason is that the client primarily wanted to give up to a non-member broker-dealer.

Q. They couldn't do it on New York?

A. They couldn't do it on New York.

Q. Detroit, as I understand it, has a rule which would allow members to give up to NASD members?

A. 40% to NASD, as I remember the rule.

Q. In a sense, then, was it a sort of competitive problem? If you wanted to retain the business of these particular institutional clients, you would have to do it on an exchange which had a more liberal rule than New York, so that there would be persons to give up to? Is that just about the essence of it, would you say?

A. I think it is probably the usual way it works.

In a very real sense, the directed give-up is a type of volume discount. On one exchange, the Detroit Stock Exchange, members are permitted to give-up part of their commission to any NASD member. This fact has caused members of the Mew York Stock Exchange to join the Detroit Stock Exchange. Open-end investment companies have suggested to member firms that if they did not join the regional exchange, they would simply take their commission business to firms which did. Whatever the reason for execution on regional exchanges -- the best interest of the customer or the best interest of the member firms -- the fact is that these executions, from the New York Stock Exchange member point of view, fragment the market in the same way as executions in the over-the-counter market. Generally, an execution on a regional exchange is not accompanied by a tape print available to the general public; the book on the New York Stock Exchange is bypassed; the floor brokerage or correspondent fees which would be retained by the New York brokers are lost; the specialist on the New York Stock Exchange is deprived of an opportunity to participate. The following colloquy with the Executive Vice-President of the New York Stock Exchange explained the rationale for permitting regional exchange executions and prohibiting over-the-counter executions:

Q. A number of member firms have expressed this view: that any agency order going off-board does violence to the book and the expectations of the customer who has put limit orders on that book, and yet the same member firms have been among the most anxious to most recently join the regional exchanges and to exacerbate that problem.

A. Yes, but what is the motivation?

Q. The motivation, obviously, is to keep the open end investment company business ... the member firm has [struck] a balance between the duty of an Exchange member to the book and the desire to make commissions^ and he has resolved that balance in favor of the last.

A. Or is it also the instructions of the customer?

Q. I don't know if we are saying anything different.

A. Of course, if the customer says I want this executed on the Pacific or Mid-West or Detroit and they are members there, what can they do?

Q. What about off-board, Mr. Gray? What if the customer says I would like this executed with Weeden or directly with another fund?

A. Then you have the problem of what about the orders on the floor, either on the book or in the crowd.

Q. You have that same problem on the regional.

Q. Aren't you just worrying about the problem when you feel like it? When it is the regional, you are saying that these other reasons outweigh the question of the book. When it is a question of an over-the-counter transaction, however, then you bring in the book.

The inconsistency of the rationale was pointed up by the testimony of a member firm:

Q. What is it about going to Detroit, having no tape, no print, having a cross there which takes away from the primary market which you feel is justified but doing the same thing -- taking away from the primary markets by going to the third market where it can perhaps literally benefit your customer you find inappropriate? You are just taking an inconsistent position.

A. Yes, we are taking an inconsistent position.

A. Not necessarily one we want to take.

A. We didn't welcome this.

Q. Of course, I want to pursue that. So the reason I take it you don't welcome it is because [of] the competitive pressures to join Detroit. If you want to keep commissions coming into your firm or if you want to increase your commission business you have to do it. So you have made a balance between your own entrepreneurial profit and this philosophy of the auction market in the primary market. And you balance it and say we are going to Detroit. But where the balance is going to the third market which does not help you but may help your customer versus staying on board, apparently [in making] that balance you decided to stay on board.

A. To keep it on the floor.

Q. That's right.

The New York Stock Exchange staff, on numerous has taken the position that if a regional exchange gives approval under its rules for off-board trade by one of its members, who is also a member of the New York Stock Exchange, approval

must also be obtained from the New York Stock Exchange before the trade can be consummated off-board. Mr. Schutz testified in this connection as follows:

Q. You mentioned a moment; ago that regional exchanges have rules with respect to their members, and members can therefore execute on that exchange. What is the New York Stock Exchange position with respect to off board requests by dual members in dually listed stocks which are addressed to a regional exchange of which they are a member?

A. If the transaction is to be made not on the regional exchange, but over-the-counter, the position of the Exchange has been that it requires the approval of the New York Stock Exchange.

Q. Would that be so even if the rules of the regional exchange and their procedures and standards are being complied with?

A. Once the transaction is made off the floor of the Exchange I would say that it becomes subject to the regulation of the New York Stock Exchange.

Q. I take it that position has been communicated to members of New York from time to time?

A. Yes.

Q. Are members of New York required to ask your permission when they go off board on a regional exchange, or do you normally find out about such situations in your inspections?

A. You mean where they get approval from a regional exchange for a trade off the board?

Q. Yes, how do you find out about it?

A. I don't recollect any specific incident, but it would probably come out as a result of one of our examiners reviewing the records of the firm and reporting that the transaction was made over the counter in listed securities.

The New York Stock Exchange has advised its members on numerous occasions of this position. A member of the Board of Governors of the Exchange and a past Chairman, noted however:

Q. Suppose a member of the Mid-West, in complying with the mid-west rules and regulations, asked permission of the Mid-West to go off board on Mid-West

and under their interpretation of their rules permission is granted, would New York have any objection to that?

A. No. The Mid-west Stock Exchange is administering its Exchange to this person who is a member of the Mid-west Stock Exchange. I think that the rules of the Mid-west Stock Exchange are more compatible to ours than any other system on the Exchange, but that has no bearing.

Q. Suppose it were any Exchange, I take it your answer would be the same?

A. Yes.

Q. Are you familiar with the New York Stock Exchange position of its staff, that a member of the Regional Exchange may not execute an order off board that after obtaining permission from that Regional Exchange even if he is a member, unless he gets permission from New York in addition?

A. I am not.

Q. Would you be in favor of that position?

A. No.

* * *

A. That's correct, because we think the more we can keep on the floor the better market there is on the floor and it is an open market and everyone knows what transpired and the Exchange can survey the thing.

It seems clear that a principal distinction, from the members' point of view, which prompts different treatment between the two markets -- regional and over-the-counter -- is the fact that an execution on the regional exchange provides the member firm with two commissions while the execution with a third market dealer on-board provides only one commission. In addition, the institutional investors can more readily justify paying a full commission on floor rather than requiring the member to seek an off-board execution for them -- on a negotiated fee basis. While it seems anomalous that institutional investors might prefer not to negotiate a service fee, except to the extent of the directed give-up, it must be recognized that the use of the give-up can only function in the context of a minimum commission rate. If the rate were negotiable, there would be nothing to give-up and, concomitantly, nothing with which to reciprocate non-executing member firms who sell fund shares or have other claims to the institutional commission dollar. Rather than forego the possibility of losing the commissions generated by open-end investment companies, member firms generally have not been

reluctant to execute on those exchanges and to concede to this kind of competitive pressure. It appears that the member firms who appear most concerned about dilution of the "primary" market (irrespective of whether it is "primary" or not in a particular security), have been among those most recently joining regional exchanges. Since the open-end investment companies have been unable to work out any system whereby the third market-maker can "give-up" part of its net trading profit (if a non-member market-maker was willing to "give-up" part of its profit, the gain ordinarily would be for the benefit of the fund and not for the benefit of those that sell fund shares), the institutional investor has not executed directly with non-member dealers who make markets. Instead, the investment companies have made use of the commission dollar they must pay through the framework of the regional exchanges. In this connection it appears that certain regional exchanges in recent years have grown, not because of the capital available on the floor or their competitive strength, but rather than the liberalization of their commission rate structure. The following testimony summarizes the reasons for regional exchange executions and the rationale given for executions on such exchanges and not in the third market:

Q. Can you tell us why you joined the regionals four or five years ago, particularly Detroit and Mid-West?

A. We found that mutual funds were requesting us to do business on the regional exchanges.

Q. I take it then you are referring to business in dually listed stocks?

A. Yes.

Q. Can you briefly tell us about what percentage of year commission business for listed stocks is done on New York and Amex and the Regionals?

A. Could I say this this way: that I don't think that any more than eight percent would be done on the regionals. Eight to nine percent. These would be usually larger trades. It would be difficult to put a percentage figure on them. Not too great a percentage on the Amex, and I would say 88 percent or 87 percent on the New York Stock Exchange.

Q. So you probably do more on the regionals than you do on the Amex?

A. Yes.

Q. Can you tell us the circumstances under which you would be doing business on a regional on a dually listed stock?

A. Often times if a mutual fund asked us to find a bid or an offering, they say they want to do it on a regional.

Q. I don't follow you.

A. If they give you an order, or if we offer them a security, depending upon which side you are on, they will say we'll do it if we do it on a certain exchange.

Q. You are describing a situation where you have a cross and the execution is to be on the Regional?

A. Yes.

Q. You don't mean that you are going to take the order to the floor of the regional and expect to get the execution there with the specialist or the book on the regional?

A. That is correct.

Q. Are there any other occasions where you will use a regional exchange?

A. There are some stocks that are traded on the regionals, that if I have been ordered to buy in New York and it is a substantial order I will protect myself on the three exchanges, Pacific, Mid-West and New York. I'll have bids down at the same time on three Exchanges.

Q. Why would you do that?

A. To give the customer the best execution I can.

Q. This would be a situation where the customer would get the benefit in the event that power -- buying power [is] generated on one of the Regionals.

A. Or selling -- if this was a sale. If some man came in to cross a block of stock I would want to be protected in case it should trade. That's all. If I go up to the Exchange and there is something blocking, I will go back and find out how much is blocking. If I think it is reasonable I will usually go ahead and do it and tell the customer that in the flow of market he lost X number of shares. I think they are all professionals and they realize this. It is a major problem. ... If I don't get anywhere, there is another problem and I have to go back to my buyer or seller and tell them what it is. They are usually professionals and they say go ahead and do it on another exchange.

Q. I see. Well, how do you determine what the situation is on the New York with respect to the book?

A. You send the broker out and make a cross.

Q. What does he do?

A. I don't know. I have never been a floor broker.

Q. Well, at any rate he reports back to you --

A. There is an impediment somewhere; yes.

* * *

Q. Is there any reason why you can't put all the orders on New York rather than going to the regionals?

A. If everybody else put it down there it would be fine too.

Q. Why doesn't your firm put all the orders on New York and not comply with the institutions desiring to go to some other regional exchange?

A. Because some other people are trading on the regional' and you want to protect your customer.

Q. Aren't other people also trading in the so-called third market?

A. Yes; they are.

Q. Isn't it possible that a bank might put an order into First Boston and your going to them might give you the same effect as if the bank had put the order on the Midwest?

A. It is a possibility.

Q.: Do you understand that the third market -- the dealers in the third market are receiving orders from pension trusts, banks, insurance companies, just the same as any exchange is receiving it or any regional exchange?

A. I'm not that familiar with the third market but if you say so I guess they are.

Q. Do you think they are executing all their orders from non-member broker-dealers?

A. No.

Q. Do you think then they are basically positioned traders?

A. This is what I thought.

Q. If they are position traders, isn't it possible they might be willing themselves to take the opposite side to the same extent that the specialist on the Midwest would take it?

A. Or specialist on New York?

Q. Yes. Do you think, from your own experience in the street, that the capital available to First Boston, Weeden and American Securities in the stocks in which they make markets is inferior to the capital of the specialists on the Midwest, Detroit and the Pacific Coast?

A. I don't know what the capital is of the regional exchanges. I don't think they can compare with the over-the-counter.

Q. Well if you also believe that they are position traders wouldn't it be more to your customer's advantage to check that market and the regional market?

A. I think as far as customer advantage, the customer knows I am not going into the third market so there is no advantage or disadvantage.

VII. Rule 394 and Non-Members

Though in the absence of specific exemption Rule 394 proscribes direct off-board trading by Exchange members, practical and conceptual problems are raised in determining the extent to which a member's status as such should be imputed to a non-member organization which he serves as a director and/or controls. The problem is essentially one of determining whether the member's duty is to the Exchange, as specified by Rule 394, or to the stockholders or beneficiaries of the non-member organization with which he is affiliated.

The existing Exchange policy is expressed by the following resolution, approved by the Board of Governors on December 17, 1959:

"The staff recommends that a member, allied member or employee of a member organization who, as an officer or director in a non-member organization, takes part directly, or through a person under his control, in effecting a transaction in a

listed stock off the Exchange, be required to obtain prior approval of the Exchange."

This resolution according to an Exchange memorandum was in connection with

"a request by Lehman Bros, that the staff reconsider the position it has taken regarding the relationship between Lehman Bros, and The One William Street Fund, Inc. Three persons associated with Lehman Bros., or its corporate affiliate, William Street Sales, Inc., occupy, concurrently, positions as directors and officers of The One William Street Fund, Inc, They are members of the executive committee which approves or rejects Lehman Bros.' investment recommendations, and, as the Fund's principal operational officers, they decide when and with whom (member or non-member) to place orders. They have authority to trade in listed stocks directly with institutions, over-the-counter. [Footnote: The Exchange has been assured that this authority would seldom be used. (Footnote in original memorandum.)] The staff has taken the position that as long as any of these persons continues in the relationship described above, Exchange permission must be obtained before any transaction is effected in listed stocks off the Exchange."

* * *

"The Lehman Bros. case is not the first one involving this problem to come to the attention of the Exchange. In three earlier cases involving members who were associated or seeking to become associated with a non-member organization, the Exchange insisted that its permission be obtained before such non-member organization effect any transaction in a listed stock off the Exchange. It is significant that in all these cases the member, in his non-member organization position, had a substantial part in the effecting of securities transactions."

The staff noted that a member's activities in a non-member organization were not beyond Exchange supervision and that a member could not avoid its obligations by "pretending to be two persons."

The staff concluded:

"The staff feels that a member, allied member or an employee of his firm should be required to seek Exchange permission if, in his non-member organization position, he takes part in the effecting of a transaction in a listed stock off the Exchange. If his position in a non-member organization has no connection with the effecting of securities transactions he need not obtain Exchange permission, unless, of course, he controls or substantially controls the affairs of the non-member organization. Such a construction makes Rule 394 clearly applicable in the Lehman Bros. case."

The staff recommendation was approved as noted above. Mr. Harold Schutz described another situation as follows:

A. "We used to have a situation involving Union Securities which is not part of Eastman Dillon Union Securities Company, and I an not familiar with their connection with the member firm Involved; but they had some kind of agreement that they would come to the Exchange if they wanted to trade over the counter in a listed stock. We used to handle it just the same as we did any other request."

Q. You are speaking of the situation where Selligham was a member?

A. That's right.

Q. When were these requests made, what year?

A. I would say they were made in '52, '53, '54, up until the time Union Securities became a part of Eastman Dillon.

Q. So that Union Securities portfolio transactions were subject to approval by the staff?

A. Yes.

In 1958, the Exchange advised a member as follows:

[begin text of letter]

August 19, 1958

Mr. B. M. Eubanks
Messrs. Stewart Eubanks Meyerson & Co.
216 Montgomery Street
San Francisco 4, California

Dear Mr. Eubanks:

Thank you for your letter of August 13th.

The prospectus of First National Mutual Fund, Incorporated which you sent along with your letter, indicates that the Fund is not self-distributing, and it has an investment management contract with the First National Investment Corporation. So long as both of these conditions obtain, the Exchange would not interpose

any objection to the association of your partner, Mr. Harry Meyerson, with the Fund as a Director and, possibly, as an officer.

However, should he accept either or both such positions, a complication might arise. As you know, members and member organizations may not effect over-the-counter transactions in listed securities without specific prior Exchange approval.

A member or allied member does not divorce himself of that status even though at the same time he may become an officer or director of a mutual fund. Therefore, he may not do through the mutual fund anything he couldn't do as a member or as part of a member organization. Specifically, this would mean that no transactions in listed securities could be effected over-the-counter by or for the Fund without specific prior approval of this Exchange.

Possibly both your firm and the Fund may wish to give further consideration to this restriction before coming to a decision in respect of Mr. Meyerson's proposed association with the Fund.

[end text of letter]

Nor is the problem limited to member affiliation with investment companies. The following memorandum sets forth the staff position for trustees of who are members of the Exchange:

[begin memo text]

OFF BOARD TRADES BY A TRUST

May 11, 1964

Mr. Alan Roth called toe a short time ago presenting the following situation:

Mr. Roth and Mr. Gerard are trustees of a trust. They have engaged investment counsel. The investment counsel would decide what was the best investment for the trust to make, or the best time or item to sell. Messrs. Roth and Gerard would approve the decision and the investment counsel would then place the order for the trust.

In some cases the investment counselor may feel that a better market may be obtained for a listed security over-the-counter than on the Exchange, and proposes to trade with a non-member in the stock.

QUESTION

Can Messrs. Roth and Gerard, as trustees, approve a decision by the investment counselor when a listed stock may be traded off the Floor?

RECOMMENDATION

Inasmuch as Messrs. Roth and Gerard have to approve the investment decision, the investment counselor does not have sole discretion and authority to act for the trust. Therefore, the situation is the same as though Messrs. Roth and Gerard decided what to buy or sell, and consequently they are bound by the Exchange rules. The trust therefore should not be permitted to trade off the Floor without the prior approval of the Exchange.

[signed by] Harold Schutz

[end memo text]

Testimony of member firms reveals that non-member organizations, affiliated through a member or allied member who in fact are directly responsible for the portfolio decision of funds, do occasionally trade in the third market without requesting permission of the Exchange. These firms testified that they were unaware of the adoption of the New York Stock Exchange staff recommendation quoted above. Mr. Edward Gray, Executive Vice-President of the New York Stock Exchange, remarked that such Board of Governor policy decisions with limited application are not widely circulated, but that "people whom the staff believe or whom the Governors believe should be appraised of it are appraised of it."

Justifications for off-board transactions were offered by Mr. Avery Rockefeller of Dominick & Dominick, who noted in speaking of the policy of the Dominick Fund:

* * * "These five fellows go in a room to make up their mind of what to do. When they come out, four of them put on their D&D hat and the one keeps his Dominick Fund hat and places that order. He can give on the placement of that order all the instructions necessary whether to Dominick and Dominick or Smith-Barney or First Boston [a non-member], or Merrill Lynch or anybody else, on how that order should be handled."

The most frequently offered justification for off-board trading by members on behalf of non-members with which they are affiliated is the paramount fiduciary duty to obtain the best execution. When asked his feelings about the duty of a fund director with respect to listed securities also traded off-board, Mr. Daniel D. McCarthy of Eastman Dillon replied:

A. I think it is his obligation to get the best price but not in the specific security. I think there is an average. I don't think you could ever nail one trade and say whether it was a good trade or a bad trade. I'd say, as a matter of practice, to go to the place where you could get the beat price.

Q. ... I want to clarify that. Do you think that the general duty, from a fund director's point of view, Is to act in a way where his procedures are such that he will seek out the best price wherever it may exist?

A. I don't think I could dispute that statement.

Q. Would you say that that is the best price for the fund, including commissions paid by the fund?

A. I think the best price is always determined in dollars and cents.

Such price would be the net price paid by a fund off-board as compared to the net cost after imposition of Commission for an on-board trade.

Clifton Walker of Hornblower, Weeks expressed a similar view:

Q. In other words, a company that you are a Director of is perfectly free to go to the third market if it feels it is in its interests to do so?

A. Yes. And as a Director, I would insist that they do it.

Q. If they could get a better--

A. Anything that they could do better elsewhere than with any business association that I am associated with, I would insist that they do it elsewhere [off the Exchange].

Another firm commented:

A. I would go further than that: I would refuse to even vote or participate in the discussion. I would leave it to the other directors to make up their minds.

Q. And you feel that, whatever the portfolio policy is, it must be, I assume, for the benefit of the shareholders?

A. Absolutely.

Q. And if that meant going to the third market in isolated transactions, so be it?

A. That's right.

In view of the almost unanimous opinion that the director of a non-member had a duty to the shareholders or beneficiaries of such non-member to obtain the best price, the firms were asked why they did not believe they had the same duty to brokerage customers. Mr. Clifton Walker of Hornblower, Weeks responded:

A. I am operating in a completely different capacity.

Q. I understand that, but you also have a duty to that person, perhaps even stronger than your duty as a Director, at least a very strong duty without making comparisons.

A. I see a tremendous difference. When I am dealing with a corporation of which I am a Director, I am in a trustee capacity; I am elected by the stockholders to use whatever talents or knowledge I have to the best immediate interest of that company. When I am operating as a partner of a brokerage firm, we advertise, we tell all our customers that we are members of the New York Stock Exchange. Everything, our entire conduct of our affairs indicates that we are doing business on the New York Stock Exchange. And when a customer comes to us, he normally expects us to do business there, and if he wants to do business away from the New York Stock Exchange, he should go to somebody else.

Mr. Milton Steinbach of Wertheim & Co. similarly distinguished the duty to the brokerage customer:

"Well, if I may say so, I don't quite see the comparison because in one instance my client comes to me as a broker; for this [other] service which I perform as a director of the company, the company is in an entirely different position than the client is because the company, as far as I am concerned, is to do the best I can in the interest of its stockholders."

VIII. Competition Between Markets

The Special Study noted that the third market provided a competitive element which, on balance, was beneficial to the securities markets. Multiple trading in listed securities was found to detract, however, from the continuous auction process and the depth of the specialists' books in the primary exchange market. To counteract the harm of the fragmented markets and the dilution of depth on the Exchange, the Study cited several benefits of competition which directly resulted from the third market: (1) price competition, facilitated by the third market's elimination of ancillary investor services; (2) profitable access to listed

stocks by non-member broker-dealers who previously experienced a competitive disadvantage in handling listed stocks for customers; and (3) the advantage of a negotiated market as compared to the auction process on the Exchange floor.

The Study also pointed out that the third market was complementary to the primary market by adding needed depth in the handling of large blocks. The problem was essentially defined as one of achieving a balance between the centralization of all buy and sell orders on the one hand and the benefits which are inherent in the existence of competing markets on the other.

Since its publication, the problems discussed by the Special Study have increased as the third market has grown in volume as well as in relation to the volume of business done on national securities exchanges. This growth occurred notwithstanding the record share volume done in recent periods on the New York Stock Exchange. The substantial volume both on the New York Stock Exchange and in the third market reflects, to a substantial extent, the increased activity of the institutional investor. Member firms and the Exchange point to the increased use of brokerage services by investment companies, corporations, pension trusts, insurance companies, banks, etc. In addition to the increased volume, some member firms have also noted that the size of orders have increased to the extent that block transactions of 25,000 or 50,000 shares are not uncommon. As neither the books on the floor, the orders in the crowd, or even the potential specialist participation, can, under ordinary circumstances, be expected to provide the necessary liquidity at a reasonable price, it is necessary for many member firms to actively seek out the opposite side of a transaction in order to facilitate the execution of a large order. Nor can the third market unilaterally absorb the substantial orders which frequently demand execution; the third market dealers can only assist in absorbing blocks. To the extent that the third market dealer seeks to find buyers for blocks put to them, they are of course seeking out some of the same sources that the member firm also apparently has canvassed in the execution of the customer's order.

The pressure of large blocks on the market has prompted member firms to organize substantial institutional departments in order to negotiate crosses, and to use off-board secondaries in order to merchandise the securities quickly and effectively but at a service fee substantially in excess of the minimum commission rate schedule. Member firms have also started to act as a type of auxiliary specialist by buying securities for their own account in order to facilitate the execution of a customer's block order. Member firm participation is usually limited, however, to the purchase on the Exchange of a block of securities for their own account at a "cleanup" price, i.e., the lowest price received by the customer for the block -- minus an amount equivalent to a commission. Member firm participation in this type of transaction does not compete with the specialist

market since normally the member firm and the specialist bilaterally agree on the cleanup price and execute the cleanup of the block at the agreed price.

In this connection it should be noted that the periodic releases of the New York Stock Exchange, which refer to the minimal "discount" from the last sale before the clean-up of a block, are significantly underestimated. This is because the Exchange computation is based on a sale which is itself part of the block transaction. For example, if the last sale on an Exchange is at $50, and an order to sell 25,000 shares is brought to the floor and is executed as follows:

[table omitted]

The Exchange reports this transaction (24,500) as having occurred within 1/8 of the previous sale. Actually, the meaningful discount from the customer's point of view from the last sale, is, in this example, 3/4 of a point.

In a study conducted of the last fifty transactions in which two large member firms participated as principal with public customers on a "clean-up" basis, it was found that forty-seven trades involved purchases from a public customer. The price differential from the last sale prior to the execution of the block was as follows:

[table omitted]

It is also interesting to note that of the fifty block transactions, only twenty-eight involved purchases from or sales to the book, excluding transactions with the book, if any, at the "clean-up price." Furthermore, less than 1,000 shares on the book were taken in eighteen of the twenty-eight block orders. In half the cases in which the book participated, however, two percent or less of the entire block order was absorbed by the book. This is indicated in the table below:

[table omitted]

On block "clean-ups," the specialists have commented that they do not buy the security at a price higher than the member firm. As a result, the member firm and the specialist do not compete in order to obtain a higher price for the investor, and indeed, both have an economic motive to purchase at a price which takes into account their economic risk, i.e., a price as low as possible while simultaneously satisfying the customer. The practice whereby agents act as principal for their own account raises some fundamental problems; the problems are compounded when it is recognized that in this kind of situation the member firm will not seek out the third market to determine whether it was willing to purchase the block or a portion of it on a net basis -- in the example above, at a price between 49-1/4 and 50. As noted earlier, the member firm will on occasion ask the third market-maker to participate <u>on-board</u> and charge it a full

commission. As a result, the failure to go off-board removes any competitive pressures on the specialist from the third market and therefore does not provide any incentive for the specialist to raise his price on the cleanup for a portion of the block. The economic effect of the foregoing situation can be shown as follows:

[table omitted]

The member firm's compensation is made up of the following:

(a) A commission from its customer for the agency execution on 20,000 shares.

(b) A markdown equivalent to a commission charged its customer on 5,000 shards for the security purchased for its own account.

(c) A commission on the third market dealer's purchase of 4,500 shares.

(d) A commission on the purchase by the bank for 10,000 shares.

The member firm's risk for the shares it purchased is on a cost base of approximately 48-3/4 (49-1/4 -- 1/2 point commission). [Footnote: It should be noted that the American Stock Exchange does not permit a member firm to add or subtract an amount equivalent to a commission on an on-board trade with a member. In contrast to the New York Stock Exchange, the Amex takes the position that if a member deals from its own account with a member of the public, the order must be executed at a net basis with no additional fee added. The member firm may profit solely from its trading position and is not permitted the extra cushion of a service fee. This position again reflects a more flexible attitude of the Amex toward the minimum commission rate schedule in order to facilitate the best execution for the customer.]

In the kind of a trade described above, the original customer obtains proceeds equal to the various tape prices minus a commission or its equivalent. In this kind of transaction, some third market-makers have indicated that they owe no duty whatsoever to the member firm's customer and that if the member firm does not wish to tell its customer of the existence of a market outside the Exchange, they are perfectly willing to join with the member firm in buying at the cleanup price. The third market-makers also commented that their cleanup price is lower than the price they would quote to the member on an off-board trade because they realize that they will also be required to pay a full commission for the execution if it was brought to the floor. The same situation, of course, applies to other financial institutions who make up the opposite side of a cross. In short, each imposition of a commission on an institutional investor who participates in a cross changes the price that the initiating party will receive or pay out for his execution.

The Exchange takes the position that permitting member firms to go off-board to execute the order would not inject competitive benefits into the overall marketplace. It claims that any existing competition, which is allegedly minimal, would not be increased by giving & member firm the right to go off-board. This, in turn, is based on the assumption that the third market simply does not make a better market on any portion of the block than the price which can be obtained for the cleanup of the entire block on-board. Similarly, the Exchange officials assert that if the rules were made more flexible, so as to permit member firms to take advantage of superior executions off-board, "the Exchange would be reduced to a chalk board." Exchange members and Exchange officials claim that if the rule were liberalized so as to permit a member firm to go off-board only in situations where the off-board market was better than the Exchange market, it would fragment and destroy the primary market. It is difficult to reconcile this position with the comments of the Exchange that the off-board market is not a better market than the Exchange floor. The following testimony by the current Executive Vice-President of the Exchange points up the argument:

Q. Well, let me ask you this: Have any member firms or specialists told you that the fact that the third market exist has caused the specialists to perhaps narrow his spread or been somewhat more willing in certain circumstances to take a larger position than he might ordinarily take?

A. No, I don't think so.

Q. In other words, you don't think it has any effect whatsoever of his narrowing his quote or his positions?

A. No, I think that has been largely due to an educational process by the Exchange itself.

Q. And you don't think that the external economic pressure of the non-member is another factor which is assisting your educational process?

A. It might, but I can't evaluate it. Don't forget, you are talking about a market that is continuously in being and one that is happenstance.

Q. Well, we are riot discussing here the pros and cons of the marketplace.

A. Well, I am merely saying you are saying you have a competing market, I have doubts you could even consider it so on a day by day, minute by minute proposition.

Q. In other words, you don't think it is really a price competitive market in any given stock at any given time?

A. I would say that it is not a competitive market in the sense that it is continuous and is there all the time.

Q. Well, if it is not continuous and if it is here today and gone tomorrow, what are you so concerned about?

A. Why am I concerned about it? I'm not.

Q. So that you don't really care if they expand, because you don't think they are a competitive force in the market that will hurt the Exchange market, at least?

A. Well, you are asking me to make a very general statement that I am not prepared to do.

Q. Well, if member firms would have some more degree of flexibility in the extent to which they could go to the third market do you think that that would tend to increase the competition with the specialists?

A. I think it would tend to diminish our market to a chalkboard.

Q. Why?

A. Why? Because everybody would be trading over-the-counter as they please.

Q. Why would a member firm who has a brokerage duty to a customer and who would charge the customer the same commission go there and reduce your market to a chalkboard?

A. It would.

Q. But why would they make that decision to go to the third market?

A. Why would they make it?

Q. Yes.

A. Well, again, we are talking in broad generalities, and I don't think you can attack this problem through broad generalities.

Q. I'm saying, "Why would they go there?"

A. In blocks?

Q. Well, you don't mean that the third market is better on blocks than the Exchange, do you?

A. No, I didn't say that.

Q. Well, when would they go to the third market?

A. When they chose to.

Q. Why would they do it?

A. What?

Q. Why would they do it?

A. You'll have to ask them.

Q. Well, you indicated that you thought they would go there and reduce you to a chalkboard, and I am trying to find out what the possible motivations would be to go there. You raised the question of blocks, and it is unclear to me as to what motivates a member firm to take his blocks to the third market if the rules were looser.

A. Save them time and effort.

Q. How would it do that?

A. Because it is conceivable that in a particular situation he could get a net price on a block period. Or, if he -- whereas if he puts it on the floor he has to work.

Q. How does he have to work?

A. The Broker on the floor, the firm itself, to generate the other side.

Q. And you think, then, again, that the member firm -- the reason for the 394, then, is to protect the member firm from some intrinsic laziness on their part?

A. No, 394 is there to keep the market on the floor for investors.

Q. Yes.

A. Period.

Q. Well, it is unclear why they would all run away if the rule were looser.

A. Well, all you have to do is look at history. See what happened to the bond market.

Q. What did happen? That is a very important example.

A. It went off the floor.

Q. Why?

A. I don't know.

Q. Did it go off-board because the market makers had a better market?

A. No. Our own members made the bulk of it.

Q. Why did they not want to go on the floor?

A. They could handle the whole thing in their office.

Q. Was the price better for the customer?

A. Well, when you are talking about bonds and you are talking about a particularly particular characteristic of a security, most of the bond business today is done by professionals.

Q. Yes. Are you saying that it is a good thing or a bad thing that it went off floor?

A. I think it was a poor thing myself.

Q. But it was the members who brought them off floor?

A. The members were making the markets, that's right.

Q. Well, I want to go back to the stocks again.

A. Which they could do if 394 were eliminated.

Q. Well, isn't the reason that they wanted to deal with the principal and make the jobbers turn themselves?

A. I don't think so.

Q. Well, the member firms that went off the floor were they not market makers themselves?

A. Sure.

Q. So they were acting as principals?

A. That's right.

Q. And making trading profits?

A. Or losses.

Q. They wanted to have the risk of trading profits or losses. Now, what we are talking about merely the agency execution where there would be no motive to make a dealer trading profit, . . .

A. Why not? They could act as dealer with their customers if you had no 394.

Q. Now, that is an important point. Let's not talk about a rule which would permit you to act as dealer or make markets or to buy or sell as principal. Let's talk about a rule which would be flexible to the extent of permitting agency executions to go off floor where the member firm would be required to charge a full commission. In that kind of situation, do you think the auction market or the Exchange market would be reduced to a chalkboard, and if so, why?

A. Well, it seems to me that when you would say they had to put agency orders of the customers on the floor, I go back to what you said about executing customer orders in the best market.

Q. Well, don't you think that members will always, being members of the New York Stock Exchange, always maintain their responsibility to go to the best market, no matter what the rule says?

A. Well, you are the one that raised the question about the over-the-counter market having the best price.

Q. No, I asked you whether you thought it was the best. My question now is if the member firm has the right to go off-board, don't you think they will always go to the market which is best for their customer?

Competition basically envisions a system in which the price, quality and quantity of commodities are determined by and are continually subject to the interaction of supply and demand in free and open markets. In a competitive system, natural market forces determine the allocation of resources which, of course, includes capital. The capital market, however, presents a unique competitive problem: market centralization in the form of exchanges achieves the maximum interplay of competitive forces in the sense of determining the price of the security, but the exchange system is non-competitive in another sense in that access to the marketplace is limited. Although the Exchange argues that the principal goal should be concentrated primary competition, it may be possible to assure to the investing public the needed maximization of the benefits of competition, particularly in the handling of blocks.

As noted elsewhere in this report, the exchange process is not a continuous auction even in the more active issues. As noted, liquidity during the interim between auctions is provided by the specialist who stands ready to buy or sell as principal and who profits from these transactions by selling on the offer side and by purchasing on the bid side -- the "jobber's turn." To the extent that a member has no choice but to trade with the specialist, the primary aspects of the exchange process are monopolistic rather than competitive. Although the public could obviously benefit from competition between the specialist and the third market, this is precisely the type of competition which Rule 394 prohibits. In a block transaction, for example, the Rule frees the specialist and the member from competitive forces and allows them to bilaterally bid down the market and thus purchase the security at a preferential price. While there is no active interplay of supply and demand in such situations, the demand could easily be increased and the problem remedied by relaxing the off-board prohibition to allow the third market dealer to participate in the transaction on a net basis. Thus, where the third market member wishes to acquire or dispose of a position, where it has an order or indication of interest which would "fit" the member firm's order, or simply where dealing with the third market-maker would net the public investor more dollars, the benefits of competition would seem to be obvious.

The Exchange maintains, however, that competition must be sacrificed to achieve the full interplay of supply and demand on the Exchange floor. While the Exchange argues that relaxation of Rule 394 would reduce the floor to a "chalk board," it is apparent that the exchange markets have lost their vitality in areas where their own members have made competing markets with the specialist (the bond market) and not where members have restricted their activities to performing the brokerage function of seeking out, as agent, the best prices for

their customers. Member firms today are constantly seeking out non-members to facilitate the execution of orders; the problem is how to permit those who can add both depth and competition to be an effective adjunct to the marketplace. Indeed the Exchange fear of fragmentation of the primary market would seem equally applicable to diversification via the regional exchanges; nonetheless New York Stock Exchange members have recently assisted in its fragmentation by joining the regional exchanges. Furthermore, the effects of fragmentation of the primary market could be minimized by thorough communication between the Exchange and the third market and perhaps by reporting the off-board and regional transactions on a central tape.

An excellent example of the anti-competitive aspects of Rule 394 can be constructed from the events following the listing of Chase Manhattan on the New York Stock Exchange in March of 1965. Prior to the listing, a member broker could seek the best price for his customer by canvassing seventeen competitors, nine of which were New York Stock Exchange members. Since the listing, however, all members with orders for Chase stock must come to the specialist, for under Exchange rules, members may neither compete with the specialist nor seek a better price from an off-board market-maker. In this connection, a bank stock dealer in Chase noted in a letter to the staff:

"In its design to preempt the long-standing market for Chase Manhattan stock, the NYSE stifles competition by crippling the freedom of brokers, dealers and traders. Through Rule 394 the Exchange forces its members, under penalty of expulsion, to refuse to deal with non-member bank stock dealers. This boycott has resulted in two separate markets in Chase, each out of touch with the other, operating to the advantage of the specialist and member traders and to the disadvantage of customers and their member brokers.

"From the viewpoint of the Public Investor, whether unsophisticated or professional, individual or institutional, Rule 394 by eliminating competition has hurt the total market for Chase Manhattan stock, reducing its depth and liquidity. Nine major member firms are no longer functioning as competing market makers in Chase stock. Rule 394 has cut down sharply the number of places to which the Public Investor can go and shop for markets in Chase. He may go to non-member bank stock dealers and negotiate business on terms more economical than on the NYSE, but the total ability of the non-member dealer to perform, to buy or sell blocks as he did prior to listing, is now hampered by a fractured market. The dealer no longer has access to member traders and member brokers. This is also true of the member broker who may no longer call non-member dealers and who must channel his order to the exchange specialist in Chase Manhattan.

"Whether the Public Investor enters the market to buy or sell Chase through a member broker or through a non-member broker-dealer, Rule 394 has deprived him of the wide marketability which resulted from the former interplay of all competitive forces. The elimination of the interaction among numerous competitors and the consequent reduced flow of inter-dealer bids and offers have adversely affected the depth and liquidity of the market. There are fewer hands ready to buy and sell."

In sum, the New York Stock Exchange seems to be inhibiting competition by increasing its own business through a boycott of other markets; access to competitive markets is proscribed and the member broker is denied the opportunity to obtain the best possible price for the public investor.

There is little doubt that significant anti-trust questions are raised by Rule 394. While the following materials are not intended to provide a definitive staff position on the applicability of the Sherman Act to Rule 394, the analysis of the cases and thoughts expressed therein are important to any evaluation of the Rule.

Section 1 of the Sherman Anti-Trust Act, 15 U.S.C. §1, provides as follows:

"Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations, is declared to be illegal ..."

In the landmark Standard Oil case [Standard Oil Co. v. United States, 221 U.S. 1 (1911)], the United States Supreme Court defined restraints of trade by adopting the common law "rule of reason," holding that the Act prohibited unreasonable restraints of trade. Certain types of restraint have long been considered to be so unreasonable as to constitute per se violations; that is, the mere fact of their existence constitutes a violation of the Sherman Act without regard to the extent of the injury resulting therefrom or the motivation. In other words, there are certain contracts or combinations which because of their "pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and, therefore, illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." [Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958).]

In its interpretation of the Sherman Act, the Supreme Court has had to consider the applicability of the Section I prohibition to group boycotts, i.e., concerted action by a combination of firms or individuals to refuse to deal or to deal with others only on disadvantageous terms. In W.W. Montague & Co. v. Lowry, 193 U.S. 38 (1904), the legality of an association of tile manufacturers and wholesalers was before the court. The association prohibited sales by manufacturers to non-members and prohibited sales by wholesalers to non-

members at less than list price (which was 50% higher than prices paid by members). The Supreme Court held that such a boycott was in violation of the Sherman Act and that a treble damage action was proper.

A line of cases which considered the legality under the Sherman Act of trade association activities is also relevant. The legitimate role of a trade association in gathering facts and data and disseminating information to members of an industry was not questioned. However, legitimate trade association functions were often found to be overshadowed by activities such as price-fixing, division of markets or other anti-competitive arrangements. Thus trade associations whose operations tended to facilitate price fixing, limit production, allocate markets or limit distribution were clearly in violation of the Sherman Act. [Footnote: See Attorney General's National Committee Antitrust Report 17 (1955).]

In American Column & Lumber Co. v. United States [257 U.S. 377 (1921)], the association members owned only 5% of the mills in the industry but produced one-third of the national output. An elaborate information exchange program involving frequent meetings, production figures, sales, transaction prices, economic forecasts, inventory and shipping data was held illegal on the ground that the association went beyond mere collection, analysis and dissemination of industry information. The Court found the association was "a combination to restrict production and increase prices . . ." [Id. at 410] whose activities constituted a restraint of trade and circumvented the anti-trust laws through concerted action which could not become legal merely because it took the form of a trade association. [Footnote: See also United States v. American Linseed Oil Co.. 262 U.S. 371 (1923)]

In two subsequent cases [Maple Flooring Mfrs. Ass'n. v. United States. 268 U.S. 563 (1925); Cement Mfrs. Protective Ass'n. v. United States. 268 U.S. 588 (1925)] the Court distinguished American Column & Lumber on the ground that the association's activities in question did not in fact involve price fixing or other anti-competitive activity. The Court found that the information involved, which did not include specifics of past transactions or announcement or filing of current prices, was not such as involved concerted action with respect to prices, production or restraint of competition [268 U. S. at 586]. In Cement the Court also upheld an exchange of information among sellers concerning duplication of specific job contracts which was designed to avoid padding of these contracts. There was no evidence however of concerted action with regard to prices, production or other competitive factors. Neither was there an attempt to exclude or impede the business of non-members or any indication that non-members were being prejudiced by the actions of the association.

In Eastern States Retail Lumber Dealers Ass'n y. United States, [234 U.S. 600 (1914)] however, the Supreme Court invalidated an arrangement whereby members of a retail lumber dealers association boycotted suppliers who dealt directly with the retail trade by circulating a report among members identifying such suppliers. Although there was neither agreement among members as such nor any penalty for violation, the report was found to have the "natural tendency" to cause member retailers to withhold patronage from listed suppliers. [Footnote: Because of this coercive effect the case was distinguished from Anderson v. United States. 171 U.S. 604 (1898), and was held to be within the ambit of the Montague case, supra.]

The landmark trade association case is Sugar Institute. Inc. v. United States [297 U.S. 553 (1936)] where the Court held that an association requirement that members adhere to publicly-announced prices until publicly rescinded, tended to artificially maintain price levels and, with the Institute's other rules, to limit price competition, thus violating the Sherman Act. It is significant that although the system was adopted to end secret under-the-table price concession arrangements -- which were harming an industry itself in a deteriorating position and in need of remedial measures [297 U.S. 553, 575. See Attorney General National Committee Antitrust Report 21-22. (1955).] -- the Court held that the program went far beyond "any unfair methods of competition caused by the secret price concession system." [Id. at 582] The two outstanding facts in the Court's view were defendants' relative position in the industry -- which was substantial -- and the fact that sugar was a standardized commodity sold largely on the basis of price. "Since price would tend to be uniform in such a market, restraints on various aspects of price competition become peculiarly important." [Attorney General's National Committee Antitrust Report, 22 (1955)]

Language in the Sugar Institute opinion and in earlier industry association cases indicated that certain situations might exist where organized refusals to deal might be justified on the ground that such refusals were necessary to curb industry abuses or fraudulent business practices. [Footnote: See Anderson v. United States. 171 U. S. 604 (1898) and American Livestock Commission Co., 279 U.S. 435, 437 (1929) cited supra. See also Cement Mfrs. Protective Ass*n. v. United States. 268 U.S. 588, 604 (1925); Swift & Co. v. United States. 196 U.S. 375, 395 (1905)] The result in Sugar Institute and later cases did not give very much comfort to that position. It was found that the claim that anti-competitive devices are being utilized only to eliminate abuses or improper practices and raise ethical standards was often used as an excuse to eliminate or stifle competition. Frequently, the '"unethical" conduct sought to be eliminated turns out to be the vigorous competition which the antitrust laws are designed to stimulate and protect." [Footnote: Brief for the United States as amicus curiae p. 39, Silver v. New York Stock Exchange, 373 U.S. 341 (1963)]

The dicta in these cases indicating some permissive scope to group-organized refusals to deal as a means of eliminating or curbing abuses or raising the level of business conduct were finally "eclipsed" in Fashion Originators Guild v. Federal Trade Commission [312 U.S. 457 (1941)] where the Supreme Court held illegal an agreement among members to boycott retailers who followed a policy of selling garments copied by other manufacturers from members' designs. The Guild's action was admittedly designed to destroy competition from "style pirating" firms. The boycott was effected by circulating lists of noncooperating retailers to whom Guild members and "cooperating" retailers would refuse to sell.

As a result of the Guild's efforts over 12,000 retailers agreed to "cooperate," but more than half agreed only out of fear of being themselves boycotted by the member manufacturers. The manufacturer-members held a commanding position in the industry and public demand made it important for retailers to stock at least some of the members' merchandise. An elaborate system of tribunals was set up to decide whether a particular registered design had indeed been "pirated."

The Court held that the Guild's plan violated the policy of the Sherman Act in the following respects:

"[I]t narrows the outlets to which garment and textile manufacturers can sell and the sources from which retailers can buy (Montague & Co. v. Lowry. 193 U.S. 38, 45; Standard Sanitary Mfg. Co. v. United States, 226 U.S. 20, 48-49); subjects all retailers and manufacturers who decline to comply with the Guild's program to an organized boycott (Eastern States Retail Lumber Dealers' Assn. v. United States, 234 U.S. 600, 609-611); takes away the freedom of action of members by requiring each to reveal to the Guild the intimate details of their individual affairs (United States v. American Linseed Oil Co. , 262 U.S. 371, 389); and has both as its necessary tendency and as its purpose and effect the direct suppression of competition from the sale of unregistered textiles and copied designs (United States v. American Linseed Oil Co., supra, at 389). In addition to all this, the combination is in reality an extra-governmental agency, which prescribes rules for the regulation and restraint of interstate commerce, and provides extra-judicial tribunals for determination and punishment of violations, and thus 'trenches upon the power of the national legislature and violates the statute.'" [312 U.S. at 465.]

The Guild argued that the measures taken were reasonable and necessary to prevent the "devastating evils" of "style piracy" which were asserted to be harmful not only to the Guild members.

but consumers and retailers as well. The Court held the justifications were not adequate [Footnote: "Under these circumstances it was not error to refuse to hear the evidence offered, for the reasonableness of the methods pursued by the

combination to accomplish its unlawful object is no more material than would be the reasonableness of the prices fixed by unlawful combination." 312 U.S. at 468] and indicated again that combinations of businessmen could not, even in the name of eliminating serious industry evils and benefiting the public, assume quasi-governmental functions and combine to dictate the terms upon which others in the industry might do business. The Court thought it to be the policy of the antitrust laws to protect both the right of entry and actual existing business from combinations of firms in an industry whose actions limited the freedom of others to compete.

Similarly, in United States v. National Association of Real Estate Boards [339 U.S. 485 (1950)] a schedule of non-mandatory commission rates was prescribed as part of the Board's code of conduct and standards. (No sanctions were invoked for departures from the rate schedule.) The Court nevertheless found:

"Price-fixing is per se an unreasonable restraint of trade. It is not for the courts to determine whether in particular settings price-fixing serves an honorable or worthy end. An agreement, shown either by adherence to a price schedule or by proof of consensual action fixing the uniform or minimum price, is itself illegal under the Sherman Act, no matter what end it was designed to serve. That is the teaching of an unbroken line of decisions. See United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 218 et seq.; United States v. Paramount Pictures. 334 U.S. 131, 142, 143. And the fact that no penalties are imposed for deviations from the price schedules is not material. See Eastern States Lumber Assn. v. United States, 234 U.S. 600, 608-609; American Column Co. v. United States, 257 U.S. 377, 411; Federal Trade Commission v. Pacific Paper Assn., 273 U.S. 52, 62. Subtle influences may be just as effective as the threat or use of formal sanctions to hold people in line."

Thus by 1953 the Supreme Court was able to state in United States v. Columbia Steel Co.. 334 U.S. 495. 522-21 (1953) (dicta):

"For example, where a complaint charges that the defendants have engaged in price fixing, or have concertedly refused to deal with non-members of an association, or licensed a patented device on condition that unpatented materials be employed in conjunction with the patented device, then the amount of commerce involved is immaterial because such restraints are illegal per se." (Emphasis supplied) [Footnote: As proscribing collective refusals to deal the Court cited Associated Press v. United States. 326 U.S. 1 (1945); Fashion Originators' Guild v. FTC, 321 U.S. 457 (1941); Eastern States Retail Lumber Dealers' Ass'n v. United States, 234 U.S. 600 (1914); W. W. Montague & Co. v. Lowry. 193 U.S. 38 (1904). Other footnotes omitted.]

Again in 1958, in Northern Pacific Railway Co. v. United States. 356 U.S. 1, 5, (1958), the Supreme Court listed group boycotts as unreasonable restraints of trade per se. citing the Fashion Guild case. And in Klor's v. Broadway-Hale Stores, 359 U.S. 207 (1959), the Court held that group boycotts or concerted refusals to deal except at higher prices had long been considered per se violations of the Act, even though the individual discriminated against was insignificant in the stream of commerce. More recently, in Radiant Burners [364 U.S. 656 (1961)], utility members of the American Gas Association refused to provide gas for use in plaintiff's ceramic burners because they had not been approved by the association and were thus not granted the group's seal of approval. Association approval involved testing for "safety, utility and durability of gas burners." Nevertheless allegations of a refusal to deal even on such terms was held to state a cause of action. [Footnote: Even in depression born Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933) where the Court permitted certain industry sales practices on a regional basis involving 73% of the area's bituminous coal production, the Court emphasized the existence of effective competition from other regions and pointed out that there was no showing of actual or contemplated price control by defendants. The Court held "that the Sherman Act did not forbid cooperation among a small group, within a large competitive industry, where entry was easy and uncontrolled in order to end 'injurious [competitive] practices' and improve the groups competitive position 'where the group must still meet effective competition in a fair market and neither seeks nor is able to effect a domination of prices.' (288 U.S. at 374)" Attorney General's Report, p. 23.]

The Court's finding is in the context of the allegation that the Association's "... tests are not based on 'objective standards'" but were influenced by petitioner's competitors and that "its [the Association's] determinations can be made 'arbitrarily and capriciously.'" [364 U.S. at 658] The petitioner's burner was allegedly unreasonably refused the Association's seal.

Thus, where a group, association or combination affects or may affect competition by denying access to a market or membership in the association when such membership is necessary or important, such activity violates the antitrust laws. This is true even if the association's purpose is the elimination of industry evils or the benefit of the public, unless the membership in the group is in fact open to all on a fair and reasonable basis and restrictions are not employed to lessen competition or give competitive advantages to members over nonmembers. In Radiant Burners it appears that if the standards for obtaining the seal were based only on safety and were administered fairly, the Association might have survived antitrust scrutiny. It must be clear, however, that where price-fixing, division of markets or other per se violations are involved no degree of ethical cover will protect the combination (National Assoc. of Real Estate Boards). [Footnote: "In the Court's view, a concerted restraint by a powerful

combination was legally unjustifiable, even if intended to inhibit only admittedly invidious trade conduct or acknowledged commercial torts. This [Fashion Originators] and later Supreme Court pronouncements declare the rule that group action coercing outside parties is deemed an undue restraint of trade and, whatever its purpose, is likely to fall as unreasonable per se." Attorney General's Report, supra, at p.133 (footnote omitted).]

Further, combinations which use group boycotts (Eastern States; Fashion Originators), insist on limiting sources of supply (Montague & Co. v. Lowry; Standard Sanitary) require disclosures which affect the ability to compete or suppresses competition by dictating the terms on which competitors may do business (Fashion Originators) may not survive even if aimed at elimination of industry evils. So long as the combination's activity affects more than an insubstantial share of the market (and substantiality can shrink to fairly low levels, see International Salt) or limits ready access or entry to a market the anti-trust laws will apply.

The fact that the group boycott is accomplished by membership in an association does not affect the outcome. In Associated Press v. United States, 326 U.S. 1 (1945), the Supreme Court had before it the legality of the Associated Press' exclusive news communications among its members and the fact that new members in competing areas had to submit to majority approval and other conditions to membership if their competitors objected. The Supreme Court found this constituted a restraint of trade under the Sherman Act and said that "arrangements or combinations designed to stifle competition cannot be immunized by adopting a membership device accomplishing that purpose," 326 U.S. at 19. The same results had been reached earlier in the Montague case, supra, where the Supreme Court rejected the defense that the plaintiffs were free to join the association. The Court found there that the plaintiffs were probably not eligible for membership and in any event were subject to arbitrary rejection and that more importantly under the Sherman Act they could not legally be put under the obligation to join the association or be dealt with on discriminatory terms. See also United States v. Columbia Steel Co.. supra.

In Board of Trade v. United States [246 U.S. 231 (1918)] the Court upheld the "call rule" of the Chicago Board of Trade prohibiting members who bought after the close of business from making such purchases at a price other than the closing bid at the exchange's regular session. The Court concluded that the rule had no appreciable effect on market prices or on the volume of grain coming to the market. The rule was found to serve a legitimate regulatory purpose of the exchange, rather than impairing competition by affecting prices. The aim of the rule was to bring more transactions to the exchange where they would be the subject of the competitive market. This finding was in the context of the Court's assessment that the rule applied in a narrow area, only to a small part of the

grain shipped and only for a part of the business day, and did not really affect the market.

As in Appalachian Coals the basic consideration relied upon by the Court in saving these arrangements or rules is the finding that there was no anti-competitive effect -- no attempt to improve one group's position at the expense of others in the business. The Chicago Board of Trade ruling indicated that the restriction was reasonable in the light of its insubstantial effect and failure to affect competition and thus could be saved.

It is fair to say at this stage that neither Board of Trade nor Appalachian Coals have much precedential value. The broader implications of Board of Trade were effectively rejected in the landmark Trenton Potteries case [273 U.S. 392 (1927)]. The Court held that not only had the district court properly refused to give a jury an instruction based on Board of Trade, but that it had properly given a charge based on the per se rule which Board of Trade respected. In any event the basis for Board of Trade -- that the call rule had no real effect on the market nor did it materially affect volume of trade -- was probably incorrect. It is doubtful that without specific statutory support such as may be furnished in an exchange regulatory statute that case would be again decided in such a manner. Not only was Board of Trade essentially limited to its facts in Trenton Potteries but the Court in United States v. Sacony-Vacuum Oil Co. clearly rejected as a defense the asserted need to eliminate competitive evils.

"Whatever economic justification particular price-fixing agreements may be thought to have, the law does not permit an inquiry into their reasonableness. They are all banned because of their actual or potential threat to the central nervous system of the economy."

As we have noted in the discussion of United States v. National Assoc. of Real Estate Bds., combinations engaging in price fixing, division of markets or other per se violations requires the balancing of other economic or social considerations. It is also clear, that Appalachian Coals, which is often shunted aside as a situation where the decision was influenced by the desperate condition of the mining industry during the early depression, is no longer viable authority in supporting combinations which might have taken comfort from the implications of Board of Trade. [Footnote: See analysis by Prof. Bork, supra, at 822-25. See also discussion of United States v. Paramount Pictures. Inc.. 334 U.S. 131 (1948) and White Motor Co. v. United States. 372 U.S. 253 (1963) 74 Yale L. J. at 826-27.]

The case of Anderson v. United States. 171 U.S. 604 (1898) must also be evaluated. In that case the rules of the "Traders Live Stock Exchange," an association of cattle traders in Kansas City, prevented members from dealing

with non-members, or those who dealt with non-members. The Court found that anyone could become a member, that no attempt was made to set prices, that the members competed with each other and with outsiders and that there was a substantial competition outside of the members so that interstate trade was not affected. In addition to the distinguishing factors, the case does not appear to represent the current trend of Supreme Court decisions, Thus, in Evening Hews Pub. Co. v. Allied Newspaper Carriers. 263 F. 2d 715, 718 (3rd Cir.); cert, den. 360 U.S. 929 (1959) the appellants, relying on the Anderson case, asserted that to come within the Sherman Act their activities must directly affect interstate commerce and there must be undue restrictions thereon harmful to the general public. The court rejected the appellant's argument, held the group boycott illegal per se. and stated that the Anderson case does "not represent what we think is the present law."

The leading decision respecting the application of the Sherman Act to registered securities exchanges is Silver v. New York Stock Exchange. The question before the court was whether the New York Stock Exchange violated the Sherman anti-trust act by ordering its members to sever wire connections with plaintiff without giving him notice, without assigning any reason for the act or affording him an opportunity to be heard. At the outset, the Court stated that the "concerted activities" of the Exchange and its members "would, had it occurred in a context free from other federal regulation, constitute a per se violation of Section 1 of the Sherman Act." However, while the Court mentioned Fashion Originators and Klors in support of this statement, it made clear that the per se doctrine had a narrower application in the case of registered securities exchanges. The Court concluded that the activities of the Exchange in denying plaintiff due process were unlawful per se. [Footnote: "Since it is perfectly clear that the Exchange can offer no justification under the Securities Exchange Act for its collective action in denying petitioners the private wire connections without notice and an opportunity for hearing, and that the Exchange has therefore violated Section I of the Sherman Act ... There is no occasion for us to pass upon the sufficiency of the reasons which the Exchange later assigned for its action." 373 U.S. 341 at 365.] However, the basis of the Court's determination was that the Exchange could derive no possible justification from deviating from the policies of the Securities Exchange Act. [Footnote: "The point is ... the Exchange has plainly exceeded the scope of its authority under the Securities Exchange Act ... and therefore has not even reached the threshold of justification under that statute for what would otherwise be an anti-trust violation." Id. at 364-365.]

It seems clear that under these circumstances the refusal to deal with non-members required by Rule 394 is on its face a per se violation of the Sherman Act, unless that rule and the refusal required thereby is based on a policy required by the Exchange Act in order to effectuate its purpose.

The circumstances of the Exchange's adoption and enforcement of Rule 394 do not warrant concluding that, on balance, the purpose or effect of the Rule was the vindication of any self-regulatory policy contemplated by the Exchange Act. Although certain beneficial regulatory results arguably flow from restriction of trading to exchange floors, the uneven application of the Rule which may both avoid any beneficial results and defeat collateral purposes of the Act suggests that the major result of the Rule seems clearly to have been to prevent exchange access by competitors of the Exchange market. No regulatory justification or vindication of legislative policy appears to be involved; to the contrary, the Rule prevents needed capital from being raised with a concomitant weakening of the Exchange market. Since the Exchange Act contains no explicit immunity for actions of registered exchanges, the general rule that immunity will be implied only if that immunity is necessary to carry out the purpose of the regulatory statute involved is applicable. Immunity from the anti-trust laws probably is limited to the extent the policy of the regulatory statute requires that restraints on competition exist. In this context there seems to be no blanket immunity from the anti-trust laws for exchanges under the Exchange Act; exemption of exchange action from the anti-trust laws exists "... only to the extent necessary to protect the achievement of the aims of the Securities Exchange Act." [Footnote: Silver v. NYSE. 373 U.S. at 361. See United States v. Morgan, 118 F. Supp. 621 (S.D. N.Y., 1953).] The existence of markets without such restrictions as are enforced under Rule 394 and the ability of the Exchanges to use alternative means to obtain the minimal self-regulatory benefits of the Rule seem to militate against its propriety. The mass of discriminatory exceptions, the relationship of the Rule to the preservation of the minimum commission rate schedule under circumstances where its rationale is questionable, the fact of its recentness as a response to competition, its arbitrary method of enforcement and its conflict both with the concept of promoting competition and the fiduciary duty of the broker to the client also raise most serious questions concerning the propriety of the Rule under our anti-trust laws.