CHAPTER VI

EXCHANGE MARKETS

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CHAPTER VI

EXCHANGE MARKETS

A. Introduction

This chapter is concerned with trading markets which are organized as exchanges, as distinguished from over-the-counter markets. The treatment of securities exchanges in this chapter relates primarily to their functioning as trading markets, and to the roles of those exchange members who are directly involved in the trading mechanism. Thus, detailed discussion of the exchanges as self-regulatory bodies is left to chapter XII. Exchange listing rules and practices, which in part determine the securities traded on exchanges and impose certain regulations on their issuers, are considered in chapters VIII and IX.

The entire chapter focuses primarily on the New York Stock Exchange (NYSE). Although there are 14 registered national securities exchanges, it goes without saying that the NYSE is by far the most important securities market in the country. As is noted in chapter I and elsewhere in this report, the dominance of the NYSE extends to every area of the securities industry: with few exceptions, the leading firms in the industry are among its members, and the securities for which it is the primary market include the outstanding corporations in the country. Its various trading rules and procedures are of paramount importance for these reasons and because they influence and affect the rules and practices of other exchanges.[1] In light of the importance of the NYSE and its members, some general data about the securities traded on the NYSE and about its member firms are set forth in sections 3 and 4 of this part to serve as a background for the chapter as a whole.

1. THE LEGISLATIVE BACKGROUND

The Exchange Act contains many provisions relating to the various mechanisms and operations of the exchange markets. In general terms it may be said that the Commission has been granted broad authority, direct and indirect, over the auction market. However, as with most legislation, many of the statutory provisions were designed to meet certain specific problems—in this case the problems were connected with various manipulative activities characteristic of the speculative atmosphere of the 1920's. In a statement entered in the Congressional Record, Senator Fletcher, one of the sponsors of the bill which was to become the Exchange Act, stated:

> Although the bill does not prohibit all speculative activities on stock exchanges, its purpose is to make stock exchanges marketplaces for investors and not places of resort for those who would speculate or gamble.[2]

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[1] While the auction market is examined in this chapter mainly in terms of the NYSE, it should be noted that, in the mechanics of its trading market, the American Stock Exchange (Amex) closely resembles the NYSE. The other exchanges are of lesser importance as auction markets, and for the most part present different questions; attention is given to these exchanges primarily in chs. VIII and XII.

[2] 78 Congressional Record 2270 (1934).

This congressional purpose is reflected in the various sections of the act which are aimed at curbing such speculative activities as pools and the attendant devices of "wash" and "matched" sales, rumors, unwarranted pegging or stabilization, and certain transactions in puts, calls and options.[3] The provisions granting regulatory authority over credit,[4] short selling and stop-loss orders[5] and trading by corporate insiders[6] were also aimed at curbing speculative excesses and their effects.

However, curbing undue speculation was not the sole purpose of the legislation. In the same statement, Senator Fletcher said:

> The bill seeks to protect the American people by requiring brokers on these exchanges, members of these exchanges, to be wholly disinterested in performing their services for their clients and for the American people trading on the exchanges.[7]

Various provisions of the act, particularly those contained in section 11, which grants the Commission wide authority over the trading practices of members, were aimed at carrying out this purpose.

Thus, it is clear that the provisions of the statute dealing with market activities emerged from two purposes—the first, an attempt to curb unhealthy speculative activities, and the second, to provide for fair dealing and fair access to the markets.

It should be further noted that though the legislation sought to curb experienced abuses and reflected problems characteristic of a particular era, the Special Study has not found the Commission's statutory authority over exchange market activity to be inadequate despite the changed conditions and times. In many trading areas the Congress went beyond specific authorizations and granted the Commission broad authority to act in "the public interest" or "for the protection of investors." This broader grant of power was not fortuitous but was intended to allow flexibility in dealing with intricate and unforeseen problems. As Congressman Lea said on the floor:

> * * * where we gave the regulatory commission power, it would be a flexible power. If the commission finds a mistake has been made, it can readily change its rules to more favorable ones and thus accomplish the purposes of Congress.[8]

Thus, with respect to the matters covered in this chapter, no insufficiency of stautory authority has been found and no legislative recommendations are made. The existing powers of the Commission appear sufficiently broad to provide added controls or other remedies where the need is indicated.

2. SCOPE OF THE CHAPTER

Part B of the present chapter generally describes the methods of trading in effect on the NYSE, including a general description of the transmission of orders to the Exchange, their execution on the floor, and the methods through which reports of sales and other market information are disseminated to the public. This part also includes a brief description of the functions of various classes of members who are involved in the trading process on the floor of the Exchange. Part C is primarily a statistical presentation of the composition of mem-

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[3] Exchange Act, sec. 9.
[4] Exchange Act, sec. 7.
[5] Exchange Act. sec. 10(a).
[6] Exchange Act, sec. 16.
[7] 78 Congressional Record 2270-2271 (1934).
[8] Id. at p. 7862 (1934).

bers' trading as principals; i.e., other than as agents executing orders for the public. Most of this activity is by "floor" members (specialists, odd-lot dealers, and floor traders) who typically do not deal directly with the public. The remainder of trading activity by members for their own accounts is by members whose orders originate off the floor in the same manner as public orders.

The next three parts—D, E, and F—describe and analyze the functions of those floor members who are most directly involved in the trading process and who also trade for their own account on the floor; they deal respectively with the role of specialists, odd-lot dealers and floor traders. Part G contains a short discussion of member trading which originates off the floor of the Exchange.

Certain trading practices historically associated with the exchange markets are also considered in this chapter. "Short" selling is one such practice, and because it has a potentially strong effect on prices it is treated separately as part H of the chapter.[9] This is followed by a discussion in part I, of the minimum commission rate schedules, focusing on their structure and administration, and on the methods and standards involved in the setting and review of rates. Finally, the chapter concludes with a brief discussion in part J of the impact of automation on the exchange markets.

The methods of study of the various subjects are described in the introductory portion of each part. Generally, tables and charts which are in the text are identified by lower-case letters (e.g., table VI–a); other tables and charts are set out at the close of the chapter, and are identified by Arabic numerals (e.g., table VI–1). Certain tables and charts relating to a computer analysis of NYSE members' transactions are collected in appendix VI–A, and are identified in the following manner: appendix VI–A, table 1.

3. DIVERSITY OF SECURITIES TRADED ON THE NYSE

Although primary attention in this chapter is given to the NYSE, it should not be assumed the Exchange is a monolithic institution in which, because of the listing standards imposed, securities of uniform characteristics are traded. Quite the contrary, the securities bought and sold on the Exchange differ considerably with respect to many significant features.[10]

The extent of trading occurring in the various securities traded on the Exchange ranges from relatively nominal to very substantial amounts. At the end of 1961, 1,145 common stocks were listed on the NYSE. Although the median level of transactions in these stocks for that year was approximately 465,000 shares, approximately 9 percent of the common stocks had transactions of less than 100,000 shares while another 9 percent had transactions of 2 million shares and over. With respect to individual companies at the two extremes, the extent of the disparity is even more striking. For example, stocks such as Erie & Pittsburgh Railroad, Wheeling & Lake Erie Railway, and Beech Creek Railroad traded about 3,000 or fewer shares during the year. On the

[9] In the section on exchange specialists, certain other specific trading practices are discussed. Although data were gathered on the subject of "stop loss" orders, this subject is currently under separate study by the Division of Trading and Exchanges and only passing references are made to it here.

[10] A comparison of various characteristics of NYSE stocks with those traded in other markets is contained in ch. VII.B.5.

other hand, stocks in which there was considerable interest such as Studebaker-Packard, Brunswick, and Sperry Rand had transactions of about 10 million shares during the year.

As a result of these divergencies in share volume, the great bulk of transactions consummated in 1961 was concentrated in a relatively small number of stocks. Thus, the most active 5 percent of common stocks accounted for approximately 29 percent of total common stock share volume during the year while the top 15 percent of common stocks absorbed over 50 percent of common stock volume.

In addition to common stocks, there were 396 preferred issues listed on the NYSE as of the end of 1961.[11] Many of these issues are held by institutions which trade in them relatively infrequently. As a result, they had ranges of activity substantially different from those of the common stocks. The median annual volume for the 396 preferred stocks was about 11,000 shares, while those with a volume of less than 2,000 shares accounted for 10 percent of the total number of such stocks; and at the other extreme, preferred stocks with a volume of 90,000 shares and over accounted for 10 percent of the number of preferreds. With respect to individual cases, stocks such as Beatrice Foods 3⅜ percent convertible preferred and Long Island Lighting 4¼ percent series D preferred traded only a few hundred shares during the year, while the Atchison, Topeka & Santa Fe 5 percent noncumulative preferred had transactions of 960,000 shares during year.

Differences are also apparent with respect to other aspects of securities listed on the exchange. Thus, while the median company had approximately 8,000 shareholders, about 2 percent of the companies had less than 800 shareholders, and 19 percent of the companies had 25,000 shareholders and over. Similarly, while the median number of shares outstanding was approximately 2,500,000, about 1 percent of the companies had less than 200,000 shares, and 15 percent had 10 million shares and over. And while the median company had total assets of about $100 million, about 2 percent of the companies had assets of less than $10 million and about 6½ percent had assets of $1 billion and over. Finally, while the median price level on the NYSE at the close of 1961 was $35 per share, 6 percent of the stocks had prices under $10 and 3 percent traded at prices of $100 or over.

Such differences in the characteristics of issues traded on the Exchange are bound to have some impact in the kinds of markets maintained on the Exchange. As is shown in part D of this chapter, the activities of specialists may be quite different with respect to issues at opposite ends of the spectrum of activity: At the high end a minimum of specialists' trading is necessary while at the low end the market may be wholly a "dealer" market; moreover, for the most inactive preferred stocks a wholly different kind of market exists, where the specialist usually acts only as a broker.

4. DIVERSITY OF NYSE COMMISSION FIRMS

Chapter I contains a discussion of the broker-dealer community in the entire securities industry. Special consideration of the structure of the NYSE community is important, however, not only because of its

[11] This includes all stocks other than common stocks; i.e., preferred stocks, guaranteed stocks, etc. This classification is followed by the New York Stock Exchange as well.

preponderant weight—its members accounting for some 75 percent of total broker-dealer income—but also because of the complex of interwoven activities, reaching into other markets, in which its members participate. Some insight into the structure of that portion of the NYSE community which does a commission business with the public may be gained from the annual income and expense reports filed with the exchange.[12]

These reveal a great disparity in the size of firms, with 43 percent of the total 1960 income accruing to the top 5 percent of reporting firms and only 9 percent to the lower half of firms. The considerable importance to NYSE members of activities off the Exchange is revealed by the composition of 1960 gross income received by the group as a whole. Less than half of gross income (39.8 percent) comes from gross NYSE commissions.[13] Some 8.3 percent comes from commissions and fees from transactions on other exchanges—both the American and regionals. The over-the-counter market accounts for 7.8 percent of gross income in commissions and fees and for an undefined portion of the 11 percent of gross income coming from profits on trading and arbitrage. Profits from underwriting syndicates and selling groups provide 10.8 percent of the total, while 13 percent comes from interest received on customers' balances.[14] The remaining 9.3 percent of total income is derived from a number of lesser sources including commodity income, service charges, fees for account supervision, and firm investments.[15]

This composition of income is far from uniform among all firms, however, as significant differences occur in firms of different income ranges. Generally, income derived from Exchange activities—that is, income from NYSE commissions and interest on customers' accounts, which are based exclusively on listed securities—form a larger percentage of total income the larger the size of the firm (in terms of gross income). Income from over-the-counter securities and from trading and arbitrage, on the other hand, comprise a larger percentage of total income the smaller the size of the firm. Income from other exchanges and from underwriting syndicates and selling groups show no clear relationship to size.

Diversity also exists in the concentration of various major income sources among members. The greatest concentration occurs in those activities connected with the Exchange, with 54 percent of all interest received on customers' accounts accruing to the 5 percent of the firms at the top of this category,[16] and 46 percent of all NYSE commission income going to the top 5 percent of firms. The smallest degree of concentration occurs in over-the-counter income, of which 35 percent goes to the top 5 percent of firms. The degree of concentration of

[12] The analysis which follows is based on reports filed by 162 firms in 1954, 283 firms in 1957, and 372 firms—a substantial majority of the firms doing a public commission business—in 1960. Examination of changes over the years was based on data covering only those firms which reported in each year; the separate analysis of 1960 data was based on all firms reporting in that year.

[13] Since gross commission income is defined to include both gross commissions before give-ups to others and net give-ups received from others, it contains some double counting and overstates the share fo NYSE commission income in the total.

[14] A part of interest received on customers' balance is offset by a portion of interest paid out on all borrowings, which equals 10.5 percent of total income but covers the cost of borrowing for other purposes as well.

[15] These figures differ from those arrived at on a sample basis for 1961 in table I–12, in the inclusion of interest income, the different breakdown of gross income used in the NYSE reports, and double counting such as that in note 13 above.

[16] The firms were ranked separately for each income source.

other major income sources lies somewhere in between, as 44 percent of income from other exchanges and from trading and arbitrage and 40 percent of underwriting income accrue to the top 5 percent of firms in each of the categories.

Of considerable significance also are the trends revealed by a comparison of 1954 and 1960 data for those firms which reported in both years. While this was plainly a period of growth, with a 72-percent increase in total gross income, growth was considerably greater in some income sources than in others. Gross income from NYSE commissions rose by 57 percent, interest from customers' accounts by 129 percent, income from over-the-counter business by 123 percent, and income from other exchanges by 94 percent. Income from underwriting syndicates and selling groups, and income from trading and arbitrage rose by 79 and 76 percent, respectively.

There were important differences, too, in the distribution of growth in each activity among firms. While there was a general tendency for firms with a larger gross income to show greater percentage growth in NYSE commission income, no clear relationship was evident between size of firm and its growth experienced in other income sources. In most sources of income—other than NYSE commission income and interest on customers' accounts—the greatest rate of growth was reported by those firms which had the smallest income from the respective source at the beginning of the 1954–60 period. In these areas, therefore, there was a general trend toward catching up, as those with less income from a source showed relatively greater growth. In both NYSE-connected and other activities, however, the concentration of income going to the very top firms increased.

B. Operations of Exchange Markets

1. MECHANICS OF THE MARKET

a. *The continuous auction*

The fundamental distinction between exchange and over-the-counter markets is that the exchange provides a centralized marketplace or "floor." All buying and selling interests are funneled to one place, where buyers have an opportunity to find the cheapest sellers, and sellers the most eager buyers.

The method of trading on the two major New York exchanges is[17] known as the continuous auction system. This system, although somewhat resembling the conventional auction procedure, differs from it in that it is a two-way process with competition among sellers as well as among buyers, and that parties usually can achieve an execution, at least for 100 shares, at any time during the trading session.[18] The prevailing "market" or the "quote" for each security is the highest bid and the lowest offer, e.g., 50 (bid), 50¼ (offer). An investor desiring to buy or sell with as little delay as possible will usually do

[17] Although the purpose of this section is to describe the operation of stock exchanges generally, the following discussion deals most specifically with the NYSE and all references are to that Exchange unless otherwise noted. Much of the discussion is, however, equally applicable to the Amex and, to a lesser extent, to certain of the other exchanges.

[18] The unit of trading for most stocks is 100 shares, known as a "round lot." In some inactive stocks, the round lot is 10 shares. Only round lots are handled in the auction system. Orders for fewer shares than a round lot, called "odd lots," are traded under a separate procedure. See pt. E of this chapter.

so "at the market." If the investor does not wish to execute at the market price, he may enter his own bid or offer to buy or sell at a particular price. This is known as a "limit" order. He may also enter a "discretionary" order, empowering his broker to decide the time and price at which to execute the transaction.

Trading in each security takes place at a specified place on the Exchange floor known as a "post." There are 18 posts on the floor of the NYSE, each with an average of about 75 stocks traded at it.[19] A broker who is at a post to trade in a particular security is in "the crowd," which is merely a way of saying he is participating in the auction.[20]

When two or more parties have placed bids (or offers) in a security at the same price, technical rules determine who is entitled to the transaction. These are known as "priority," "precedence," and "parity." "Priority" holds that the bid or offer which is first in time is entitled to the first execution. If all orders were placed simultaneously, or if the party entitled to priority has effected his transaction,[21] the principle of "precedence" becomes determinative, holding that bids (or offers) are to be executed in order of size.[22] All bids for amounts as large or larger than the amount of stock offered are considered of equal size, or on a "parity." These bidders then "match" (flip a coin) to determine who is entitled to the execution. If none of the bids is as large as the amount offered (or no offer as large as the bid), they are executed in order of size, with parties having bids (or offers) of equal size "matching" to determine the order of execution.

The continuous auction method of trading, in which orders from the public to buy and to sell are often joined at a central locations, operates best when there are many participants in the auction. In recognition of this, the Exchange limits the issues which may be traded on its floor to those which meet its standards for distribution.[23] It has also forbidden its members and member firms [24] from trading or executing orders in NYSE-listed issues off the NYSE floor, except on other organized exchanges [25] or with special permission.[26]

b. Mechanics of execution

In 1962, nonmembers were involved as buyers or sellers in about 76 percent of round-lot volume on the NYSE. In a typical transaction, a nonmember gives his order to an employee in the office of a member firm.[27] The order is usually then wired or telephoned to the order room of the New York office of the firm, and transmitted from there to the Exchange floor by the direct telephone or teletype which each

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[19] In addition, a 19th post, known as "Post 30," has about 200 inactive stocks assigned to it.

[20] The term "crowd" is a technical one and should not be taken to mean that there is always a large group of competing brokers in each or even most stocks. See pt. D of this chapter.

[21] When an execution occurs, all other orders "on the floor" awaiting execution lose their priority and are treated as if they all arrived simultaneously. Because an execution thus "clears the floor," the principles of precedence and parity assume importance.

[22] On the American Stock Exchange, unless one bid (or offer) has priority based on time, all are considered of equal status and "matching" determines their order of execution.

[23] See ch. VIII.B.

[24] The concept and composition of "member firms" is discussed in sec. 2 below.

[25] See ch. VIII.B.

[26] Rule 394. Members are permitted to trade "off-board" without special permission in about 200 preferred and guaranteed stocks, known as the exempt list.

[27] As pt. D of this chapter and ch. VIII.C.4.b point out, certain nonmembers have direct access to the Exchange through specialists. Also some nonmembers have direct access to floor brokers who are not members of commission firms.

member firm is entitled to operate from its office.[28] Some member firms transmit orders by teletype directly from the office of origin to their clerks on the floor; in such cases, the firm's central or main office is notified of the order by a duplicate machine.[29] When the clerk receives the order by telephone, he writes it out on a small piece of paper showing the stock symbol, the number of shares, the type of order—buy, sell long or sell short—and the terms of the order—market, limit or discretionary. If he has received the order by teletype, he simply tears it off the teletype receiver. He then signals the firm's floor broker by having his number flashed on a large board in the trading area or floor. The floor broker picks up the order (or sends a page, an Exchange employee, to do so), and goes to the trading post where the particular stock is traded. A price indicator on the outside of the post, operated by the "reporter" (another Exchange employee), shows the price of the last sale of each stock assigned to the post and also shows whether that sale was higher, lower, or at the same price as the last sale. The floor broker determines the present quote in the stock, usually by asking the specialist.

Other members may also be present in the "crowd." It is the floor broker's responsibility to obtain the best possible price for his customer within the terms of the directions given by the customer—for example, if the member has a limit order, he is to execute it at a specified price or better. The broker makes a "bid" or "offer" for his customer within the framework of the rules of the auction market. If the order is "at the market," the broker, after ascertaining that he cannot receive a better price, will usually execute a buy order at the prevailing offer or a sell order at the bid. After the sale is consummated the members on both sides of the transaction complete their verbal agreement by noting each other's identity [30] and reporting the transaction back to their respective clerks. The clerks then notify their central offices, often by automated teletype, in which cases routing machines direct duplicate reports by teletype to the offices of origination, which inform the customers that their orders have been executed. Later in the day the selling firm "compares" the transaction with the buying firm and confirms the existence of the transaction.

An order of a member of the public may be executed against an order of another member of the public, or, as discussed below, with a specialist, floor trader, or odd-lot dealer on the other side.

c. Sales information

All published sales information, although disseminated in several ways, originates from the same source, the ticker tape. For regulatory purposes the Exchange also receives reports of executed transactions in various forms from its members and member firms.

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[28] Clerks may operate the telephones located at the walls alongside the floor, but may not move about the floor or execute orders.

Member firms having no New York office usually have a correspondent arrangement with a member firm which has a New York office or floor partner, under which the out-of-town correspondent transmits its orders over direct wires to the New York firm. The New York firm then handles the execution and clears the transaction and takes care of the bookkeeping involved.

[29] In combination with the duplicate reporting of executions, this makes it possible to key the direct transmission to the floor into a central accounting system.

[30] If the order has been left with the specialist (see sec. 2.b, below), he takes the member's name and gives the other party's name.

As of January 31, 1963, there were 3,795 tickers in operation in 700 cities.[31] The ticker tape is supposed to reflect most transactions[32] in each security in chronological sequence shortly after each transaction takes place on the floor. Reporters are stationed at each of the 19 posts. After a transaction takes place, the reporter records it on a slip of paper and gives this to a carrier page (also an exchange employee), who places it in a small plastic container which is carried by pneumatic tubes to the stock exchange ticker room.[33] The reports coming from the various posts are divided among three control stations. The tape itself is produced at each of these stations by means of a mechanical device resembling a teletype, on which the sales data are typed. The tape from each of these control stations is fed into a central control station which automatically synchronizes the three sets of sales data so that sales appear on the tape in proper order. The central control station transmits the information over Western Union wires to tickers throughout the country. These tickers are able to print 500 characters per minute; their printing capacity is the limiting factor on the dissemination of sales information.[34]

An interval of several minutes normally elapses between the time a transaction takes place on the floor and its actual appearance on the tape. Because the capacity of the ticker is limited, heavy trading may cause additional delays.[35] The exchange, attempting to keep prices as current as possible in times of delay, deletes the first digits of the prices, then deletes volume figures when the tape is 2 minutes late. When the tape runs 5 minutes late, the exchange gives "flash" prices in selected stocks.[36]

In replying to complaints of investors, the exchange takes the position that normal (and abnormal) delay in reporting is such that the tape cannot be used as a reliable source by investors to check whether their orders have been properly executed.[37]

Sales information for NYSE stocks also appears in the familiar form of stock tables in many daily newspapers. These tables may give the daily opening, closing, high, and low prices and the reported volume. The source of this information is the NYSE tape. Under

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[31] Approximately 20 percent of all tickers were leased to nonmembers. Of the 3,795 tickers, 3,650 were stock tickers; the remainder were bond tickers. NYSE rates for its ticker service are scaled on a geographical basis. There are seven zones and the change varies according to the zone, from a low of $55 per month in the New York City area to $130 per month on the west coast.

[32] The NYSE makes it the selling broker's responsibility to notify the reporter of a transaction for publication on the tape (NYSE Guide, par. No. 2125A (1962)). Although certain instances of failure to report transactions come to the notice of the Exchange, such omissions apparently are not made the subject of disciplinary actions. For discussion of an instance in which a member failed to report transactions on the tape, see ch. XII.B. The Midwest Stock Exchange has recently imposed an automatic $5 penalty for failure to report transactions.

For a discussion of transactions which, under the rules, may be omitted from the tape, see below. According to the NYSE, tape volume is understated by about 5 percent due to such transactions. For a general discussion of the reliability of price and volume information, see pt. J of this chapter.

[33] The carrier also calls out the sale to the odd-lot broker. See pt. E of this chapter.

[34] In addition to the ticker tape itself, many member firms utilize a device which projects a portion of the moving tape on a screen for the convenience of their employees and customers. This device, known as a Trans Lux, is attached to 2,622 of the operating tickers.

[35] During the market break of May 1962, the abnormal volume on the Exchange caused the tape to run as much as four hours late.

[36] When the tape is late the Exchange now gives flash prices in 100 active stocks, presenting them in groups of 50 at about 5-minute intervals. During the market break of May 1962, flash prices were given in 30 stocks at intervals which were more or less improvised throughout the day. Flash prices are obtained by collection from reporters on the floor, a process which in itself consumes some time with the result that flash prices are not as timely as are ordinary prices when the tape is on time. See pt. J of this chapter for a description of plans by the Exchange to automate part of the reporting mechanisms, including plans for a 900-character-per-minute ticker sometime in 1964.

[37] This subject is more fully discussed in pt. J of this chapter.

one recently developed method this tape is "fed" into computers operated by press associations, converted into tabular form and sold to subscribing newspapers. Barring an abnormally late tape, afternoon newspapers can publish stock tables, lacking only individual stock volumes, by 4:15 p.m. (New York time), and complete tables have been published by 5:25 p.m. At last report, 526 newspapers carried exchange stock tables, of which 136 were complete tables and 176 showed fewer than 100 stocks.

Current sales information is also published by a daily market publication service known as the "Fitch Sheets," which lists, for each NYSE stock, the sale price and volume of each transaction in the order in which it appeared on the tape. The time of the transaction is not given, although the sheets are divided into two sections, one for sales occurring between 10 a.m. and 1 p.m. and the other for sales between 1 p.m. and the close.

The ticker provides information on whatever transactions may be currently taking place, and the publications previously referred to relate, in varying degrees of detail, the history of trading at the end of the day. There are also services by which an interested person can determine, during the day, the last sale price in a particular security. About 650 firms have installed Teleregister boards, rented from the Teleregister Corp., which provide such information. These boards differ in the number of stocks and the amount of information which they carry. Some boards provide opening, high, low, and last-sale prices; others provide only last-sale prices. The rental cost depends on the amount of information provided and the number of stocks covered, and on the volume on the Exchange.

The New York Stock Exchange has license agreements with three companies which use computers and other data processing techniques to digest and make available information from the ticker tape.[38] By punching a few keys on a small office machine, a subscriber can obtain, for any NYSE security he selects, the last-sale price and other related information. As of January 31, 1963, 1,142 different offices had such units in operation. The cost to the subscriber (who may be a member or nonmember) varies according to the number of machines used and the information made available. The Exchange approves the subscribers on the same basis as its ticker subscribers and charges them a fee.

Another source of the last-sale information is the two major NYSE odd-lot firms. These firms use large Teleregister boards and also manually record the transactions as they appear on tape. They supply last-sale and similar information at no cost to all member firms who deal with them. Such information may then be passed on by a member firm to investors.[39]

d. Quotations

Quotations (the prevailing bids and offers) for NYSE stocks are disseminated by the Exchange to member firms over a private wire service. Nonmembers can receive quotations only from members.[40]

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[38] The companies are Scantlin Electronics, Inc., Ultronic Systems Corp. and the Teleregister Corp.

[39] See pt. E of this chapter for a more extensive discussion of this service.

[40] The Exchange supervises the installation of private wires between members and nonmembers, to protect its claimed property right in Exchange quotations. The Exchange's approval is conditioned, in part, by the nonmember's entering an agreement which limits the further dissemination of quotations obtained by the nonmember from the member through use of wire connections.

During the course of an average day the Exchange system is called upon to supply about 100,000 quotations.[41] Although members throughout the country may use this quotation service, the cost of long-distance telephone lines has generally limited its use to members' New York offices. Member firms which do not maintain New York offices generally obtain quotations through New York correspondents.

In order to obtain a quote, the member must dial the Telephone Quotations Service of the Exchange, which in turn has received the quote over a direct wire from a clerk at each of the trading posts on the Exchange floor. Two methods are used to transmit quotes to member firms. For about 300 of the most active stocks, quotations are recorded directly onto magnetic drums by quotation clerks on the floor.[42] When a new quotation is established for a stock, the quotation clerk presses a key connecting the post telephone turrent with the proper magnetic drum which records the reporter's voice and erases the old quotation. A member desiring a quotation dials, on a special line, the code by which the stock has been designated. All other quotations are handled on a telephone operator system. About 50 clerks sit in a room facing a large electric panelboard on which the latest quotes are posted. This room is connected by telephone to the trading posts on the floor, and the quotation clerk at each post continually reports any changes in the quotations. Inquiries to this department are also made by means of private telephone lines.

The Exchange has permitted the data processing companies mentioned above to disseminate quotations through the same devices used for sales information. Of the 1,142 offices using such devices as of January 31, 1963, 699 were receiving quotations. The Exchange does not permit devices in the offices of nonmembers to receive quotations.

The Fitch Sheets, discussed above, also publish a daily list of quotations as of 11 a.m. Quotations at the close of the Exchange day are printed on the tape and also are furnished by the two major odd-lot firms. Some newspapers publish closing quotations in stocks which were not traded; these quotations are not current in the same sense as those previously discussed.

2. IDENTIFICATION OF EXCHANGE MEMBERS

Membership in the Exchange is achieved by purchase of a "seat." Each owner of a seat, who must be an individual, has the privilege of trading on the floor of the Exchange. For a brokerage firm to be an NYSE "member firm," at least one member of the Exchange must be a general partner or a director holding voting stock.[43] At the close of 1962, there were 1,366 members of the NYSE, of whom 1,101 were affiliated with 672 member firms, 259 were unaffiliated, and 6 were inactive.

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[41] In 1962 the Quotations Service gave 25.9 million quotations to member firm offices. New York Stock Exchange, 1962 Annual Report, p. 11.

[42] The quotation is obtained by a reporter who gets it either by asking the specialist or by listening to bids and offers being made in the crowd. The reporter gives the quote to a page who gives it to the quotation clerk.

[43] As noted in ch. I.B.1.b, the Exchange uses the term "member organizations" to refer to both member partnerships, which it calls "member firms," and member corporations. Throughout this report, unless specific qualification appears, "member firms" is used to include both partnerships and corporations.

The general partners or voting stockholders of member firms who are not themselves holders of Exchange seats are denominated "allied members," described more fully in ch. XII.B.

The membership of the Exchange may be classified by the functions performed.[44] Some members are office partners of their firms and hold seats to entitle the firm to the commission-rate advantages of membership,[45] while all others (aside from a small inactive group) are engaged in various activities on the Exchange floor itself. Floor members of the Exchange may be classified as follows: floor brokers (commission-house and "two-dollar" brokers), specialists, odd-lot dealers, and floor traders. Each of these functions is discussed below.

Until very recently the purchase of an Exchange seat generally entitled a person to the full privileges of exchange membership, with the exception that prospective specialists had to pass a test.[46] Within the last few months, however, the two major New York exchanges have introduced an examination for prospective exchange members. A member who wishes to perform a particular function must take that part of the test covering the activity in which he proposes to engage.[47] With the exception noted above, this is the first time in the history of major exchanges that simple membership will not carry with it the privilege of engaging in any exchange activity.[48]

a. Floor brokers—commission-house and "two-dollar" brokers

Commission-house and "two-dollar" brokers are those Exchange members who actually execute orders on the floor of the Exchange as agents for others.

Commission-house brokers are members of member firms which receive and solicit orders from the public. Their function is to execute orders forwarded from their own firms or their correspondents. Their compensation depends upon their participation in the profits of their own firms, although the Exchange has a policy that a floor broker's participation must not be below a prescribed minimum.[49]

Two-dollar brokers are independent floor brokers not affiliated with a commission firm, although there are some firms composed of two-dollar brokers. One of the main functions of these brokers and firms is to execute orders for commission houses having more business than their own floor brokers can handle. For this service the two-dollar broker receives "floor brokerage," which is a set minimum fee and is part of the total commission received from the investor.[50] Unlike a specialist, who also holds and executes orders (usually limit orders, which cannot be executed immediately) for a commission-house broker, the two-dollar broker is available to execute orders at any post.[51] Also, commission firms having no partners on the floor may enter into an arrangement with a two-dollar broker or a two-dollar brokerage firm to act as their agent to execute orders.

In recent years, certain two-dollar brokers have specialized in handling large orders which would normally occupy too much time

[44] See ch. I.B and tables I–3 and I–4 for a breakdown of membership as of Dec. 31, 1962.
[45] For a discussion of commission rates, see pt. I of this chapter.
[46] See ch. XII.
[47] See ch. II.B.2.c.
[48] See ch. II.B.2.d.
[49] Rule 314 and supplementary material.
[50] The term "two-dollar" broker derives from what at one time was the standard floor brokerage fee. Under present rules the average floor brokerage fee is about $3.50 per hundred shares. See pt. I of this chapter, containing a discussion of the commission structure.
[51] See sec. 2.b, below.

of the commission-house broker.[52] Having achieved reputations for their ability in executing such orders quickly and without unduly affecting the market, these brokers come to know possible buyers or sellers of "blocks," and when they receive an order they may be able quickly to locate interest on the other side and arrange to match or "cross" the orders.[53]

b. Specialists

A specialist is an Exchange member who stays continuously at one post and participates in trading, as both broker and dealer, in the stocks in which he is registered with the Exchange as specialist. The continuous auction market and the division of the floor into posts creates two problems which have led to the development of the specialist system. First, brokers who have orders to execute at other posts may forward an order to the specialist, especially if the order is a limit order and the specified limit is remote from the current market price and therefore cannot be filled immediately. The specialist holds the order for execution when the market moves to the price specified in the order. Such an order may be transmitted to the specialist by a floor broker or directly by the phone clerk through a tube system.

A second function derives from the fact that the continuous auction market is often too "thin" to insure that an order will meet its counterpart at a "fair" price. Where this is the case, it is the specialist's function to buy or sell for his own account at a fair price, to the extent necessary to maintain a "fair and orderly market." It is estimated that in about 60 percent of all transactions, the specialist in the stock will be on one side of a transaction or the other, either as a broker (when an order is forwarded to him by another broker) or as a principal. The specialist system, the various aspects of the broker and dealer functions and the mingling of the two functions are the subject of part D of this chapter.[54]

c. Floor traders

The floor trader, like the two-dollar broker, is a freelance member of the Exchange, but one who trades entirely for himself. Unlike the specialist, he has no responsibility in the execution of orders for the public or the maintenance of an orderly market. Some members are full-time floor traders, while others floor trade intermittently. These latter may often be floor members who trade for themselves when their other business is slack. Part F of this chapter discusses floor trading.

d. Odd-lot brokers and dealers

To avoid confusion in floor transactions, the major exchanges have long required that regular trading be done in standard quantities, termed round lots. On the New York Stock Exchange, the regular unit of trading in all except the most inactive stocks is 100 shares. All transactions in lots of fewer than 100 shares ("odd lots") are handled through odd-lot dealer firms. For example, if an investor desires to purchase 125 shares of a stock, 100 shares will be purchased as

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[52] See ch. VIII.C: occasionally these brokers may be contacted and given orders directly by institutional investors rather than through a commission firm. In such cases the member must charge the nonmember the full prescribed nonmember commission and not just floor brokerage, even though only a floor brokerage was performed. See pt. I of this chapter.

[53] See ch. VIII.C.

[54] See also ch. VIII.E., dealing with regional stock exchange specialists.

a round lot and the balance as an odd lot. The function of the odd-lot dealer, therefore, is to purchase or sell as principal to meet all odd-lot orders presented by Exchange members. On the NYSE, the odd-lot dealers retain the exclusive services of a large number of associate brokers who execute odd-lot orders and also trade round lots in order to offset the long or short positions acquired in odd-lot trading for the dealer firms. A discussion of the odd-lot dealers, the associate brokers, and the mechanics of their operation appears in part E of this chapter.

C. Members' Transactions

1. INTRODUCTION

In the year 1961, member purchases and sales as principals in the round-lot market of the New York Stock Exchange totaled 524,527,000 shares, or 24.6 percent of all purchases and sales in the round-lot market. This significant member participation in trading on the Exchange is accounted for by various types of members, each of which tends to display distinct trading patterns and motivations. Floor traders, for instance, buy and sell for their personal accounts on the floor of the Exchange, primarily seeking quick profits on "in-and-out" transactions. Other members on the floor trade not for personal investment or speculation, but rather to facilitate the purchase and sale of stocks by others. Odd-lot dealers station their associate brokers on the floor to buy and sell odd lots (not included in the share total), and to offset their positions acquired in odd-lot trading in the round-lot market. Specialists are registered in stocks which they are expected to buy or sell, under certain conditions, in order to provide orderly round-lot markets. Those members who trade from off the floor, which includes virtually the entire Exchange membership, are the least homogeneous grouping of members in terms of trading patterns and motivations, for their trading represents a broader mixture of personal investment or speculation, arbitrage transactions, dispositions of personally held allotments of new offerings, and other operations.

In a great many instances this member participation in the market, especially by specialists and odd-lot dealers, improves the quality and usefulness of the exchange markets. On the other hand, permitting members to trade in securities as principals raises two fundamental problems, both of which were spotlighted by the congressional hearings which produced the Securities Exchange Act of 1934.

The first is a conflict-of-interest problem which assumes many forms in the securities business. Most members of the public deal with exchange members as brokers; that is, as agents or fiduciaries. If the member trades as principal—as an underwriter, as a specialist with his own capital at risk in his assigned stocks, as an owner of stock in any way—his investment advice or his handling of public orders may be subject to bias by virtue of his own interest. The second problem raised by members' trading as principals is that their trading may be such as to unduly influence price movements or excite excessive speculation.

With a view to preventing the type of price manipulations and conflicts of interest uncovered by the congressional hearings,[55] the

[55] See Senate Committee on Banking and Currency, "Stock Exchange Practices," S. Rept. 1455, 73d Cong., 2d sess. (1934). See also Hearings on Stock Exchange Regulation Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d sess. (1934) (hereinafter cited as "House Hearings").

originally introduced version of the Securities Exchange Act prohibited virtually all principal transactions by members of exchanges, possibly even including transactions for personal investment.[56] The bill provided, in short, for the "segregation" of broker and dealer functions, and contemplated "pure" exchange markets made up exclusively of brokers.

In the hearings which followed the introduction of this bill, the exchanges argued that elimination of the dealer activities of various members would severely disrupt or destroy the exchange markets. Faced with the complexities of exchange legislation for the first time, Congress responded by deleting in progressive steps the segregation provisions of the original bill. Thus, the first amended version of the bill [57] prescribed that "Membership of a national securities exchange shall be limited to brokers * * *," but provided several fundamental exceptions to this limitation. If not in contravention of rules of the Commission, members could register as combined broker-dealers, but under no conditions could these functions be combined by members "while on the trading premises" of an exchange, nor could a broker effect any transaction for his own account while on exchange premises. Members could register as odd-lot dealers or specialists, but each specialist could act only as a dealer or a broker, not both. In this and all subsequent versions of the bill, and in the act as passed, Congress made clear the fact that its treatment of the segregation problems was not to be considered a final solution by directing the Commission "* * * to make a study of the feasibility and desirability of the complete divorcement of the functions of dealer and broker * * *" and to report, with recommendations, the results to Congress by January 1, 1936.

The amended segregation proposal was deemed to be unnecessarily harsh by the president of the NYSE, who testified:

> I cannot believe it is wise to make such a revolutionary change in the accustomed method of doing business until it is shown that any possible abuses cannot be eliminated in some less drastic manner. I suggest, therefore, that this section be amended so as to allow the Commission to adopt such rules and regulations as it may deem necessary in regard to members of an exchange combining the function of dealer and broker when actually engaged in business on the floor of the exchange. This suggestion will give the Commission full power to change and correct its rules as conditions may require. Such a power is essential to experimental regulation in so technical a field and is not possible under fixed rules of law.[58]

This approach was, for the most part, adopted in a subsequent committee print of H.R. 8720, which directed the Commission to—

> * * * prescribe rules and regulations (1) to prevent floor trading by members of national securities exchanges, directly or indirectly, for their own account or for discretionary accounts, and (2) to prevent such excessive trading on the exchange, but off the floor by members, directly or indirectly, for their own account, as the Commission may deem detrimental to the maintenance of a fair and orderly market.[59]

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[56] H.R. 7852, introduced by Congressman Rayburn on Feb. 10, 1934, 78th Congressional Record 2378 (1934). Sec. 10 provided that: "It shall be unlawful for any member of a national securities exchange * * * to act as a dealer in or underwriter of securities. * * *."

A limited exception provided that specialists could act as dealers, but only to the extent of effecting transactions on "fixed price orders." Although not incorporated in the bill, the House Committee on Interstate and Foreign Commerce felt an exception for odd-lot dealers was appropriate. House Hearings at p. 123.

[57] H.R. 8720, introduced by Congressman Rayburn on Mar. 19, 1934. 78th Congressional Record 4876 (1934).

[58] House Hearings at p. 725.

[59] See sec. 10 of the House or Senate committee print dated Apr. 4, 1934.

The prohibition against floor trading was qualified by a subsection that permitted members—if the Commission concurred—to combine broker and dealer functions as specialists, and to register as odd-lot dealers. Finally, in a subsequent amendment of the bill, the directive to "prevent" floor trading was modified, giving the Commission authority to "regulate, limit, or prevent" such trading.[60]

As passed, therefore, the 1934 act did not establish the segregation of broker and dealer functions, nor did it eliminate any type of member or member function. Instead, the act relied on certain prohibitions against the manipulation of security prices and the use of manipulative and deceptive devices, and conferred on the Commission broad powers to regulate members' trading in section 11.[61]

The Commission's "Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker," completed in 1936, concluded that "* * * it is not advisable for the Congress at this time to enact legislation requiring the complete segregation of the functions of dealer and broker." [62] At no time has the Commission found it necessary to prescribe any rule under the powers granted it by section 11 of the act. It has, however, encouraged the exchanges to adopt rules to prevent excessive trading by members and to meet other problems arising out of such trading. Later parts of this chapter—dealing with specialists, odd-lot dealers, floor traders, and off-floor traders—treat these problems and the rules designed to meet them in detail. This part is restricted to a general description of member trading, including the volume of such trading, its relationship to price movements, and the extent of its concentration in stocks by price, price range, and activity.

2. METHOD OF STUDY

Three 1-week periods ended January 27, March 24, and June 16, 1961, were selected for study. During these weeks the Standard & Poor's "500" Stock Composite Index changed +1.28, −0.18 and −1.48 respectively. Data covering member trading in each stock each day over these periods were obtained from reports of trading activity filed by members with the NYSE, questionnaires, and other sources. These sources are further described in appendix A, and in each of the following parts of this chapter that deal with member trading activities.

3. VOLUME OF MEMBERS' TRANSACTIONS

Between 1937 and 1942 total round-lot purchases and sales on the NYSE declined from 897 million shares to 267 million shares per year, and over this same period member participation dropped from 23.9 percent of total round-lot purchases and sales to 18.4 percent (table VI-1). The year 1943, however, marked the beginning of a long-term increase in both total Exchange volume and member participation rates. In each of the years 1958 through 1961, round-lot purchases and

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[60] House subcommittee print, Apr. 18, 1934. A subsequent draft of the bill H.R. 9323 struck the word "limit"; there was no further change in this phrasing. See sec. 6 of pt. F, below.

[61] Sec. 10 of the bill became sec. 11 of the act.

[62] SEC, "Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker" at p. 109 (1936) (hereinafter cited as "Segregation Report").

sales on the Exchange exceeded 1.5 billion shares, and members accounted for 23.6 to 25.7 percent of these shares.

Specialists have always accounted for more trading than any other class of members. Over the period 1937 to 1954 they accounted for between 7.8 and 11 percent of all round-lot purchases and sales on the NYSE each year. This participation rate increased to within a range of 12.3 to 14.9 percent for each of the years 1955 to 1961.

Odd-lot dealers have consistently accounted for approximately 3 percent of all round-lot purchases and sales each year since 1937, ranging above 3.6 percent only once (4.0 percent in 1947) and never falling below 2.5 percent.

Floor traders accounted for 6.8 percent of all round-lot purchases and sales in 1937, but this figure has dropped over the years and since 1945 has fluctuated in the 2 to 3 percent range.

All other member purchases and sales, accounted for by members' off-floor trading, have ranged between 2.9 percent and 6.1 percent of total round-lot purchases and sales over the years 1937 to 1961. Prior to 1955 this trading exceeded 4.5 percent only once (6.1 percent in 1949), but it has since ranged from 4.8 percent to 5.3 percent.

4. CONCENTRATION OF MEMBER TRADING

a. General measures of member concentration

The above percentage figures, although they provide a sound general measure of member participation in the market, fail to reflect variations in member participation from day to day or stock to stock. Because the impact of any given group's trading is more discernible with respect to a given stock than to the market as a whole, and is more manifest over a shorter period of time (such as a day) than a longer period of time (such as a year), much of the Special Study data is designed to reflect trading in each stock each day over the periods studied. That is, Exchange activity has been analyzed on a "stock day" basis.[63]

Data covering the 3 weeks studied indicate that all members tend to concentrate their activity in certain stock days, with some classes of members concentrating more prominently than others. Over the 3 weeks there were 16,174 stock days on the NYSE. One or more members participated in 14,970 or 92.6 percent of this total. The

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[63] The "stock day" concept is analogous to the man-hour or man-day concepts utilized in economic statistics. Thus, just as 10 man-days of labor may represent the work of 10 men on 1 day, 2 men on each 5 days, etc., 10 "stock days" may represent 10 stocks traded on 1 day, 2 stocks traded on each of 5 days, etc. That is, any stock which trades on more than 1 day is counted as one for each day it trades; e.g., General Motors trading on 3 days during a period under study would be counted as 3 stock days. If 900 stocks are traded on the Exchange on Monday, 1,100 on Tuesday, 1,050 on Wednesday, 950 on Thursday, and 1,100 on Friday, the total number of "stock days" for the week would be 5,100.

The primary merit of the "stock day" approach is that it allows a study, by days, of all trading over the period studied, but at the same time breaks down this trading according to the daily performance of each stock. Although stocks cannot be identified by name, the characteristics of each stock for each day it trades (its price, price range, and volume, etc.) are preserved. Thus it is possible to examine the trading of any particular group (public, members, or any class of members) with respect to stocks classified according to those characteristics; for example, public trading in low-priced stocks, member trading in volatile stocks, floor trader trading in active stocks, etc., as each stock displayed such characteristics in each day it traded—in other words, on each "stock day."

A complete explanation of the process of analyzing these data is set forth in app. VI–A.

following table sets forth data indicating the degree to which each member class tended to concentrate its trading over the 3 weeks:

TABLE VI-a.—*Concentration of member trading*

Member class	Percent of total round-lot purchases and sales (1961)	Data for 3 weeks			
		Percent of total round-lot purchases and sales (3 weeks)	Number of shares traded	Number of stock days in which member category participated	Average number of shares traded per stock day [1]
Specialists [2]	14.7	14.3	19,472,530	13,469	1,446
Odd-lot dealers	3.0	3.0	4,076,940	10,175	401
Floor traders	2.1	2.3	3,091,270	2,274	1,359
Members off floor	4.8	5.0	6,803,800	6,728	1,011
All members	24.6	24.6	33,444,540	14,970	2,234

[1] Averages noted in the text are slightly higher for each class of members than in fact obtained, due to the fact that stock days include only common stock days while total shares traded include preferred stocks.
[2] Single specialists traded in 12,825 stock days, while competing specialists traded in 644. The computation of total shares traded and average number of shares traded per stock day includes the data for both single and competing specialists. Other data on specialists presented in this part, however, are based on single specialists only.

As this table shows, floor traders tend to concentrate their trading to a greater degree than other members. For example, although floor traders traded about 25 percent fewer shares over the 3 weeks than odd-lot dealers, the odd-lot dealers' average participation per stock day was only 401 shares while the floor traders' average was 1,359. This average floor trader participation, it should be noted, was only 87 shares less than the specialists' average, despite the fact that specialists traded more than 6 times as many shares as floor traders over the 3 weeks.

If judged solely on the basis of the average number of shares traded per stock day, specialists and floor traders would appear to have approximately equal importance in the stock days in which they trade. Such is not the case, however. Since floor traders tend to concentrate their trading in very active stock days, they tend to account for smaller percentages of total stock day volume than specialists (table VI-2). This fact is reflected in the following table, which indicates the approximate percent of total stock day purchases and sales accounted for by the median stock day (ranked by percent of total stock day purchases and sales) of each member class for the 3 weeks: [64]

[64] See table VI-2 for more complete presentation of data.

TABLE VI-b.—*Trading by members of various classes relative to total trading per stock day*

[Based on median stock day of each member class]

Member class	Percent of total stock day volume [1]	Percent of total stock day purchases and sales [1]
Specialists	35.00	17.50
Odd-lot dealers	9.00	4.50
Floor traders	6.75	3.37
Members off floor	9.75	4.87
All members	50.00	25.00

[1] The amount of trading on an exchange may be measured by computing the total number of shares sold, which is the conventional measure ("total volume"), or by computing the total number of shares purchased plus the total number of shares sold ("total purchases and sales"). The latter measure will always be exactly twice as large as the former, since each share sold must have a matching purchase.

Because the trading of any group (e.g., all members, specialists, etc.) will not ordinarily consist of an equal number of purchases and sales, the trading of a given group must be measured by adding its total purchases and its total sales together. This total may then be expressed as a percent of either total exchange volume (sales) or total exchange purchases and sales, depending on the purpose for which it is to be used. If the purpose is to establish the group's participation in total purchases and sales the participation is best expressed as a percentage of total purchases plus sales. If, however, the purpose is to determine the percent of "total volume" in which a group member participated as buyer or seller, the group's purchases and sales should be expressed as a percent of "total volume." The resulting percentage may overstate somewhat the percentage of volume in which the group participated if members of the group were on both sides of any of the transactions included in the data, but such instances are generally limited and therefore do not destroy the usefulness of this measure.

In any event the market participation of a particular group expressed as a percent of total purchases and sales will always be one-half as large as when expressed as a percent of total volume since total purchases and sales are always equivalent to "twice total volume" (a phrase used interchangeably with "total purchases and sales").

Specialists, therefore, accounted for approximately 35 percent or more of total stock day volume in half of the stock days in which they traded, while floor traders accounted for only about 6.75 percent or more of total stock day volume in half of the stock days in which they traded.

b. Concentration of member trading by stock days

The fact that specialists and odd-lot dealers trade in a greater number of stock days (i.e., have a broader dispersion of their trading) than other members is attributable in large part to their market functions, which foster broader participation in the market. An effort was made to determine whether other factors—the price, price range, or trading volume of stock on a given day—exhibit any relationship to the trading patterns of these members, and whether such factors play a determinative role in the trading of floor traders or members off floor. The first step in this effort was to plot the distribution of stock days in which each member class participated against total stock days over the 3 weeks. Thus, a series of line charts were prepared,[65] the bases of which represented every stock day over the 3 weeks, arranged from the stock day of lowest price (or price range, or total volume) to the stock day of highest price (or price range, or total volume). The vertical axis of each chart was marked off from zero to 100 percent to indicate the cumulative percent of each member class' stock days falling at or below each price (or price range, or total volume) level. As the bases of the charts are also divided into percent rankings (lowest 10 percent, next 10 percent, etc. of stock days as ranked by price, price range, or total volume, as appropriate),[66] it is

[65] Charts VI-1 through VI-4.

[66] The actual percent rankings are set forth across the top of each chart, but the 10 percent, 20 percent, 30 percent, etc., lines are carried to the bases of the charts to facilitate reading of the data.

possible to read from each chart the percent of any given member class' stock days which fall into the lowest 10 percent (or 20 percent, 30 percent, etc.) of all stock days over the 3 weeks, as ranked by price, price range, or total volume.

As measured by the number of stock days in which each class of members participated, it does not appear that any class of members has a notable preference for either high- or low-priced stocks (chart VI–1). Floor traders tend to favor very slightly the lower priced stocks, as 22 percent of the stock days in which they participated fell within the lowest 20 percent of all stock days, as ranked by stock price. The other member classes show a slight preference for the higher priced stocks. Thus approximately 46.5 percent of the stock days in which specialists participated, 44.5 percent in which members off floor participated, and 44 percent in which odd-lot dealers participated fell in the lowest 50 percent of all stock days over the 3 weeks as ranked by stock price (i.e., fell below the median stock day as ranked by stock price).

Members show a more pronounced tendency to participate in those stock days with wider daily price ranges (chart VI–2). With respect to both specialists and odd-lot dealers, only 44 percent of the stock days in which they participated fell below the median of all stock days ranked by price range. For members off floor the percent dropped to 39, and for floor traders it plummeted to 22. That is, as measured by the number of stock days in which each member class participated, 78 percent of all floor trading, 61 percent of all off-floor trading, and 56 percent of all specialist and odd-lot dealer trading occurred in those stock days with daily price ranges wider than the median price range over the 3 weeks. The most notable concentration in stock days of wide price range occurred with respect to floor traders. For example, 80 percent of all stock days over the 3 weeks had a price range of 2.8 percent or less,[67] yet only 56 percent of all stock days in which floor traders participated had a price range of 2.8 percent or less. Stated conversely, 44 percent of all stock days in which floor traders participated were among the top 20 percent of all stock days as ranked by price range.

Even more pronounced, when measured by the number of stock days in which members participated, is the tendency for members to trade in stocks experiencing high volume on any given day (chart VI–3). As in the previous instances, specialists reveal this propensity to a lesser extent than other members; approximately 44 percent of the stock days in which they participated fell below the median stock day as ranked by share volume. The percent of stock days of other members falling below the median were: odd-lot dealers 36 percent, members off floor 23 percent, and floor traders 10 percent. If market activity is measured by number of transactions per stock day rather than by share volume per stock day, the pattern of member concentration remains virtually the same (chart VI–4).

c. Concentration of member trading by share volume

Concentration of member trading may be studied not only by analyzing the types of stocks or stock days in which they have any trading

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[67] Price range is expressed as a percent of the closing price on each stock day.

at all but also by analyzing their volume participation in various types of stocks or stock days. For example, while as shown in the last section, members seem to have no strong preference between high- and low-price stock days as measured by the relative number of stock days in which they trade at all, when the share volume of their trading is analyzed there is a decided tendency to higher participation rates in high price stock days.

The data used in this analysis (member percentage participation rate data) and the presentation of these data differ fundamentally from the stock day data above in that they reflect aggregate member trading rather than the trading of each class of members separately.[68] As a result, trading patterns of the membership as a whole that appear in the data may not hold true with respect to each member class individually.[69] Since specialists accounted for a preponderance of all shares traded by members over the 3 weeks, the specialist data tend to dominate the aggregate data and may obscure trading patterns of other member classes.

The member trading patterns that appear in these data do not in all cases coincide with the patterns indicated in the stock day data noted above. Thus, although members tended to trade in an equal number of stock days of high-priced and low-priced stocks (chart VI–1), as noted above they showed a definite tendency to increase their percentage participation rate in higher priced stocks (app. VI–A, chart 1 and table 1). That is, within the stock days in which they traded, members accounted for a greater percent of total volume in the high-priced stocks than in the low-priced stocks.

With respect to the price range of stock days on the other hand, both the stock day data and the participation rate data reflect a member tendency to trade more heavily in stock days of wide price range. That is, members tend not only to participate more frequently in days of relatively wide price range (chart VI–2), but as well to increase the volume rate of their participation as the price range widens (app. VI–A, chart 2 and table 2).

No clear relationship appears in the participation rate data between total stock day volume and member-participation rates as a percent of that volume (app. VI–A, chart 3 and table 3). Thus, although most member classes show a strong tendency to trade in the more active stock days (chart VI–3), the percentage rate of their participation within such stock days does not increase as total volume increases.

5. MEMBER PURCHASE AND SALE BALANCES

A most significant question with respect to member trading is whether it tends to stabilize or destabilize prices. Although different measures of stabilization have been employed, as noted in subsequent parts of this chapter, the measure employed here is the degree to which members are buyers or sellers on balance in stock days of rising and declining prices. That is, a member trading pattern which tends to produce purchase balances on declining stock days and sale balances on rising stock days would indicate that members exert a stabilizing

[68] These types of data are presented separately for specialists and members off floor in pts. D and G of this chapter.

[69] Another respect in which these data differ is that only the stock days in which members traded are included in the analysis in this section.

influence on the stock days in which they traded. Data for the 3 weeks studied produced just such a pattern (app. VI–A, chart 4 and table 4).[70] Aggregate member trading for the period studied, therefore, exerted a rather clear stabilizing effect on stock day price movements.

On most of the stock days in which members traded over the 3 weeks, however, their net balances were small. Member purchases exactly equaled member sales in 8.8 percent of all stock days in which any member participated. Odd-lot dealers posted zero balances in 5.4 percent of the stock days in which they participated, while floor traders posted zero balances in 11.9 percent of their stock days. Specialists and members off floor had zero balances in 9.4 and 7.6 percent of their stock days, respectively. All members as a group posted net balances in the +200 to −200 share range (including zero balances) in 44.9 percent of the stock days in which any member participated. Individual member classes posted such balances somewhat more frequently; 54.6 percent for floor traders, 66.4 percent for odd-lot dealers, and 57.0 percent for members off floor.[71] On a substantial number of occasions, however, members posted sizable net balances. Members as a whole, and each member class individually, had net balances in excess of 1,000 shares in very roughly 10 percent of the stock days in which each category traded. With the exception of odd-lot dealers, each member class posted balances in excess of 10,000 shares on several occasions. The nature and significance of member net balances are treated in greater detail in the parts on specialists, floor traders, and members off floor, to follow.

6. SUMMARY

Member purchases and sales as principals account for approximately 25 percent of all purchases and sales in the round-lot market of the NYSE. To a large extent this trading, particularly by specialists and odd-lot dealers, contributes to the efficient functioning of the market. At the same time, however, the potential conflicts of interest between these members and nonmember participants in the market, and the possible impact of member trading on stock activity, raise fundamental problems of exchange regulation. As a general background for the following parts of this chapter, which treat these problems in detail, this part has sketched the general characteristics of member trading, both for members as a whole and for the major classes of members—specialists, odd-lot dealers, floor traders, and members off floor.

As measured by the number of stock days in which they participate, members do not seem to show a preference for stocks of any given price level. Within the stock days in which they do participate, however, there is a pronounced tendency for members to account for a greater percent of total trading volume in high-priced stock days than in low-priced stock days.

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[70] In this instance the fact that specialist data dominate the aggregate data for all members is particularly important. Although specialists trade in a stabilizing fashion (app. VI–A, chart 9 and table 9), members off floor tend to show consistent sale balances regardless of price movements (table VI–80) and floor traders tend to trade in a destabilizing fashion (table VI–71).

[71] Specialist balances in the +200 to −200 range were not computed. However, in 55.7 percent of the stock days in which they traded, they posted net balances in the −300 to +200 share range.

Members participate in a greater number of stock days of wide price range than narrow price range, and in addition the volume of their trading tends to increase as the price range widens.

Most pronounced is a tendency for members to trade in a greater number of stock days of high volume than low volume. Within these stock days in which they trade, however, the volume of their trading (expressed as a percent of total stock day volume) does not appear to vary as a function of total stock day volume.

Finally, over the 3 weeks studied members as a group were generally buyers on balance on stock days of declining prices and sellers on balance on stock days of rising prices, and thereby exerted a stabilizing influence on price movements. As to this particular characteristic, however, the various types of members tend to be more dissimilar than similar. The group data are dominated by the trading of specialists, who tend to trade in a stabilizing fashion. Members off floor, on the other hand, tend to be sellers on balance regardless of price movements, while floor traders exhibit a destabilizing pattern of trading.

Because member trading accounts for a substantial percentage of total Exchange trading, and because it is engaged in by individuals responsible for operating a public securities market, it necessarily poses many basic problems in the areas of Exchange regulation and self-regulation. In several of the following parts of this chapter these problems are treated in detail.

D. Specialists

1. INTRODUCTION

Although centralized securities exchanges have been in existence for several centuries, the specialist system, as presently in effect on major American exchanges, is less than 100 years old. About a century ago the American exchanges adopted the continuous auction method of trading, which is responsible for the present specialist system. Under the continuous auction system, each issue is traded at one designated place on the floor called the "post." There are 19 such posts on the New York Stock Exchange (NYSE), 21 on the American Stock Exchange (Amex), 7 on the Midwest Stock Exchange (MSE), and 31 on the Los Angeles and San Francisco floors of the Pacific Coast Stock Exchange (PCSE). At each trading post are one or more exchange members who "specialize" in some or all of the issues traded at the particular post, and who are registered with their exchange as "specialists" in their particular securities. Their activities are circumscribed by section 11 of the Exchange Act and the rules of the different exchanges.

The specialist performs two basic functions with respect to the issues in which he specializes. As a broker, he holds and executes orders for the public (usually forwarded to him by other exchange members). As a dealer he is a "market maker" and trades for his own account in the securities in which he is registered.

The service that the specialist performs as broker derives from the nature of the continuous auction market and an exchange which trades a large number of issues. It is the basic obligation of a broker to execute a customer's order expeditiously when, according to its terms and under the rules and procedures of the market, the order is

capable of execution. Many investors use "limited price" orders specifying a price above which the customer will not buy or below which he will not sell. Until the market moves to the point set by the customer, such orders are not capable of execution. A floor broker cannot carry limited orders with him as he moves about the floor since he may be elsewhere as the limit is reached and may "miss the market." It is likewise not feasible to have floor brokers wait at a post for a limit to be reached since in some cases the market may never move to the limit, and in others it may take hours, days, or weeks until such orders can be executed. Under existing trading methods it is a practical solution for floor brokers to transmit limited orders to a single broker who stations himself at the post and acts as a central repository of such orders. The utility of this function has never been questioned.

The specialist who holds an order is a subagent[72] in a fiduciary relationship with his principal, the customer who originated the order. Thus, in the event of an erroneous execution a customer may hold both the specialist and his own broker liable for any damages. Section 11 of the Exchange Act prohibits a specialist from disclosing information regarding orders placed with him. In the alternative, a proviso grants authority to the exchanges or the Commission to require full disclosure of *all* orders which the specialist holds. The unexecuted public orders entrusted to the specialist for execution comprise what is known as the "book."

Section 11 of the Exchange Act also permits the specialist to act as a dealer, but his dealer transactions must be restricted "so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market." An Exchange rule reiterates this limitation; at the same time, as discussed below, specialists are encouraged to engage in dealer transactions in order to maintain a fair and orderly market.[73] As a reflection of the specialists' obligation to maintain fair and orderly markets, their dealer participation extends fairly evenly over all types of stocks rather than being concentrated in particular stocks classified by price or volume (charts VI–1 to VI–4).

As of the middle of 1962 there were 360 specialists registered on the NYSE, of a total membership of 1,366; 159 specialists registered on the Amex, of a total membership of 499; 40 specialists on the MSE, of a total membership of 400; and 31 specialists on the PCSE, of a total membership of 160.

In 1961, NYSE specialists bought or sold as dealer 312,190,000 shares or about $12.7 billion worth of securities; this amounted to 29.3 percent of total round-lot volume. During the same period, specialists were involved as brokers in about 30 percent of round-lot volume.[74] These figures indicate that the conduct of specialists directly affects the interests of a large proportion of investors and illustrate the specialists' importance in the auction market. But in addition to their volume of trading, no other class of exchange member is so intimately connected with the trading process and in so crucial a position to affect trading as to prices and as to manner and speed of execution of orders. Thus, the rules and practices defining the functions and conduct of the specialist business are of vital significance to the health of the entire auction market and affect all of those who deal in it.

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[72] Restatement of the Law of Agency (Second), sec. 5 (1958).
[73] NYSE Guide, par. No. 2104.10.
[74] See sec. 5, below.

In the staff report on the Amex, the specialist's crucial position was described as follows:

> In his unique capacity the specialist stands at the heart of the Exchange market mechanism. He has intimate knowledge of the past market action of the stocks in which he specializes. He also has sole access to the specialist book showing outstanding orders both below and above the market, which affords him a great competitive advantage over the public. In addition, he exercises a significant influence on the public appraisal of a security, since he is the one who quotes the market. For all these reasons, it is a matter of tremendous importance in the maintenance of a fair and orderly market that a specialist's transactions as principal be only of such kinds and in such amounts as are consistent with his function of acting as broker at the vital center of the auction market.
>
> The statutory scheme and the rules of the Exchange have attempted to establish a workable regulatory pattern whereby the specialist is permitted to trade for his own account in addition to acting as a broker. These provisions were designed to resolve the inherent conflict arising from the combination of functions by maintaining the fiduciary standards which are expected of a broker and yet permitting him to trade as a principal to maintain the continuity of a fair and orderly market.
>
> In the course of the present Special Study of Securities Markets we intend to inquire further into the functioning of this regulatory pattern. * * * [75]

The staff report on the Amex described "manifold and prolonged abuses by specialists" on that exchange. Because of this background, certain aspects of this investigation were directed toward determining whether similar patterns of conduct were present among NYSE specialists. No such patterns have been discovered. On the other hand, the very absence of major illegality under the present rules has served to highlight more subtle and complex problems concerning the activities of specialists. Most of this part is devoted to a discussion of these problems.

2. SCOPE AND METHODS OF STUDY

This part of chapter VI examines the functioning of a system which strives to reach compromises in three important respects: the first is between self-interest and fiduciary obligation; the second, between a completely free market and a market made "orderly" by the professional market maker; and the third, between a similarity of objectives and a great diversity in the activities of individual specialists and in the characteristics of individual securities traded.

The following discussion of specialists concentrates on the activity of NYSE specialists. But the basic organization of the specialist system of the Amex and the market characteristics of its stocks are such that the NYSE data apply to many of that exchange's specialists. Therefore, most of the general statements of this part are applicable to both the NYSE and the Amex, except as to matters associated with specific policies of the NYSE. Certain problems peculiar to the Amex system have already been covered in the Amex report. The specialist system on the regional exchanges is not parallel to that of the NYSE because of the dual trading system, limited volume, and other factors. Except where specifically noted, none of the discussion or conclusions of this part can be considered applicable to those exchanges.

Data for the study were obtained in various ways. A questionnaire EX-1 [76] was sent to all NYSE specialists. Many files of the NYSE

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[75] SEC, "Staff Report on Organization, Management, and Regulation of Conduct of Members of the American Stock Exchange," p. 23 (1962) (hereafter "Amex report").

[76] A copy of this questionnaire appears in app. VI-B.

floor department were examined, and testimony was taken from 23 specialists, 2 other important floor members, and supervisory exchange officials.

Questionnaire EX-1 asked for data on the specialist, his firm, and particular subjects selected for detailed study. These subjects included "stopping" stock, block transactions, "stop" orders,[77] investment positions in issues in which the specialist is registered, types of orders accepted, and income and capital data.

Specialists were also requested to submit various statistical data on "stopped" stock for February 21, 1962, and on "stop-loss" orders for March 19 through March 30, 1962.[78] Furthermore, all orders held by specialists at the close on February 16, 1962, and at the opening on February 19, 1962, were requested for 103 selected stocks; [79] these issues were selected to provide a cross section of stocks of high activity, low activity, and median activity.

Complete specialist trading data were requested for 3 selected weeks in 1961, those ending January 27, March 24, and June 16. During these weeks the Standard & Poor's "500" Stock Composite Index changed +1.28, −0.18, −1.48, respectively. The results of various studies of this data appear throughout this part and elsewhere in this chapter, and are referred to as the "3-week study."

Trading data covering the period of the May 1962 market break were also requested from specialists in 50 stocks. This included detailed trading data for May 28, 29, and 31 and weekly purchase and sale data for the period of September 1, 1961, to June 29, 1962.

The rules and policies of the NYSE governing the conduct and performance of specialists, together with various unpublished Exchange documents interpreting and supplementing these, have also been studied. Exchange files pertaining to specialists were examined for the period January 1, 1959, through August 1962. These files consist of the routine studies of all specialist firms performed by the floor department of the Exchange, and also contain customer complaints, disciplinary and quasi-disciplinary actions taken against specialists, and capital reports. Circulars and other memorandums circulated among specialists by the Exchange for the period January 1, 1957, through December 1962 were examined. The files of the Commission containing unpublished studies and correspondence between the Commission and the Exchange from 1934 to the present were also studied.

The specialists invited to testify were selected in part on the basis of the answers to the questionnaire, and in part to include a cross section of specialists. However, most were affiliated with the larger specialist firms, and almost all of these were the senior partners of their units, with many years of experience as floor members on the Exchange. Investigatory visits were made to the offices of a few specialists to gather additional data or to confirm data previously accumulated. In addition, members of the staff spent time on the floor of the Exchange observing floor operations.

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[77] Data on stop orders were collected for a study of the subject conducted by the Division of Trading and Exchanges and are not included in this report.
[78] See forms A and B of questionnaire EX-1 in app. VI-B.
[79] See form C of questionnaire EX-1 in app. VI-B; the stocks are listed in app. VI-C.

3. THE HISTORY OF THE SYSTEM AND THE REGULATORY PATTERN

a. History of the system

Until shortly after the Civil War the NYSE operated as a "call" market.[80] Under the "call" system, an exchange official calls the names of particular stocks one or more times during the course of the day, and all brokers holding orders from their customers trade at that time. Even prior to the Civil War a "street" market characterized by continuous trading in NYSE issues had developed, and more volume was often accounted for there than at exchange calls. By 1869, the two markets had consolidated. Business at the calls had been decreasing and continued doing so, and the calls were finally discontinued a few years later.

Although the abandonment of the "call" system was the result of increased volume, the conversion of the Exchange to a continuous auction must have resulted in relatively thin trading markets. In a "call" market, brokers collect all orders for execution at the time the stock is reached on the list, and the price level is the result of the execution of all the orders which have arrived in the market over a period of time. On the other hand, in a continuous auction market, a market order is usually executed as soon as a willing party on the other side is found.

There appear to be no historical data showing how the problem of continuity was handled, if at all, between the adoption of the continuous auction market and the turn of the century. Likewise, the exact time that members first became specialists is unknown. By 1909, however, specialists were a significant enough factor on the Exchange to merit mention in the Hughes Committee Report.[81] Still, the demarcation between specialists, commission brokers, and floor traders was apparently not yet fully established.[82]

The first specialists seem to have been primarily brokers,[83] handling limited orders for other members. This appears to have been their most important function until at least the first decade of this century. This is not to say that specialists during this early period did not trade for their own accounts. Their trading, however, was probably similar to that of floor traders though concentrated in their own specialty stocks, with which they were most familiar.[84]

With the passage of time, floor brokers probably tended to give their limit orders to those among the many competing specialists who were

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[80] Unless otherwise noted, the material in this part is from Eames, "The New York Stock Exchange" (1894).

[81] Report to Governor Hughes of the Governor's Committee on Speculation in Securities and Commodities. Reprinted in Van Antwerp, "The Stock Exchange From Within," p. 426 (1913).

[82] Twentieth Century Fund, "The Securities Markets," p. 405 (1935).

[83] This is confirmed by testimony of a leading specialist at the hearings which led to the Exchange Act:

"Mr. ADLER. Twenty-five years ago [about 1909] a trading specialist was more or less unknown. Over a period of the last 25 years, not only the desire of specialists to trade, but at the request of commission houses who are our customers, the trading specialist has come into being.

* * * * * * *

"CHAIRMAN. The primary function of a specialist is to act on commission for another house.

"Mr. ADLER. Yes."

Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 before the Senate Committee on Banking and Currency, 73d Cong., 1st sess., pp. 6792–6793 (1934) (hereafter "Hearings on Stock Exchange Practices").

[84] See sec. 6.e(1), below.

willing to deal as principal when that became necessary in order to give a broker a "good" execution—generally an execution close to the last sale.[85] Indeed, the cornerstone of the conventional argument that the specialist has an economic incentive to deal for his own account is that, by providing a liquid market and preventing unreasonable price fluctuations, the specialist will be favored with increased commission business.[86]

Whether as a result of the pressure of competition or other factors, there did arise so-called "dealer" specialists. Finally, in about 1939 the Exchange began an affirmative program to compel specialists to become dealers, possibly in response to the needs of commission houses faced with difficulty in obtaining good executions in that period of low volume. As a major part of that program, the first specialist capital requirement was instituted in 1939.[87] Although this requirement is somewhat similar to the one in effect now, which is considered "nominal," vigorous enforcement of the rule in the early days led to the demise of a number of specialist firms. Also at about this time, the Exchange withdrew the registration of some specialist firms for their failure to deal adequately. A present reflection of this policy is that a specialist unit with a good record as dealer is more likely to have newly listed issues allocated to it. Even in recent years there has been a steady decrease in the number of separate specialist units, from 136 as of January 2, 1957, to 109 as of January 2, 1963 (table VI-3).[88] Furthermore, the Exchange since 1953 has had a policy of not allocating new stocks to one-member specialist firms, and does not allow any single-member specialist ventures to be started. It seems fairly apparent that the existing one-man firms (and some other small ones) are holdovers from the time when specialists were primarily brokers.

As the dealer specialist emerged, a drastic decline in competing specialists has occurred. In 1933, there were 466 stocks with competing specialists, in 1957, 228 stocks, and today only 37. The decline has been steady and, if anything, has accelerated; as recently as 1960 there were 137 stocks with competing specialists (table VI-3). Historically, competition occurred in stocks where the existing specialist's service was not satisfactory or where the volume was heavy.[89] At present, competition is unsatisfactory for several reasons. Commission firms are often confused as to who is quoting the market in active stocks. The commission firms do not shop for the best service but

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[85] The price of execution is always important to brokers, especially in actively traded issues. A customer who places an order of even moderate size in an inactive issue knows he must wait a reasonable time for an execution or may have to trade at a discount from the last sale. But an investor in a well-known issue would be surprised if his order of moderate size was transacted at a discount. For a more complete discussion of this aspect of the dealer function, see sec. 6.a, below.

[86] Hearings on H.J. Res. 438 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 87th Cong. 1st sess., p. 116 (1961) (hereafter Hearings on H.J. Res. 438). SEC, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, p. 40 (1936) (hereafter "Segregation Report").

This argument loses force with the present scarcity of competing specialists. At present for the vast majority of stocks, there is only one specialist to whom a commission broker can give a limit order.

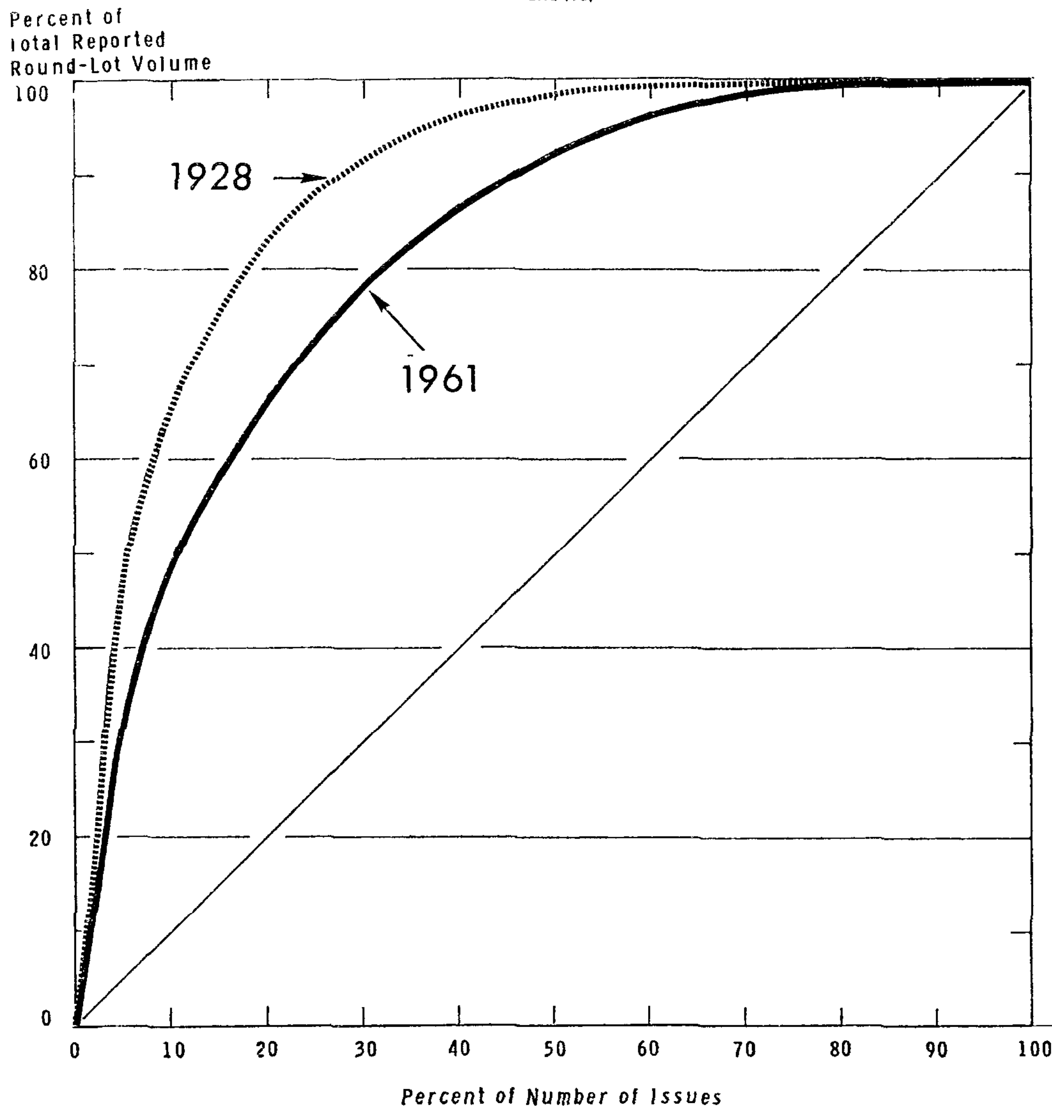
[87] This required specialists to have $10,000 in liquid assets, or liquid assets sufficient to purchase 100 shares of every 100-share-unit issue in which they specialized, whichever was greater. See sec. 4.c, below.

[88] In 1933, there were 105 individual specialists; currently there are only 21 (tables VI-3 and VI.c).

[89] At one time, commission firms invited specialists to start competing books.

often give each competitor half their brokerage business.[90] In addition, neither competitor accepts full market-making responsibilities, thus adding to the Exchange's regulatory problems.

The emergence of the dealer specialist and the decline of competing specialists are associated in time with a decrease in the average total volume of trading per issue and also in the concentration of volume in



the most active stocks. Specialists have testified that the changes in volume characteristics from the 1920's to the present has had an effect on their functions. As a rough measure of this assertion, the study analyzed volume data for two bull market years, 1928 and 1961. In 1928, the reported stock volume was 930,893,276 shares and in 1961, a year of relatively comparable volume, 1,021,264,589 shares, a difference

[90] Similar allocation of business to the odd-lot dealer is discussed in pt. E.3.d of this chapter.

of 10 percent. However, in 1928, 1,176 issues were listed on the Exchange, while in 1961 there were 1,541. Thus, there was an annual average volume per stock of about 792,000 shares in 1928 and 663,000 in 1961 or 16 percent less. Furthermore, in 1928, 44 percent of the volume was accounted for by the 50 most active stocks, while in 1961 the 50 most active accounted for only 25 percent of volume.[91] In light of the total volume figures, the change in concentration means that in the most active stocks, public markets were thinner in 1961. The dealer function, which is important in assuring executions close to the last sale, has accordingly received increasing emphasis.

Thinner markets in active stocks have also led to thinner books with less opportunity for specialists to earn brokerage in their stocks.[92] This decline in brokerage income has probably been another cause in the decline in competing specialists. A good example of this may be found in the fact that in 1928 volume in U.S. Steel was 19,809,700 shares, and at about that time, there were eight competing specialists in the stock. In 1961, when volume in the stock was 3,345,400 shares, the number of competing specialists had declined to two.[93]

Perhaps the most dramatic indication in the shift of emphasis from broker to dealer can be found in the comparison of the testimony given by two Exchange presidents, almost 30 years apart. When the then president of the Exchange testified in the course of Senate hearings in 1933, the first reference to specialists was as follows:

> Senator BROOKHART. What is a specialist?
> Mr. WHITNEY. A specialist is one who executes orders for other brokers on the Exchange in a particular stock.[94]

In 1961, NYSE President G. Keith Funston was asked a somewhat similar question and replied:

> [T]he essence of being a specialist is dealing for his own account. That is being the specialist.[95]

b. The regulatory pattern

The specialist system has had its critics almost from its inception. Criticism has historically focused on the conflict of interest between the broker and dealer functions and the possibilities of manipulation inherent in the specialist's market position. This section deals with the historical development of the regulatory pattern as connected with these problems.

In 1909, the Hughes committee noted the receipt of complaints that specialists who dealt in inactive securities bought and sold for their own account while acting as brokers. The report stated that such dealings, without the principal's consent, are illegal. The report also noted that "the practice of specialists in buying and selling for their own account often serves to create a market where otherwise one would not exist." Because of this latter factor the committee was against the segregation of the broker and dealer functions, "notwith-

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[91] The top 5 percent of all stocks in 1928 accounted for 40 percent of Exchange volume, while in 1961 the top 5 percent accounted for 33 percent of the volume (table VI-4 and chart VI-a).

[92] For example, the specialist in Transamerica stated that even after making rough adjustments for splits, etc., his brokerage in this issue is now only about one-third as great as it was in 1929.

[93] In 1928, U.S. Steel was the third most active stock on the NYSE. Its 1928 volume of 19,809,700 shares was over 9 million shares greater than the stock that was the volume leader in 1961. In 1961 U.S. Steel was the forty-second most active stock on the NYSE.

[94] Hearings on Stock Exchange Practices, at p. 254.

[95] Hearings on H.J. Res. 438, at p. 116.

standing that the system of dealing in specialties is subject to abuses."[96]

In 1910, probably in response to the Hughes committee criticism, the Exchange adopted a rule prohibiting specialists from trading with the book, i.e., dealing as principal with a customer whose order the specialist holds as agent, without the customer's consent.

The next period of criticism came about 10 years later and still focused upon the conflict of interest between broker and dealer functions. In 1922, criticism by member firms and the public led the Exchange to appoint a committee to suggest improvements.[97] The most significant change resulting from the committee's study was a modification of the 1910 rule so as to permit specialists to trade with their book "provided the price at which the stock is taken or supplied is justified by the conditions of the market, and provided that the member * * * giving the order * * * having been notified as soon as possible, accepts the trade and reports it."[98]

Renewed criticism of the specialist system came a decade later, but now the main focus was on manipulation rather than conflict of interest. The Pecora investigation of 1934 followed the collapse of the bull market of the twenties. A significant portion of the testimony concerned the activities of specialists as participants in the pools and other manipulative activities that had characterized the previous period of speculation. The Exchange Act was the result of that investigation. The provisions of the act relating directly to specialists are in section 11, as follows:

(a) The Commission shall prescribe such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors (1) to regulate or prevent floor trading by members of national securities exchanges * * *. It shall be unlawful for a member to effect any transaction in a security in contravention of such rules and regulations, but such rules and regulations may make such exemptions * * * within the limitations of subsection (b) of this section, for transactions by * * * specialists, as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

(b) When not in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, the rules of a national securities exchange may permit * * * a member to be registered as a specialist. If under the rules and regulations of the Commission a specialist is permitted to act as a dealer, or is limited to acting as a dealer, such rules and regulations shall restrict his dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market. * * * It shall be unlawful for a specialist or an official of the exchange to disclose information in regard to orders placed with such specialist which is not available to all members of the exchange, to any person other than an official of the exchange, a representative of the Commission, or a specialist who may be acting for such specialist; but the Commission shall have power to require disclosure to all members of the exchange of all orders placed with specialists, under such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. It shall also be unlawful for a specialist acting as a broker to effect on the exchange any transaction except upon a market or limited price order.

* * * * * * *

(e) The Commission is directed to make a study of the feasibility and advisability of the complete segregation of the functions of dealer and broker, and to report the results of its study and its recommendations to the Congress on or before January 3, 1936.

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[96] Van Antwerp, "The Stock Exchange From Within," p. 426 (1913).
[97] "The New York Stock Exchange, Report of the President, May 1, 1921–May 1, 1923."
[98] "The New York Stock Exchange, Report of the President, May 1, 1921–May 1, 1923." The rule reached its present form in 1932. See sec. 7.a, below.

Although the investigation centered on manipulation, it is apparent from the face of section 11 that Congress was also concerned with the specialist's trading advantages and the conflicts of interest inherent in the mingled broker-dealer functions.

Immediately after the organization of the Commission, and even prior to the segregation study required by the statute, the staff in 1935 proceeded to formulate rules governing the conduct of specialists and other exchange members. These rules, in the main, were general; they were not promulgated as Commission rules, but were recommended to all exchanges for them to adopt.

Many of these rules were aimed at curtailing manipulative conduct. Two were of a recordkeeping variety: Specialists were required to be registered as such with the exchanges [99] and to keep a record of all orders placed with them.[100] Two rules were specifically aimed at pool activities: One prohibited specialists from participating in joint accounts with nonmembers,[101] while another prohibited specialists from acquiring various kinds of options pertaining to issues in which they specialized.[102] Finally, one rule merely repeated the statutory mandate limiting all specialist transactions as principal to those reasonably necessary to maintain a fair and orderly market.[103]

In its Segregation Report, the Commission did not recommend separation of the broker and dealer functions, although problems arising from the mingled functions were recognized and further study was suggested. The report discussed and analyzed the contentions in favor of and against the specialist system. Most important were these conclusions:

> Recognition must be given to the fact that the specialist in acting both as broker and dealer has an inherent conflict of interest. From the present evidence it is not possible to conclude whether that conflict can be eliminated in such a way as to enable him to function more adequately in the public interest. Further exploration of such a possibility * * * should be continued.[104]

Finally, in 1937, the Commission set forth by means of an interpretation [105] its regulatory position with respect to specialists and their functions. This interpretation, which still embodies the Commission's policies with respect to specialists, came to be known as the Saperstein Interpretation (named for the Director of the Division of Trading and Exchanges who prepared it). It avoided hard-and-fast rules and defined permitted transactions under the statutory standard—"reasonably necessary to permit him to maintain a fair and orderly market"—as those which enhanced price continuity and minimized the effects of imbalances between supply and demand. Also, it made clear that each specialist-dealer transaction, and not merely the total course of dealing, had to meet the test. Thereafter the NYSE added portions of the Saperstein Interpretation as interpretative material to its own rules.[106]

The regulatory pattern has remained unchanged since 1937 despite the increasing emphasis on the dealer function. The policy underlying

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[99] Now NYSE rule 103.
[100] Now NYSE rule 121. This material must be kept for 1 year.
[101] Now NYSE rule 94.
[102] Now NYSE rule 105.
[103] Now NYSE rule 104.
[104] Segregation Report, p. 111. The report also suggested three specific rules to govern specialist trading. These rules are discussed in sec. 6.b, below.
[105] Securities Exchange Act release No. 1117 (Mar. 30, 1937).
[106] NYSE Guide, par. No. 2104. The interpretation and the NYSE rules are discussed in sec. 6.b, below.

the Saperstein Interpretation was to minimize specialist trading by testing each trade with a standard of market necessity in order to minimize the conflict-of-interest problem and the trading advantage of the specialist, but the criteria of the interpretation have apparently been flexible enough to justify increased specialist trading if market conditions dictate. Thus, the growth of the dealer function has tended to negate or at least obscure the original purpose of minimizing the problems of conflict of interest and trading advantage, even while the expressed criteria have been found applicable to new conditions. As is shown in the following sections, problems of specialist trading and conflict of interest are still fundamental ones.

4. STRUCTURE OF THE NYSE SPECIALIST SYSTEM

a. Size and form of specialist units

As noted above, 360 NYSE members are registered as specialists. They are organized into 110 specialist units of between 1 and 9 specialists (table VI-5). Each of these units may be composed of individuals or legal entities of various kinds. A few of these units are registered in the same stocks and compete with each other. As of May 1963 there was one individual specialist who was unaffiliated with another unit and had no partner off the floor. The internal composition of the specialist units and their variation from one another present a highly complex picture. The wide range of the organizational techniques employed is merely the background for the wide variations of size and also of capital and performance.

The components of specialist units include individuals, partnerships, corporations, joint accounts, and combined books. Partnerships and corporations take their conventional legal forms. A joint account would be described in legal terms as a joint venture, and may be made up of two or more individuals, partnerships or corporations. In joint accounts, the participants keep separate books for brokerage orders, but maintain a single trading account.[107] The converse of the joint account is the combined book, in which the trading accounts of the participants (who again may be individuals, partnerships or corporations) are maintained separately, but the participants are partners for purposes of the brokerage aspects of the business. Thus, while there is a single book for purposes of accepting and executing brokerage orders, for trading purposes each participant acts according to his own judgment and profits or losses are not shared.

As the following table indicates, partnerships are the predominant form of organization:[108]

TABLE VI-c—*Components of the 110 units*

Partnerships	114
Combined books	30
Joint accounts	25
Affiliated and unaffiliated individual specialists	21
Corporations	9

[107] The participants in the joint account divide the profit or loss from the trading account as they agree. For orders that a participant may execute for the joint account, he charges the account floor brokerage.

Brokerage income cannot be divided between the joint account participants, since Exchange rules require that the minimum brokerage fees can go only to the member who executes the transaction. If the participants of a joint account decide to split brokerage income according to a predetermined ratio, the book must be transferred between them so that each participant is able to execute his share of orders. See sec. 5, below.

[108] As of February 1963.

The unit of average size has three specialists. However, the largest units—those comprising the top 10 percent of all units—have an average of seven members and represent 22 percent of all specialists (table VI-6).

The average number of common stocks assigned to specialist units is 12. Most units handled between 6 and 15 common stocks, but there are 2 handling between 36 and 40. The 11 units constituting the top 10 percent handle 269 stocks, for an average of 24 stocks per unit. These 269 stocks represent 21.2 percent of all common stocks; the 10 units constituting the bottom 10 percent had 31 stocks, representing 2.4 percent of all common stocks or 3 common stocks per unit (tables VI-7 and VI-8).[109]

Total annual share volume of stocks handled by the units show a similar pattern, ranging between 1 and 40 million shares; average annual volume for all units was 10,428,000 shares. The 11 largest units had three times the average volume, while the smallest units had about one-fifth of the average (tables VI-10 and VI-11). As is shown in this and succeeding sections, differences in size of units and concentration of issues have a direct impact on the kinds of markets maintained by specialists.

b. Specialist income

Specialist income comes from two sources, floor brokerage and trading profits. The gross income of all NYSE specialist units in 1959 and 1960 was computed from questionnaire EX-1 as follows:

TABLE VI-d.—*Gross income of NYSE specialists*

	Amount	Percent of total
1959:		
Commissions	$19,590,000	48
Trading profits	21,237,000	52
Total	40,827,000	100
1960:		
Commissions	18,919,000	55
Trading profits	15,769,000	45
Total	34,688,000	100

While the aggregate figures show that both brokerage income and trading profits are major sources of income, there is extremely wide diversity among the units. Some units realize all their income from brokerage, while others earn as much as 80 percent from trading profits (table VI-12). This may simply reflect the fact that different units have different kinds of securities—some securities are primarily commission stocks (referred to by specialists as "bread and butter issues"), while others generate trading profits. On the other hand, certain specialists are more aggressive traders. Whatever may be the cause of this range in the composition of income, it is but one example of the diversity among NYSE specialist units.

[109] Between 1957 and 1961, although volume on the Exchange almost doubled, the number of specialists and the number of issues per specialist moved within a narrow range. In fact, despite extremely differing market conditions over the past 25 years, the number of specialists has varied only from a low of 312 in 1945 to a high of 382 in 1939 (table VI-9).

At the upper end of the scale of income distribution, there is even more concentration than in the distribution of stocks. In 1960 the top 10 percent of all units earned 38 percent of total income, 26 percent of all commission income, and 52 percent of all trading profits. The figures were similar for 1959: the top 10 percent accounted for 38 percent of total income, 24 percent of all commission income, and 50 percent of all trading profits. It is noteworthy that the top 10 percent of units had greater trading profits than commission income. At the other end of the income scale, the lowest 10 percent of the units accounted for 0.4 percent of all income in 1960 and 1.1 percent in 1959 (tables VI-13 to VI-17).[110]

Expenses of specialist units seem fairly standard, and, in relation to expenses in other areas of the securities business, fairly low.[111] Many specialists run their business "out of their hat" with the assistance of a few clerks. They have no offices of their own; such office space as they may require is provided for them as an accommodation by their clearing agents. Firms which clear for themselves, or engage in other activities of course have their own staffed offices. The specialist's ability to run a large volume business at relatively modest costs as compared to other areas of the securities business illustrates the fact that the specialist is a middleman-wholesaler.

c. Specialist capital

Exchange policy requires that each specialist unit must be able to assume a position of at least 400 shares of each 100-share-unit stock, and 100 shares of each 10-share-unit stock in which it is registered.[112] The Exchange interprets the rules as placing a continuing capital obligation on specialists and routinely determines the amount of capital required of each unit. In fact, this capital requirement is now thought of as nominal, most specialists having more capital than the required amount.[113] As will be seen, this low requirement permits extremely wide diversity among the units.

Most specialists have purchasing power significantly above their actual invested capital, as the result of 25 percent margin maintenance agreements with their clearing agents. Exchange Rule 431, which generally prescribes a 25-percent maintenance requirement,[114] is the only restriction on the specialist's ability to margin his position. The Federal Reserve Board in 1949 exempted specialists from the margin requirements of regulations T and U, and this exemp-

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[110] In 1959 one unit had a loss from trading which exceeded its commission income; in 1960, two units had such losses.

[111] Each member registered as a specialist is required to pay annually a registration fee of $300 and a post space rental ranging between $1,000 for the smallest specialist units to over $6,000 for the larger units. Each unit employs specialist clerks on the floor: larger units will have up to eight or nine clerks. Generally speaking, these clerks' earnings are in the $5,000 to $8,500 per year range. There is also a $120 annual registration fee for each specialist clerk. Clearing expenses are similar to those incurred by all Exchange members. In addition, 32 specialists rent telephone booth spaces; the rents range from $320 to $1,100 per annum.

[112] The specialist at Post 30, the inactive post, must at all times have net liquid assets of $50,000. NYSE Guide, par. No. 2104.20.

Specialists on the Amex, under a recently instituted change in the capital requirement, must have a cash liquid asset position enabling them to assume a position of 10 round lots in every security in which they are registered, or $50,000, whichever is greater. However, the Amex rule may still require less capital than the NYSE counterpart because of the generally lower prices of Amex securities. (See ch. VIII.B.)

[113] The rule says nothing as to the form in which capital must be carried. A prior rule in effect in 1949 expressly required that such capital be in "the liquid form of either cash or readily marketable securities."

[114] The rule permits the specialists and their clearing agents to agree that the specialists' equity may fall below 25 percent, but if this occurs, the deficit is charged as a debit against the clearing firm's net capital.

tion has been characterized as the real foundation of the specialist's ability to trade and assume positions.

The accounts of specialists who do not clear for themselves are usually carried by their clearing agents, as margin accounts. Certain of these clearing firms, who may be specialists themselves, carry margin accounts for a significant number of specialist units. An example is one leading specialist firm which carries accounts for eight units. Such arrangements give a relatively few member firms considerable authority over the activities of many specialists, whom they may direct to reduce positions or commitments when the accounts approach the 25-percent limit.[115]

One of the questions in questionnaire EX-1 concerned specialists' capital.[116] Computations from the figures submitted show the net capital employed by each unit in the conduct of its specialist business for the first and last days of 1959 and the last day of 1960. The capital, as computed, included cash available for the unit, the value of specialty securities held by the unit (at their cost), and any credit balance, less the market value of specialty stocks in which the unit may have been short and any debit balance. The resultant figure was the specialist's liquid capital actually used to assume positions in specialty securities at these three times. This figure did not include other assets that specialists had available but did not employ in their specialist business.

NYSE specialists employed $69,099,000 in 1959 and $76,285,000 in 1960 of such capital in their business. This would be an average of $628,200 per specialist unit in 1959 and $693,500 per unit in 1960, although for both years about one-half of the units had less than $300,000. The variation among the units is significant: most units were clustered at the lower end of the scale, while those in the upper 10 percent of the scale had over 50 percent of all specialist liquid capital (tables VI-18 and VI-19).

The data also indicate a relationship between the number of common stocks per unit and the capital. Thus, the top 10 percent of units with the most capital used in carrying positions (during 1960) had 218 common stocks assigned to them (in 1961), averaging $193,080 of capital per common stock. Those units comprising the bottom 10 percent of units in the amount of capital had 80 common stocks assigned to them and averaged $6,370 per common stock.

This does not seem to be an accidental result. The extent to which specialists are willing and able to employ substantial capital in their business has an important effect on their dealer activities.[117] As noted above, NYSE policy has favored so-called "dealer" specialists in the allocation of important issues and, since specialists tend not to take large positions in less active stocks,[118] a pattern develops in which the well-capitalized specialist receives the lion's share of important, active issues; this leads in turn to a greater employment of capital by the more heavily capitalized units.

Another analysis sought to determine the specialists' gross rate of return on the liquid capital employed in their business plus the value

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[115] This power has been used and is discussed more fully in sec. 6.f, below.

[116] See app. VI-B. Because of the complexities in this area, this question was supplemented by further communications with specialists and their clearing agents.

[117] See sec. 6.d on problems arising from specialist participation and sec. 6.h on specialists' ability to bid for blocks.

[118] See sec. 6.c, below.

of their Exchange seats. Total income was compared to this capital figure (table VI–20).[119] It should be emphasized that these are gross and not net return figures.[120] The anlaysis showed a fairly wide dispersion among units; most had a return ranging between 10 and 50 percent. There was no pronounced relationship between capitalization and rate of return, although some of the more heavily capitalized units fell into the higher ranges.

In summary, NYSE specialist units show great diversity in size, number of specialty stocks, source of income, capital, and rate of return. The larger units tend to have more than their proportionate share of capital, indicating a greater ability to service the market adequately. However, as unit size increases, the major source of income shifts from brokerage income to trading profits, which suggests that trading may become an end in itself.[121] As also suggested by these data and as discussed more fully below, specialists' market participation seems to be keyed to their capital ability rather than to any uniformly interpreted standard of responsibility.

5. THE BASIC BROKERAGE FUNCTION—THE SPECIALIST'S "BOOK"

As noted above, the continuous auction market and its physical organization into different posts require that there be some mechanism to store and execute limited price orders.[122] The specialist brokerage function has evolved to meet this need,[123] although specialists also accept market orders.

Specialists are compensated for executing agency orders by the firms which transmit such orders to them. The fact that the forwarding firm pays a portion of its commission to the specialist does not affect the total commission paid by the customer who originated the order. The specialist's portion of the customer's commission is known as "floor brokerage" and there is a prescribed minimum amount set by the NYSE constitution which is the same as that paid to independent brokers when they execute orders on the floor.[124] On the Amex, contrary to the NYSE practice, when an order is transmitted to a specialist, floor brokerage may be shared by the specialist with the forwarding broker.[125] A substantial percentage of all round-lot orders on the Exchange are executed by specialists in an agency capacity. As indicated previously, aggregate specialist brokerage income for 1959 and 1960 was $19,590,000 and $18,919,000 respectively. Since

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[119] It might be argued that the proper rate of return should be restricted only to trading profits, since this is the direct employment of the capital. However, an integral part of the specialists' activities consists of executing brokerage orders and the two functions are always viewed as interdependent.

[120] Just as there are no uniform concepts used to identify specialist capital, there are likewise no uniform methods by which costs may be properly allocated, and therefore it was not possible to arrive at a net return. The representatives of the NYSE have recognized that for the determination of profitability, it would be necessary to standardize accounting procedures.

[121] See sec. 6.d, below.

[122] Such a mechanism must also include a system to determine priority between such orders. Under Exchange practices, orders entrusted to specialists are generally handled on a first-in-first-out basis.

[123] Legend has it that the first specialist was a floor broker whose activities were confined to a particular section of the floor by a broken leg. Apocryphal or not, it is fairly clear that the first specialists were differentiated from their fellow floor brokers only because they "specialized" in specific stocks, accepting brokerage orders from other members.

[124] NYSE constitution, art. XV.

[125] Amex constitution, art. VI. There is one exception to the NYSE practice that specialists must receive floor brokerage for orders they execute, which relates to orders executed at openings. See sec. 6.j, below. See pt. I of this chapter for further discussion of the minimum commission schedules.

average floor brokerage is about $3.85 per round lot, specialists executed as agents about 5,088,300 round lots in 1959 and 4,914,000 in 1960 out of a maximum of 17,164,020 possible round-lot orders in 1959 and 15,866,700 in 1960.

This section contains an examination of the kinds of orders accepted by the specialist in his brokerage capacity, and of the specialist's book and its uses.[126]

a. Orders accepted by specialists

Section 11 [127] of the Exchange Act prohibits, without exception,[128] a specialist's effecting "any transaction except upon a market or limited price order." [129]

The statute does not define limited or market orders. In common usage, a limited order is one that limits the discretion of the broker who holds it—he may execute it only at the price specified or better. For example, an order to buy a particular security with a limit of 50 may be executed only at that price or lower. If the market moves below 50, it is the broker's responsibility to execute it at a lower price if possible.

When the price moves to a point that the public bids held by the specialist at 50 are capable of execution, the order first received by the specialist at that price will normally be executed first. Specialists do not guarantee that all orders on their book at a particular price will be executed merely because the senior order at that price has been executed. Each order must await its turn for execution under technical auction market rules.[130] If another customer who had entered an order at the same price sees an execution on the tape at 50 (when the senior order is executed) and inquires as to the status of his order, he will be given a report "stock ahead," and on further inquiry he can usually determine the number of shares ahead of his order.

Although the statute refers to limited price and market orders, specialists also accept "stop" orders, a variant of both limited price and market orders. These are orders to sell securities when the current price declines to a specified point [131] or to buy when the price increases to a specified point.[132] When the price reaches the specified point, the stop order becomes a market order and is handled as such.[133]

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[126] The various problems which arise from the fact that specialists act as agent for many customers on both sides of the market, and also act as dealer, are discussed in sec. 7, below.

[127] See sec. 3.b, above.

[128] Under sec. 11(c), upon a finding of limited volume on the particular exchange, the Commission may grant appropriate exceptions to all provisions of section 11 (a) and (b).

[129] The section also restricts disclosure of information regarding orders on the specialist's book which is not generally available to other members. The Commission is given authority to require disclosure to all members of *all* orders held by specialists, but this authority has not been exercised.

[130] See pt. B of this chapter.

[131] These orders are commonly known as "stop-loss" or "sell-stop" orders.

[132] These orders are known as "buy-stop" orders. While the term stop-loss orders implies the reason for their use by investors, the function of buy-stop orders may not be as apparent. One principle reason for the use of such orders is similar to that for the use of stop-loss orders, in that an investor with a short position may desire to protect his profits or cut his losses when prices increase to a certain level. The other principle reason is that investors who make their decisions on a so-called "technical" basis may believe that a stock is not a "buy" until the price increases to a particular point.

[133] There is a variant of stop-orders known as "stop-limit" orders. Such orders contain a second specified price away from the market beyond which they may not be executed. In other words, a stop-loss order with an effective price of 50 becomes a market order at that price and may be executed at the best available price—not necessarily at 50. A limit such as 48 may be placed on the stop-loss order, preventing an execution at a lower price than 48. NYSE specialists ordinarily accept both stop-loss and stop-limit orders. Amex specialists are permitted by that Exchange to accept only stop-limit orders.