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INTER-DEALER MARKET

In the over-the-counter market there is no central location where all public or professional buyers and sellers communicate their interest in the purchase or sale of securities. Markets are made by and between broker-dealers who communicate quotations representing the prices at which they wish to deal for their own account in particular securities. These broker-dealers, commonly referred to as market makers, quote bid and asked prices and hope to profit from the difference between the bid, the price at which they are willing to purchase a security, and the asked, the price at which they are willing to sell the security. The market maker essentially performs a passive role in trading for his own account in response to incoming inquiries of buyers and sellers. To the extent that they purchase or sell on balance in transactions with other broker-dealers (who may be acting for themselves or for public customers), they add depth to the market and exercise a function not unrelated to that performed by a specialist on a national securities exchange. Each market maker quoting prices in a particular security also, in a sense, functions as a miniature exchange providing a situs for the collection of buy and sell orders. The analogy, however, cannot be drawn too far for on an exchange the orders of buyers and sellers can be crossed on the floor of the exchange without professional intervention. By contrast, in the over-the-counter market, though the market maker provides a situs for collection of orders and their execution, the orders funnelled to him do not cross. Instead the market maker is compensated by trading for his own account and profiting by the difference between the price paid by buyers and received by sellers--the spread or so-called jobbers turn. There are sometimes as many as thirty market makers, or as few as one, simultaneously quoting a market to those who are interested in a particular security. The number of competing market makers usually depends on the volume of transactions and the related possibility of profiting on high turnover from purchases and sales. Each of the competitors, through variations in their quotations, attempts to attract buying and/or selling interest.

The competing market makers do not transmit their quotations or the prices of execution of particular transactions into a central location. Instead, they advertise their markets through a voice and printed telegraph wire network which links market makers to each other, to other broker-dealers and perhaps institutional clients throughout the country. The purpose of the communication network is to permit facile and inexpensive contact with market makers with respect to the market made in the security. The greater the number of communication links controlled or used by a particular market maker, the greater the chance that it will be a dominant factor in the market in terms of the volume of business done, compared to competitors quoting the same security. Open-end telephones and private teletype wires which permit almost instant communication feed out from the offices of major market makers in financial centers to blanket the country and advise the financial community of the markets in securities traded over-the-counter. The information transmitted on the communication network is not public. The system is bilateral and basically inter-dealer. That is, communication generally is private between the parties in communication, both of whom usually are professionals, one a market maker--the other a broker-dealer acting for a member of the public or on his own behalf.[1] Because it is bilateral and private rather than public and open, a broker-dealer wishing to execute a public customer's order with a market maker must carefully check a number of lines of communication with competing market makers in order to obtain the best quoted market. On an Exchange market such checking is unnecessary since the market on the floor of the Exchange is, by definition, the best market made on the bid and offer side by the various professional and public participants. Their bids and offers, in effect, are aggregated and the best of these holds the floor of the exchange as the market.

In addition to teletype and voice communication, broker-dealers in the over-the-counter market submit their quotations at a particular point in the day to the National Quotation Bureau, a private organization which publishes the quotations on the following morning for the use of the financial community. The National Quotation Bureau "sheets" are not generally publicly available to the public. They identify the security, the name of each market maker inserting a quotation, their telephone number and their bid and asked

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1/ Large institutional or sophisticated customers may have access to the market place and trade directly with the market maker at their quoted prices rather than executing the order with or through other broker-dealers.

quotation. This information is available for approximately 8000 securities on a daily basis. The quotations are supposed to represent the precise quotation at which an inserting dealer was willing and able to execute transactions at the time of the submission of its quotation to the National Quotation Bureau. Though these quotations are "stale" when disseminated they provide a rough guide to the approximate market price of the security on the preceding day.

It should be emphasized that though the quotations of market makers are disseminated on inquiry from others, they are not continuously reported even privately, but are merely continuously available to the broker-dealer community if requested. In active stocks, because of the steady flow of requests for quotations, as a practical matter, they may emanate from the market maker on a more or less continual basis in the aggregate to all inquirers, but any specific inquirer for a quotation must recheck the market if it does not execute immediately. This is because of industry custom and practice which considers a quotation good only during the period of actual communication.

Market makers also communicate with each other in order to determine whether their markets are consistent with those of their competitors. This may be of primary importance if a market maker wishes to follow the market made by others and does not wish to be affirmatively anti-competitive on either the bid or ask side of the market. It is necessary to check the markets of competitors since the flow of information concerning demand and supply may be concentrated in certain firms whose quotations will reflect that information.

Though market makers generally expect to receive incoming calls and hope to profit by the spread between their bid and asked, sometimes the incoming callers will negotiate with market makers. They may be able to purchase securities at slightly less than the offer and/or perhaps sell securities at slightly higher than the quoted bid. Normally, a market maker who wishes to accumulate securities will raise his bid and/or negotiate more readily in order to attract orders to himself rather than to competing market makers. 1/

1/ On occasion, however, the lines of communication made available by a particular firm to the financial community may be sufficiently hardened by both custom and business relationships that the quotation of better markets under certain circumstances may not be effective to attract the orders of broker-dealers accustomed to doing business elsewhere.

Conversely, if he wishes to sell securities he often will lower his offer below that of competing market makers and thereby hope to attract inquiries from other broker-dealers who wish to purchase securities for themselves or for public customers. By shifting the bid and offer, broker-dealers therefore attempt to increase, decrease, or stabilize their inventories by encouraging or discouraging the orders of broker-dealers who are seeking the best market. The quotations therefore which are disseminated by voice and printed wire, or through the facilities of the National Quotation Bureau, are, in the aggregate, the market; they reflect the incoming buy and sell orders on the market. Quotations however, are not merely the passive indicators of demand and supply. They also represent the evaluation by the market maker of the potential for the security (and the related adivsability of maintaining or increasing an inventory position) and of course, the market maker's own financial resources and his reasons for making a market.

Under the system as described above, it is difficult for the public to know the market for a particular security. The retail quotation system provides that function . . .

Retail Quotations