In summary the orders were entered because of the necessity for complying with the capital requirements of the Exchange. [The specialist] was not available and the partners gave out the orders to another firm for execution. In view of the fact that there was no violation of the rules involved, it seems this matter should be dropped.

A specialist and former chairman, whose firm is one of the most prominent clearing agents for NYSE specialists, testified on the financing arrangements between specialists and clearing firms.[273] He stated that a clearing firm had no obligation to inform the Exchange before instructing a specialist to liquidate a position because of financial difficulties. He was asked whether he would issue such an instruction without knowing whether the liquidating transactions would be reasonably necessary to maintain a fair and orderly market. He answered:

A. Under those conditions, he has no choice. That again is an exception. This is not the ordinary run of specialist dealing. This is a case where the boy is in trouble and he doesn't want to but he has no choice. He must liquidate his position. If he didn't, I would refuse to accept his transactions.

Q. You don't think there would be any prior obligation to inform the Exchange?

A. There could not be. The Exchange should have nothing to do with that. That is a relationship between the specialist and his clearing agent. I would certainly report it to them but I would not ask their permission or try to tell them in advance what I was telling him to do. In my opinion, you just couldn't do that.[274]

When a specialist has moderately large positions a forced liquidation could have a serious market impact, but under present procedures the facts might not come to the attention of the Exchange until after the damage was done. It was testified that the Exchange took special precautions during the market break in May 1962 to ascertain the financial condition of specialists. Yet on May 28–29, 1962, when the Commission inquired of the Exchange as to the financial condition of specialists, the reply on both occasions was that there was no indication that any specialists were in difficulties. Either the Exchange's procedures were inadequate to ascertain the facts in this vital area or the findings were not revealed to the Commission.

When the specialist is in financial difficulties and is forced to liquidate his position, the stocks in which he is registered are effectively without the benefit of a responsible market maker. Specialists who are in weak financial condition, and unable to obtain additional financing, should have their stocks reassigned temporarily or permanently to another unit. Furthermore, any member firm which clears for specialists or finances them should be prohibited from terminating clearing arrangements or calling for additional margin without adequate prior notice to the Exchange.

g. Continuity with depth

Since a private dealer system cannot and should not be expected to stabilize the market (in the sense of holding price levels or stemming price trends) and since the data show that the impact of specialists' trading is probably minimal in affecting overall market movements,

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[273] As noted in sec. 4.c, above, NYSE rule 431 permits a financing clearing firm to carry a specialist account below the 25-percent maintenance requirement with the deficit charged against the clearing firm's capital.

[274] This clearing firm attempted to compel an Amex specialist to liquidate his position because he was in financial difficulties. Sometime later, in June 1962, another clearing firm terminated its arrangement with that specialist without sufficient notice to the Amex to prevent disruption in the markets of a number of actively traded issues.

the question remains whether and to what extent the specialist's role extends beyond the mere linking together of buyers and sellers. The answer would seem to lie in what might be termed "price continuity with depth"; i.e., a market which moves in small fractions but in which the specialist stands ready to make reasonable capital commitments at each significant price level. An extreme example of price continuity *without* depth may serve to illustrate the point.

On Friday, May 25, 1962, Columbus & Southern Ohio Electric closed at 62 on the NYSE. At that time there were about 2,800,000 shares of common stock outstanding held by some 19,729 shareholders. The price of the stock had been drifting down during the preceding week, along with other utilities. On Monday, May 28, 1962, the company announced increased earnings.[275] The price gyrations of this stock on May 29, are illustrative of many of the problems of the specialist dealer function. A summary of the stocks' price movement follows:

TABLE VI–i.—*Summary of the price changes of Columbus & Southern Ohio Electric*

	Volume	Open	High	Low	Close	Change
May 28	3,000	62	62	60	60	−2
May 29	6,700	57½	57½	39½	49¾	−10¼
May 31	9,200	60	61	59½	60	+10¼
June 1	2,100	59¼	59¼	57¾	58½	−1½

The stock opened on May 29 at 57½, down 2½ from the previous close. Within an hour and thirty-nine minutes after its opening, and after only 4,300 shares had been traded, the stock had declined to 39½,[276] a drop of one-third in price. Of the 4,300 shares traded, the specialist unit purchased 4,100. Each transaction but 1 involved 100 shares, and the variations between sales were one-half point from the opening until the price of 46½; thereafter, the variations were 1 point. One transaction during the decline was for 600 shares and involved a 2-point decline from 50 to 48. The rally in the stock followed the same pattern. After the market turned, the price increased on 1-point variations between sales up to 47, and thereafter on half-point variations to the closing price of 49½. All of these trades involved 100 shares. The next day the stock opened at 60 with 8,000 shares traded at the opening. The stock continued to trade in a narrow range and closed at 60. Applying the tick test, the specialist unit had a stabilization percentage of 100 percent on May 29.[277]

As a result of these price gyrations the Exchange opened an inquiry into whether the specialist unit had maintained a "fair and orderly market in the stock on May 29, 1962." After setting forth the price action of the stock the floor department stated:

[275] Earnings and dividends had increased steadily over the last few years. On June 1, 1962, the dividend was again increased.

[276] Two sales—the low of 39½ and the immediately preceding sale at 40½—were not reported on the tape. When the Exchange inquired into the reason for this, the specialist's answer was nonresponsive; the record reflects no other inquiry.

[277] After the price of the stock turned, the specialist sold 1,500 shares and bought 500 shares, participating in all but three transactions. Before the opening on May 29 he had a short position of 100 shares; his maximum long position during the course of the day was 3,800 shares. At the end of the day this had declined to 2,700 shares, which were sold at the opening on May 31 and a 900-share position was accumulated. At the close of May 31 the specialist was short 1,000 shares, which was reduced to 300 shares short by the close on June 1.

If the specialists had not participated as dealers, I would think that they should lose the stock. They did deal to a substantial degree. Yet I would not consider this an adequate market even though consideration is given to the conditions which prevailed and the absence of practically any buy orders at any price.

The specialist who handled the stock for his unit was questioned by the Exchange about the price movements of the stock.

Q. Did you give any thought at all to the possibility, due to the lateness of the tape, that the prices of this stock were not known to the people generally watching the tape?

A. Briefly, but that was a condition prevalent throughout the market. I was aware that the tape was running very late.

* * * * * * *

Q. Did this [the price movement] strike you as being unusual, even with respect to the other stocks?

A. Yes; but that day struck me as being very unusual. * * *

Finally, the specialist was asked a general question about the price action of the stock and his activities:

Q. * * * Here we have a stock that sold down 20½ points in one day, and on the opening the next day, was right back up. On the surface alone, this certainly does not look like what, in a stable utility stock, would be considered an adequate market. Would you care to make any comment?

A. Adequate market is a rather loose term. The only other thing that might have been done was to stop trading on the 29th of May. I felt that a specialist's duty is to try to maintain an adequate and orderly market; if not too great a variation between sales. And I felt we were doing just that, as we bought practically every share that sold down. Looking back on the situation, it is always easy to see what might have been done. This is a question of opinion, as I stated before. My thought was to keep the market going in as orderly a fashion as possible, considering the day and the times involved.

As a result of the investigation the specialists in the unit were called before the chairman. They were told that the price gyrations in the stock had been unfortunate and that had this not occurred during a general market break their performance would have been "completely inadequate." The floor department memorandum also states:

[The chairman] mentioned that they have been of the opinion that they had maintained an orderly market by seeing that the size of the variations between sales was one-half of a point and then one point. Nevertheless, he informed them that they had shown poor judgment. They were told that they should have taken a broader view of the situation, especially after the stock declined 10 points [on May 29] and called a governor into the crowd so that trading could have been halted until the situation clarified. This might have resulted in a better market. In any event, they should not have widened the size of the variation to one point in a utility stock of this caliber prior to discussing it with a governor of the Exchange. * * * The chairman stated that [the specialist] assured him that such a situation would never arise again, and that he told them that in view of the fact that they had dealt to such an extensive degree in the stock, no further action would be taken.

It should be noted that the specialists were not told that they should have bought more stock at higher prices but rather that they should have had trading halted.[278] Neither the floor governors nor the specialists considered whether the specialists' activity had been stabilizing—the specialists merely offering the defense that there had been reasonable price continuity which they seemed to equate with an

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[278] The statement that in view of the specialist unit's "extensive" dealings no further action would be taken is in line with the policy mentioned in sec. 6.c, above, that a heavy participation rate is usually considered exculpatory.

orderly market. The fact that the tick test showed 100-percent stabilization was not discussed—probably because its inadequacy as a measurement of stabilization is apparent in this case.

No one would suggest that the specialist had a duty, or that it would have been proper for him, to "peg" the price by buying all the offered stock at the opening price. On the other hand, it will be recalled that the Exchange has pointed to the specialist system as necessary to prevent unreasonable and excessive fluctuations which inter alia destroy the value of securities as collateral.[279] The technical price continuity provided by the specialist in this stock did not meet this criterion.

Had the specialist even doubled the size of his bids from 100 to 200 shares the decline would probably have been substantially less than it was: The specialist, by giving reasonable size (under the circumstances) to his bid or offer at a particular level, adds depth as well as continuity to the market. Although the effect here would have been to reduce the price movement of the stock, this would not have been the purpose of the specialist's transactions. The purpose would have been to give the stock adequate volume at each price level. Markets without depth detract from the worth of quotations and previous sales as indications of value. This does not mean that stocks selling at high prices should only move in the smallest fractions permitted; it does mean that in addition to reasonable price continuity the specialist should provide reasonable depth.

In fact, in specific cases the Exchange has occasionally criticized specialists for failure to give markets depth.[280] Yet none of the routine tests are used in such a way as to isolate this factor. Although the complex factors involved cannot be reduced to a mechanical formula, if the tests focused on the extent to which specialist trading prevented prices from reaching new levels, in light of the quantity and the purchase or sale predominance of public activity, there could be a clearer indication of specialist performance. The Exchange's present measurements focus only on price continuity and on the specialist's participation without attempting to combine the two, so that no judgment can be made as to whether a market is satisfactory as a result of the specialist's trading activities or whether such activities are "reasonably necessary." In effect, the Exchange may be measuring the public market. And as was pointed out above, the best way that specialist performance can be measured significantly is by the specialist's trading pattern in, and impact upon, a specific stock on a specific day.

There is no doubt that by providing depth in both good markets and bad, the specialist is more likely to accumulate an inventory and thus increase his risk. However, the business of the specialist is not an unrewarding one. A responsibility to provide continuity with depth is the reasonable concomitant to the many privileges specialists enjoy. In positioning himself for anticipated price movements the specialist may trade to accumulate inventory, which would increase his dealer profits beyond the "jobber's turn" if his market judgment is correct.[281]

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[279] See sec. 6.a, above.

[280] It is puzzling that this concept only appears by implication in the Columbus & Southern file.

[281] It may be noted again that the specialist, with his exclusive knowledge with respect to his stocks, is in a better position to make an informed judgment than anyone else. As one specialist testified:

"I sensed a general rise in the market, as you do. You can tell after you have been there 40 years. Why you can tell whether the market is going up or down."

One specialist testified that, as a result of his judgment of market conditions, he tries to adjust his inventory:

A. * * * If the market is going up, you try to be on the long side. If the market is going down you try to be on the short side.
Q. This from the standpoint of whether [specialists] are going to be able to make money in their dealer transactions?
A. This is right.

Both the accumulation and liquidation of inventories in anticipation of price movements permit the specialist to trade with the trend.[282] Thus, in a rising market the specialist may occasionally tend to purchase moderately on balance—and is permitted by the Saperstein Interpretation to do so—in anticipation of being a seller as the price continues to increase. Conversely, anticipating a decrease in price, the specialist may tend to become a seller on balance and take a short position in anticipation of being a purchaser during the decline. In either case, at the completion of the process, the specialist is in a position to act in some degree as a stabilizing force; at this point a degree of depth in his market may logically and fairly be expected.

The connection between specialists' positioning themselves and adding depth to the market is not a new one. In his 1941 book, Vernon stated that the possibility existed:

* * * that in crucial periods the specialist foresakes * * * trading "with the trend" and offers much needed support, or otherwise acts to stem a sharp unwarranted rise or decline in stock prices. Perhaps such exceptional behavior, if it exist[s], would be of sufficient weight to offset * * * [a] tendency to exaggerate stock price movements.[283]

It must also be remembered that the specialist is not purely dependent upon his trading acumen for his income. Not only does the book serve on occasion as an outlet for excessive inventory, but the brokerage function serves as a relatively riskless source of income.[284] Although the arguments against the separation of the brokerage and dealer functions have been stated in various ways, the common theme has been that the functions are interdependent—an interdependence that reenforces the view that the specialist as a market maker has a responsibility to provide markets with reasonable depth. If the conflict of interest between the two functions is to be tolerated the duty to the customer must include the obligation to maintain markets which are fair and reasonable: This is the only basis on which an agent who intimately affects the market in which his principal deals can and should be permitted to occupy a position technically adverse to his principal. Since access to the floor confers substantial trading advantages, even without the special knowledge available to the specialist, the privileges enjoyed by the specialist are compatible with the

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[282] See sec. 6.b, above, where the specialist purchased all of the offered stock in American Natural Gas, contributing to an immediate increase in price; see also the cases cited there where the Exchange seems to have evolved a rule of thumb limiting such transactions to 50 percent of the offered stock so as to ameliorate the effect of such transactions.
The one-third of the stocks in the study (discussed in sec. 6.e(3), above), which had balances with the trend as well as a high number of destabilizing transactions, may represent extreme manifestations of these practices.

[283] Vernon, "Regulation of Stock Exchange Members," pp. 93–94.

[284] At the time of the Segregation Study it was argued that the brokerage function entailed enormous contingent liabilities. As a practical matter the only possible liability is "missing the market," and many specialists testified that this very rarely happened to them because of their central location in the marketplace. The only specialist who testified that he missed markets with some frequency stated that this happened because he often attempted to better a cusomer's limit and in doing so, would miss the market if his judgment erred.

statutory scheme only if his duties to the public investor are not terminable at will but continue reasonably through good markets and bad, through profitable and unprofitable periods. In finding the balance between profit and responsibility, the regulatory processes must evolve a more sophisticated approach to the examination of specialist trading, its market effects, and the profitability of the business.

h. Specialists and block transactions

The role of institutional investors on the New York Stock Exchange has increased substantially over the last 10 to 15 years.[285] The needs of these investors are sometimes different from those of the smaller investors because institutional transactions are more likely to involve a large number of shares. Blocks of shares are often too large to be readily and promptly absorbed or supplied through the routine procedures of the auction market, but not necessarily so large as to require the use of any special distribution or acquisition plan.[286] The specialist, stationed in the center of the auction market, has an important role in the handling of blocks both as broker and as dealer.

There are substantial differences among specialists as to their dealer activities with respect to block transactions. Differences in capital ability and willingness to assume risks are reflected by the fact that some specialists will frequently make bids for 10,000 shares, whereas other specialists will limit their purchases to 5,000 or 6,000 shares and will not normally buy more. One specialist felt that his function is not to buy blocks but to stay in a liquid position in order to provide market continuity. Specialists who have achieved a reputation for dealing in blocks may be contacted directly by, and trade directly with, investors who desire to deal in large blocks.[287] Other specialists, as a matter of philosophy, refuse to deal directly with such investors and insist that all orders go through the office of a regular commission firm. The differences of ability and willingness of specialists to deal in blocks has been noticed by institutional investors, one of which stated in answer to questionnaire IN–4 that the over-the-counter market in listed securities [288] was used when the Exchange market was "thin or unorderly * * * in a particular stock." Another stated that over-the-counter dealers often had NYSE-listed securities available "at lower net prices and in greater volume." A third responded as follows:

> * * * The greatest single problem for an institution, in my opinion, is the thinnest of the market for most stocks and the enclosed forms indicate the tremendous amount of paperwork and expense involved in acquiring a block of stock on the stock exchange where we must buy a few hundred shares at a time. In an effort to avoid this we often trade blocks over-the-counter.

Finally, one institutional investor wrote:

> From time to time we have felt that some of the specialists on the New York Stock Exchange were not active enough in their assigned stocks. We wonder if

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[285] For a discussion of institutional participation and block transactions, see ch. VIII.C. Over 60 percent of the specialists noted in questionnaire EX–1 that over the last 5 years the number of blocks has increased.

[286] These special plans are discussed in chapters IV.D and VIII.C.

Of course, the number of shares constituting a "block" varies for different stocks, different specialists, and the state of the market; e.g., for some stocks 1,000 will be considered a large block while for others 5,000 or 10,000 will not be thought too large to handle ordinarily.

[287] One former chairman stated that he deliberately seeks to be known as a specialist who deals in blocks because this "brings us business."

[288] See pt. D of ch. VIII for a discussion of this market.

the standards, which have been established by the board of governors of the stock exchange for judging whether or not a specialist is adequately fulfilling his responsibilities are sufficient.

Two experienced specialists testified that the basic problem in connection with blocks is to get the specialist to make a bid at no more than a reasonable discount from the last sale. Underlying this is the fact that a specialist purchasing a block faces the same economic problem as that present in dealing in an inactive stock, i.e., it may be some time before sufficient matching counter orders arrive, and until that time the specialist is left with an inventory at the risk of the market and with his capital tied up.

Aside from willingness to deal, the capital ability of a specialist is of obvious importance. The best capitalized specialists are known for their ability to make substantial bids. The three units with the largest aggregate long and short position at June 16, 1961, had 27.0 percent of all specialist positions. These units represented 31.8 percent of total specialist capital used in carrying positions (during 1960), and had capital per assigned common stock ranging from $130,000 to $550,000. In contrast, the average capital per common stock for all units was $60,000.

Thinly capitalized specialists who want to bid for a block but are close to the 25 percent maintenance requirement must get permission from their clearing agent to go below this level. One clearing agent testified:

> * * * Occasionally a specialist will be asked to make a bid on a block of stock in which he is registered as a specialist. He knows if he does it is going to bring him below the 25 percent. He might come by and say to me, "Is it all right if I bid for [a] block of stock and if I buy it will bring me below the 25 percent." I will figure up what money is and the answer is generally "Yes." Because he is not an investor, he is going to peddle it.

In 1953 an Exchange-appointed committee studying "Broadening the Auction Market on the New York Stock Exchange" recommended an increase in specialists' capital requirements. However, no action was taken then, and when the matter was studied 2 years later the proposal was not repeated; this latter study is discussed below.

Various techniques involving the participation of specialists have evolved for the handling of blocks. Specialists may purchase the block as principal, either within the market or off-board under the provisions of rule 107(a), permitting purchases of blocks by specialists off the Exchange.[289] The block is often purchased at a discount from the last sale. The discount serves as a limited hedge against market drift and is functionally similar to a wide spread in inactive stocks.[290] The amount of the discount will depend in part on the activity of the stock and the inventory position of the specialist. A realistic discount from the seller's viewpoint may not adequately protect the specialist from market risks. Confirmation of this is found in the experience of specialists, one of whom testified that where the book was thin a moderate discount was not sufficient since "* * * I kind of felt I would have a poor opportunity of disposing of my stock in the open market."

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[289] There is a parallel sale rule, rule 107(b).

[290] There is a countervailing factor not present in inactive stocks. When the ticker tape reflects the cleanup of a block, a flurry of buying activity is often stimulated, at which time the specialist supplies stock to the market and thereby liquidates his block and keeps the market orderly.

An examination was made of specialists' activities in purchasing blocks within the Exchange market and under rule 107(a). All specialist purchases within the market of 2,000 shares and over, during the 3-week study, were analyzed to determine the size of blocks that specialists were willing to buy, the discount at which they purchased, and the prices at which the specialist liquidated the block. Of the 1,128 transactions of 2,000 shares or over that appeared on the ticker tape, specialists were the purchasers in 277 instances, or 24.6 percent of these transactions.[291] More than 40 percent of the blocks that specialists bought were over 3,000 shares, 16 percent were over 5,000 shares, and 4 percent (12 blocks) involved 10,000 shares or more (tables VI-40 to 42).

The study indicated that specialists purchased 135 blocks within the market at no change from the previous sale, 44 at a discount of 1/8, 31 at 1/4, and 36 at prices above the previous sale.[292] The differences between the price and the previous sale price could not be determined in 14 cases.

A weighted average price of successive long sales by the specialists up to the amount of the block purchase was calculated in 139 of the block situations. The following is a distribution of the profit per share among the 139:

TABLE VI-j.—*Distribution of profit per share of specialists' purchases of 2,000 shares and over*

Profit per share:	*Number of cases*
Loss	28
0 to $0.24	29
$0.25 to $0.49	32
$0.50 to $0.74	26
$0.75 to $0.99	15
$1.00 and over	9
Total	139

This indicates that when specialists purchased blocks they usually did so without disturbance to the market and in most cases without an unreasonable profit in the liquidation of the block.

Under rule 107(a), the specialist is permitted to buy a block off-board at a discount, with nothing appearing on the tape. He may make such a purchase with the approval of a floor governor, if in the judgment of the governor "the regular market on the floor of the Exchange cannot, within a reasonable time and at a reasonable price or prices, absorb or supply the particular block of stock, and that the purchase or sale will aid the specialist in maintaining a fair and orderly market." [293] The specialist need not fill the bids on his book between the current bid on the floor and the price at which he bought. For example, if the last sale price was at 30 and the specialist held bids on his book at that price and at prices down through 29, and he bought the block at 28 7/8, he would not have to fill the orders of these customers.

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[291] The information for this study was obtained from two different sources. The number of specialist purchases came from reports that specialists filed with questionnaire EX-1; the number of blocks printed on the ticker tape came from the Fitch Sheets. No attempt was made to match specialist purchases with transactions appearing in the Fitch Sheets.

[292] This study cannot be deemed to be conclusive since a few transactions preceding the purchase may have represented smaller portions of the block being executed at declining prices.

[293] NYSE Guide, par. No. 2107.10.

There have been only 76 purchases under rule 107(a) in the 10½ years of its existence, or an average of about 8 per year (table VI-43). In the case of inactive issues, the additional spread received by the specialist apparently is not enough of a hedge, if it is to result in a realistic price to the seller, to induce specialists to make such purchases frequently. A former chairman testified that the plan has not been a success.

The average size of blocks purchased under the rule was 10,200 shares, while the average size of blocks over 2,000 shares purchased by specialists within the market in the 3-week study was 3,800 shares. The two studies were also compared for time of distribution. During the 3-week study, one-half of the blocks over 2,000 shares were distributed within the next 5 trading days; one-third of the purchases under the block purchase plan were distributed in a similar period.

The discounts at which the blocks were purchased under the rule from 1953 to 1962, were: ¼ to ½ in 27 cases, ⅝ to ⅞ in 20 cases, 1 to 1⅜ in 17 cases, and 1½ and over in 12 cases. These discounts appear to be greater than those for block purchases in the regular auction market, described above.

A weighted average price of successive long sales by the specialist up to the amount of the block purchase was calculated in 75 of the rule 107(a) purchases. The following is a distribution of the profit per share among these 75 cases:

TABLE VI-k.—*Distribution of profit per share of specialists' off-board block purchases under NYSE rule 107(a)*

Profit per share:	*Number of cases*
Loss	7
0 to $0.24	6
$0.25 to $0.49	13
$0.50 to $0.74	8
$0.75 to $0.99	9
$1.00 and over	32
Total	75

Thus, the profits under the specialist block purchase plan on the whole seem substantially larger than those on blocks taken in the regular auction market.

When specialists are unwilling to commit too much of their capital to a purchase they will often ask floor traders to help them. However, some specialists have expressed various reasons against calling on floor traders. One stated that he believed that floor traders add unwarranted activity, another preferred not to share any potential profits, while still others are guided by the wishes of the broker involved.[294]

Aside from purchasing blocks, either alone or as a part of a group, a specialist may act as "finder," bringing together the buyer and seller. The specialist's central position in the market place provides him with considerable knowledge of the brokerage firms which represent consistent buying or selling interest in the issue, which may be the issue's underwriter. When specialists act successfully as "finders," they are often given part of the floor brokerage when the transaction is effected. Both the buying broker and the selling broker let the spe-

[294] See pt. F of this chapter for a discussion of the trading patterns of floor traders.

cialist "write out" portions of the order, depending upon how useful to each his services were in making the trade.[295]

In addition to the techniques just described,[296] special distribution plans not involving the specialist are available. Since these distributions are permitted only on the assumption that the regular auction market is unable to absorb the block, their number is in part determined by the willingness of the specialist unit to bid, either alone or as part of a group, for a block. One specialist, whose unit is known for its willingness to buy substantial blocks, testified that there are fewer special distributions in his specialty stocks because his unit makes substantial bids.

Certain of the techniques employed in the execution of blocks may involve fiduciary problems. When a block is purchased by a specialist in the regular auction market at a discount, the buy limit orders on his book are usually filled at their limits and the specialist buys whatever amount he is prepared to take at a lower price.[297] For example, a specialist may be asked to make a bid for 5,000 shares in a stock when the last sale was 35 and the book contains the following orders to buy: 34¾, 500 shares; 34½, 1,000 shares. The specialist might inform the seller that he could sell 500 at 34¾; 1,000 at 34½; and 3,500 at 34, the bid at 34 being the specialist's own, as principal. This is a normal method of operation in "cleaning up" blocks, but it would seem to involve a compromise of the specialist's fiduciary relationship with the buyers on his book, in that he has purchased stock for himself at a lower price than he obtained for his principal. This appeared to be recognized by one specialist who testified:

> * * * [I]f I know that there is a large order coming in and I am bidding for my own account at one price, I attempt to get it for everybody on my book at the same price.

Under the specialist block purchase plan the fiduciary problem is magnified, since the specialist may purchase the stock for his own account at a better price than a customer's limit and yet not fill the customer's order at all. One specialist testified that he did not like to make block purchases under the plan because of this conflict of interest.[298]

In 1955, as part of the Exchange-appointed Vilas Committee study of the operations of the Exchange, block transactions were given considerable attention. A subcommittee, whose report was in substance adopted by the full committee, concluded that the regular auction market, as supplemented by the special distribution plans, was wholly adequate to handle blocks. Its only recommendation, later adopted, was for the undertaking of an educational program to inform institutional investors of the methods available to dispose of or to acquire blocks.[299]

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[295] The "finding" function is considered a brokerage service so that the split of floor brokerage is not treated as prohibited by art. XV of the Exchange constitution. The use of specialists as finders has apparently developed within the past 20 years.

[296] Another brokerage technique, which was utilized until October 1961, was for the specialist to accept a discretionary order for the purchase or sale of a block. The problems with this form of order, known as a "not held" order, are discussed in sec. 7.b, below.

[297] In other cases, the specialist may mingle his bids with those on the book at successively lower prices.

[298] The Commission expressly approved the provisions of rule 107(a).

[299] See Exchange pamphlets, "Now About the Specialist," pp. 9–10, and "Marketing Methods." The committee did not recommend an increase in specialist capital requirements though, as mentioned earlier, another Exchange committee had done so (unsuccessfully) 2 years before.

In its findings, the subcommittee recognized the specialist's importance in handling blocks. At one point it stated that the specialist could satisfactorily "organize his own capital and the capital of others to make a volume market when necessary," but no discussion or recommendation was directed to the underlying problem of the inability or unwillingness of some specialists to make substantial bids, a problem which seemingly existed then but perhaps more clearly exists today.

An increase in specialist financial requirements generally might well prove helpful in dealing with the problem of the block transaction, but only if coupled with more affirmative definition of specialist obligations and surveillance adequate to assure that reluctant specialists would use their capital to an appropriate degree. However, even this will not wholly solve the problem in cases where the risks are too great for one unit to bear alone. At some point it becomes unreasonable to expect specialists to take certain very large blocks even in active stocks or even more modest-sized blocks in less active stocks.

The key here may be found in the testimony of a prominent former chairman. He stated that an argument used to persuade institutional investors to give their business to the Exchange rather than to competing markets is that the Exchange undertakes to make markets in some 1,400 stocks, many of which are difficult to handle, while the competing over-the-counter dealers can restrict themselves to "easy" dealer stocks. In fact, however, the total floor resources of the Exchange are not utilized to service particular stocks, and specialist units by themselves are often financially unable to allocate a sufficient portion of their capital to engage in a large transaction in one of their stocks.

To be better able to cope with the problems of blocks the Exchange should increase the specialist capital requirement and explore the possibilities of a capital fund, from which specialists could borrow to enable them to handle blocks beyond their economic capacity or which may also be used to partially insure specialists against possible losses when they purchase a block of stock. The adoption of such a plan may in fact, give substance to the Exchange's representation that the resources of its members are available for its entire list of stocks.

i. Long-term investment accounts

Specialists' dealings may be motivated by considerations of tax planning rather than by the needs of the market. In the Amex report, certain observations were made with respects to the practice of some specialists on that exchange of segregating securities in which they were registered as specialists in long-term investment accounts:

> The primary motive behind the creation of these accounts is to turn profits which would otherwise be taxed as ordinary income into long-term capital gains. Section 1236 of the Internal Revenue Code is the key provision. It provides that a gain by a dealer in securities from the sale of a security shall not be considered as a capital gain unless: (*a*) the security was identified within 30 days of the acquisition as a security held for investment; and (*b*) "the security was not, at any time after the expiration of such thirtieth day, held by such dealer primarily for sale to customers in the ordinary course of his trade or business."
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> * * * * * * *
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> However, purchases made on the Exchange for the purpose of segregation into long-term investment accounts raise problems which go to the heart of the specialist system. The specialist is permitted to trade for his own account only when such trades affirmatively contribute to the maintenance of a fair and orderly market. * * * Where the specialist goes into the market with the intention of segregating the securities purchased and not with the purpose

of creating a fair and orderly market, the trading is clearly contrary to the statutory and regulatory standards. Beyond this, the specialist with a long-term position now has a stake in seeing that the security rises in price—he has become an "investor" as well as a dealer.

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A further problem arises when the specialist who maintains such long-term accounts is required to sell stock to maintain a fair and orderly market and he has no stock in his specialist trading account. * * * [If] the 6-month period of the tax statute is almost over, the specialist may well be tempted to keep his stock in the long-term account and neglect the needs of the market.[300]

That this practice and attendant problems also relate to the NYSE is indicated by the fact that as of June 16, 1961, when total specialist inventory was 3,229,556 shares, 890,733 shares or 28 percent of the total inventory were segregated into long-term investment accounts.

In response to an inquiry by the Special Study, the NYSE stated its position on long-term investment accounts as follows:

The Exchange also believes that it is perfectly proper for a specialist unit to carry stock in a *Long-Term Investment Account*. This is based on the following considerations:

1. The specialist acquires the position through transactions made to maintain a fair and orderly market;
2. The stock in the Long-Term Investment Account of the specialist unit must be made available to the market if necessary, or the specialist must sell short in an amount at least equal to the amount in the investment account;
3. The specialist does not cause price trends since these are the results of public supply and demand; and
4. The Exchange policies its specialists to see that fair and orderly markets are maintained by them.

The Exchange's position raises questions of consistency with the Saperstein Interpretation, Exchange rules, and the Internal Revenue Code. The Saperstein Interpretation was made flexible expressly because the myriad of trading situations in which specialists found themselves were not though amenable to a rigid regulatory structure, and the Exchange has always taken the position that justification of specialist trading often turned on questions of judgment and degree. In view of this regulatory background, the points numbered 1, 3, and 4 in the NYSE statement seem somewhat disingenuous. Since specialist trading is and to a considerable degree must remain a matter of judgment, it begs the question to say that the investment position is acquired "through transactions made to maintain a fair and orderly market." Although many specialists testified that these positions were acquired through such transactions, two specialists whose long-term investment positions accounted for 22 percent of the total would only state that these positions were "usually acquired" in the ordinary course of business.

The NYSE's point 2 is of a somewhat different character from the others. Its rationale is that the segregation of inventory into long-term investment accounts has no effect on the specialist's market-making abilities since the stock must be made available to the market if necessary, or the specialist must be prepared to sell short against the long-term account. The question inevitably arises whether the first part of the argument is consistent with one of the requirements of section 1236 of the Internal Revenue Code, that the security not be held primarily for sale to customers in the ordinary course of business: it is difficult to see how securities can be held both for investment

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[300] Amex report, pp. 34–35.

and for servicing the market at one and the same time. The other point, that the specialist must be prepared alternatively to sell short in an amount equal to the investment account, is equally unsatisfactory. It may sometimes be necessary for a specialist to sell out his position *and* go short, to some reasonable extent, to service the market, but to preserve the long-term investment position the specialist is required to cover such a short position within 20 days,[301] whether or not the needs of the market indicate that he should cover. Again it would require means of surveillance more subtle than any which have been developed to probe the motivation of a specialist in such a situation.

The Saperstein Interpretation which permits positioning (even though temporary destabilizing transactions may occasionally result) presumably did not contemplate that specialists would be permitted to acquire and retain positions for long-term gains where there would be a tendency to further destabilize the market. Exactly this might happen if a specialist withheld his position in a time of rising prices in hope of a further increase.

There is another point with respect to these long-term accounts not mentioned in the Amex Report. In 1940, at the time of the NYSE's unsuccessful attempt, and again in 1949 in its successful endeavor, to have specialists exempted from the margin requirements of regulations T and U,[302] the Exchanges strongly argued that the needs of the market made such an exemption a proper and wise one. In 1940 it argued that the exemption was necessary because declining markets could tie up "all or a substantial part of the capital available to many specialists." In 1949 it was urged by specialists that an exemption from regulations T and U would make available "such financing [that] would permit specialists to deal in their stock more frequently, enabling them to narrow the spread between bids and offers, and generally to improve the liquidity and continuity of the market." If, as the Exchange asserts, most specialists have acquired the positions carried in long-term investment accounts through the normal course of their business, they are utilizing credit made available by their exemption from current Federal Reserve Board requirements, not to maintain continuity and liquidity but to realize an investor's gain. This also raises a question of fairness. In 1949, the Director of the Trading and Exchanges Division opposed the proposed exemption on the ground that specialists "should not be given an advantage over members of the public generally"; i.e., an ability to speculate with less equity than the public.

Thus it seems clear that the segregation of specialty securities into long-term investment accounts is subject to strong possibilities of abuse without any corresponding public benefit or means of effective regulation, and in addition represents an unfair use of the specialist exemption from margin requirements. On both grounds the practice should be prohibited.[303]

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[301] Internal Revenue Code of 1954, sec. 1233(e)(4).

[302] See sec. 4.c, above.

[303] Another area where the specialist dealer activities are biased by tax considerations is the method of costing their inventory. When specialists use the "last in, first out" method (LIFO) of inventory valuation it is to their benefit to have the same number of shares in inventory at the end of the year as they had at the beginning of the year. Specialists testified that they would purchase stock near the end of the year to be sure that they had the proper inventory position to get the tax benefit. Such purchasing would seem to be clearly inconsistent with a standard of affirmative market necessity for each specialist transaction.

j. The specialist and a free market

An Exchange official testified that "prices on the stock exchange over my years of experience are dependent upon supply and demand that comes into the market." There can be no doubt that this statement reflects the ideal of a free and open market, but it may not adequately recognize that the specialist himself has a significant impact on prices, perhaps even beyond that caused by his trading as principal. It is important to identify and analyze the area of impact, whether and to whatever extent it is considered beneficial or detrimental.

Even in providing price continuity, specialists' trading affects the balance that would otherwise result from the free play of public supply and demand. But the impact of specialists' activities on the market goes beyond this. To an extent not generally realized, the market on the NYSE is a "dealer's market" in which the specialist can at various times set and control the prices of a security.

This is particularly true in inactive stocks with thin books and few public orders. In these, the specialist acts as dealer in most transactions (app. VI–A, table 12 and chart 12) and thereby sets the prices at which buyers and sellers trade. A specific example of this was observed by a member of the Commission staff on the floor of the Exchange. The specialist in an inactive stock had an order on his book to sell 200 shares at 84½. The last sale of the stock had been at 84. A broker left the specialist a market order to buy 2,000 shares,[304] and the specialist thus became the buyer's agent. The specialist decided to execute 1,000 shares of the market order by selling that amount for his own account at 84; he then executed 200 shares against the limit order at 84½. Next the specialist decided to sell another 800 shares for his own account at 85, setting the price that the buyer paid. When the commission firm's broker returned to confirm the transaction, he brought with him an order to sell 1,000 shares of the same stock at the market. In this instance the specialist purchased the stock at 84½ for his own account, a half point beneath the last sale. Although the broker involved had the right (and duty) to negotiate a price at arm's length, the inactivity of the stock and the size of the order gave the specialist broad discretion to set the prices at which these orders would be executed.

Another example of the specialist's control over the market is disclosed in a floor department file. In this case the specialist, when questioned by a governor and member of the floor department as to why he sold a particular stock at a certain price, testified as follows:

Q. You supplied 600 [shares] at 43.
A. That is right.
Q. If you hadn't done that——
A. It could have sold at any price. I mean, had I wanted to, I could have sold 100 at 43, 100 at 43¼, 100 at 43½, 100 at 43¾, 100 at 43⅞, and so on; and just done anything I wanted to. I just didn't. I figured 43 was a very equitable price for the buyers.

The specialist often holds orders on both sides of the market which are capable of immediate execution.[305] A complex hypothetical situa-

[304] The specialist told the broker that the book was thin and that the broker should try to get limits put on the order. However, the customer did not want to limit the order but wanted the stock to be bought immediately.
[305] See sec. 7.a, below.

tion of this nature was described by one specialist. This involved a limit order on the book to buy at 104, in addition to which the specialist held both a "not held" order [306] to buy and an order to sell 100 shares at the market which was "stopped" [307] against the bid on the book and then offered by the specialist at 105. In this case the specialist was on both sides of the market as agent holding orders which, by their terms, were capable of immediate execution. When questioned as to how a price would be decided, the specialist stated:

Right here, we come back—to that word "fair and equitable market." What do you mean by "fair"?

* * * * * * *

Now we have to define "fair" as to both people. We just can't pick out one man and say we are going to be fair to you and crucify everybody else.

This answer indicates that the specialist in such a situation uses his judgment to set a fair price for all concerned, considering supply and demand among other factors. However, the prices set are not reached in an arm's-length transaction but by a single individual acting for all parties—including himself.

The control that specialists have on prices is nowhere better illustrated than at openings. Although it is impossible to isolate one aspect of the specialist's activities as the most important, any ranking would have to place the arranged opening high on the list. Particularly crucial are openings on days of great activity and price movements, both in particular issues and the market as a whole. Not only do other specialists look to the openings of industry group and market leaders in opening their own stocks [308] but so does the investing public. Those specialists who are registered in market leaders often try to open such stock promptly.[309] The specialist in American Telephone & Telegraph stated he tries to open the stock as near 10 a.m. as possible:

* * * we have found that, if word gets around that Telephone can't open, it affects the general market.

Both the volume and the specialists' participation during the opening hours are normally the heaviest of the day (tables VI-44 to VI-46).

Historically the specialist's function in arranging an opening was no different from that of any other floor member who held orders for execution at the opening. Each participant bid and offered according to his own best judgment. Some time around 1930, the present system of arranged openings was put into effect. Most brokers normally give specialists all the market orders which they receive before the opening, which specialists then use to arrange an opening price.[310] However, the floor broker who forwards the order to the specialist is permitted to retain floor brokerage.[311]

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[306] See sec. 7.b, below.

[307] See sec. 7.c, below.

[308] The specialist in Xerox tends to follow IBM and Polaroid; the specialist in Brunswick checks American Machine & Foundry. One specialist who testified that he did not look to market leaders in opening his specialty stocks also testified that he played a passive role in arranging openings; see below.

[309] The specialists in American Can, Telephone, and IBM testified to this effect with the exception that in IBM, tallying of the odd-lot orders may cause a delay.

[310] Although the rules do not require floor brokers to give all orders prior to opening to specialists, it is the general practice to do so.

[311] Such orders are known as "love orders." The rule permitting floor brokers to retain floor brokerage in this situation was promulgated for the purpose of encouraging brokers to give all orders before the opening to specialists.

The present system works to marshall all buying and selling in the hands of one person who can evaluate the situation and arrive at a "fair" price. If this process were merely a matter of pairing off one order against another, openings would be routine and mechanical. If there were an excess of buy orders, the specialist could resort to the sell orders on the book and use enough of those orders to make up the difference; in such a case, under present procedures, the opening price would be the price of the last sell order necessary to arrange a balance of orders on both sides of the market. However, consistent with the Exchange's policy of maintaining price continuity, the specialist is expected to trade for his own account when necessary to establish a fair opening price close to the prior day's last sale.

Specialists have testified that they take many factors into consideration in determining the extent of their own participation in openings and in arriving at an opening price. Among such factors are: the previous day's close; the balance between buy and sell orders, i.e., supply and demand; the orders on the book which indicate the probable trend of the market; general market conditions; overnight news affecting the particular issue or the industry group; the opening of the industry group leaders; and the specialist's own position. Some specialists testified that they consider an opening successful if the price does not vary materially after the opening, thus indicating that they have correctly judged the market. However, this criterion of success can be unreliable since specialists also testified that they are willing to back their judgment after the opening by buying or selling stock to prevent fluctuation from the opening price. As one specialist testified:

> When I open the stock up, it is because I am willing to buy stock to support [the opening price].

There was great diversity in views as to the relative importance of each of the above factors, although all specialists placed stress on the previous day's close and the balance between buy and sell orders. principally, all specialists agreed that the process is one which depends heavily on judgment. As one specialist testified:

> * * * you've got to throw a lot of stuff into the machine and come up with an answer that is not a set pattern.

A more dramatic indication of the fact that openings are not mechanical is that the specialist may use discretion in establishing on opening price even though he may have a perfect match between buy and sell market orders. This means that if a specialist holds 200 shares to sell and 200 shares to buy at the market, he does not necessarily open the stock at a price unchanged from the previous day's close although public supply and demand are in balance.[312] There seem to be three reasons which might lead to a changed opening price aside from an inbalance between buy and sell orders. A few specialists stated that if the book indicated that the price was going to move up (or down) after the opening they would try to anticipate such a movement when arriving at an opening price. A few indicated that the tone of the market as a whole might justify a price change. Others

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[312] Fourteen specialists testified that under various circumstances they might vary the opening price from the previous close though they had a perfect balance of buy and sell orders. Four specialists testified that they would not vary the opening price under such circumstances.

indicated that the news involving the particular issuer or the industry group might justify a change. Of those who stated that they would not change the opening from the previous close when their orders were in balance, one stated that his reason was that his stocks were mainly inactive, and another believed that the specilist's role in establishing an opening should be as passive as possible.

Specialists sometimes will open the stock contrary to the trend indicated by public demand and supply. One stock opened on May 29, 1962, off 1¼ from the previous day's close, although in this opening the specialist sold 500 shares, indicating that before the opening the specialists had more orders to buy than to sell. This normally would have been reflected in a price increase. In testifying about this kind of situation, Vanderbeck stated that a specialist would be justified in opening the price against the balance of supply and demand if he were anticipating further price movements "and the conditions in the general market and in this stock, and the whole situation affecting that particular stock" made his actions reasonable.[313]

Another area in which the specialist has the ability to affect prices involves the "not held" order,[314] which the specialist has the authority to withhold or to execute when he deems it propitious. If specialists were to hold a large number of such orders, they would have a reservoir of buying and selling power at their command [315] and could use such orders to "create" prices. The resulting market might be "fair" to all, but could not be deemed a completely "free" one.

Recognition of the specialist's power over the market is seen in a letter sent by an Exchange floor broker to the floor department, concerning the October 1961 directive prohibiting specialists from accepting not-held orders.

> In the average security, there is no ready market for an order exceeding 2,000 shares. If I, as the floor partner, feel that the specialist is efficient and trustworthy, I would say to him, "Unless a goodsized opposite order comes into the market, I would like you to go along on sales and protect the order wherever possible." Here you might say: "Why don't you stand in the crowd and do it yourself?" The answer is that the specialist is a human being, and, while he is willing to be of help, if he has the responsibility, and possibly the commission, he will certainly feel different toward you and your order, if you tried to play in his security in your own way. I think that this human factor—call it vexation or whatever you want—plays a great part of our daily trading. In today's trading, I feel the basis for a proper execution is a meeting of the minds between the representative of the customer and the specialist. The rule against "NOT HELD" orders makes this impossible, and should be changed.

Although specialists have considerable power over the market, there are, of course, restraints upon them: when a specialist acts as broker and dealer in the same transaction he must cross the stock and also confirm with the customer's broker.[316] Another safeguard is that specialists must obtain the approval of a floor official before executing a transaction that takes place one point away from the last sale when the last sale is less than 20, or at 2 points away from the last sale when

[313] But in an analogous situation Vanderbeck agreed that it was impossible to determine what would have happened had a specialist behaved differently than he actually did; i.e., had a substantially different price occurred at the opening.
[314] See sec. 7.b, below.
[315] This would not be the case if brokers held such orders, since then they would not be concentrated in the hands of a single individual.
[316] See sec. 7.a, below.

that was 20 or over.[317] Coupled with this limitation, floor officials have the power to halt trading if there is a large imbalance of orders on one side of the market. Although the Exchange does not tell a specialist at what prices he should deal, the floor official may suggest his view as to a fair price or may suggest that the specialist participate to a given extent. On the other hand, although the specialist's activities on an opening and at other times are subject to review at a later date and he may be cautioned if his action is inadequate, he may not be compelled to make any adjustment in the price.

A dramatic example of the importance of the authority to delay openings and of the specialist's decision to participate or not participate in an opening occurred on May 29, 1962, in IBM. IBM, one of the market leaders in the preceding period, had declined in price from 454 at the close on April 30 to 398½ at the close on May 25. On May 28, the stock was off another 37½ points and closed at 361. This price action caused widespread comment in the financial press.[318]

On May 29, IBM opened at 1:47 p.m., up 4½ points after the general market had rallied from a substantial decline which followed the opening. It is impossible to measure what effect IBM's delayed opening had on the market,[319] and obviously just as impossible to determine the probable effects had the stock opened earlier but at a lower price, but it can hardly be doubted that there would have been overall market effect. One of the specialists testified about the morning of May 29 and the condition of the market in IBM:

> Q. About how many shares did you have on balance to sell during the worst part of the morning, before the stock was opened?
> A. Before the opening?
> Q. Yes.
> A. Including short orders?
> Q. Yes, if you remember.
> A. I'd say we had 7,000.
> Q. About what percentage of orders were represented by short orders?
> A. About 10 percent.
> Q. Was there any governor in particular who supervised the opening?
> A. Yes, Eddie Stern. Because we talked about it, how glad we were that we didn't open down and then the market rallied and it would have looked even worse.

Edwin H. Stern, the governor referred to and an active floor trader, also testified with respect to the May 29 IBM opening:

> A. I remember [the opening in IBM on May 29, 1962] quite clearly. There was a tremendous amount of stock for sale. The stock had closed [at 361] * * *. Down 30 points. It might have been possible to open, I would have had to buy much more than I wished to buy, and I was very afraid of participating, being a governor and also trading. However, there was a possibility that we might open the stock there, so I called in two other governors to get their approval. I was going terribly slow.* * * I just asked for their approval in case I wanted to open it down 30 points and received it.
> Q. With you participating [as principal in the opening]?
> A. Yes.

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[317] NYSE Guide, par. No. 2079A.30. In one case a specialist did not receive approval from a floor official when he opened a stock selling below 20, more than a point beneath the last sale. No action was taken against him because the floor department felt that the price he set was a fair one—although Vanderbeck conceded that it is difficult to determine what a fair price in this circumstance would have been.

[318] See, e.g., the New York Times, May 2, 1962, p. 47; May 25, 1962, p. 44. As was noted in sec. 5.e(4), above, the specialist bought 3,900 shares, sold 4,200 shares, and had a closing inventory of 200 shares.

[319] But see the testimony of the specialist in Telephone, above, as to the effect of a delayed opening in that stock.

Q. What time was this?
A. This was before the market turned up. I would imagine before 11 o'clock, I am not sure of the time.
Q. How many shares would you have to buy?
A. A minimum of 3,000.
Q. How many shares was the specialists willing to take?
A. I do not recall.

* * * * * * *

Q. Would he have taken as much as you?
A. Less. However, while we were still in the process of working on it, and as I say I was not anxious to buy that amount, the market turned and then we continued to hold up trading as the situation changed violently. The stock then opened at 1:47 and it opened at 365½. * * *
Q. Did you buy stock on that opening?
A. No; I did not.

* * * * * * *

Q. What was your position prior to the opening?
A. I was long approximately 3,000.

* * * * * * *

Q. Did you spend most of your time that morning at the IBM post, or all morning?
A. Yes; I left the crowd a couple of times but I spent the majority of my time there.
Q. Was any Exchange [staff] official involved in the IBM situation that morning?
A. I believe Mr. Gray [the executive vice president] came down to see if we needed any help, or if things were under control. I told him * * * they were.

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Q. Did Mr. Gray ask what the specialist's position in IBM was and who would buy what in the event there was an opening at that point?
A. I do not believe so; I think he just wanted to see if we needed additional help, if we were swamped and * * *.
Q. You mean physically?
A. Yes.

* * * * * * *

Q. Did you have authority, as a governor, to indefinitely, for the day, postpone an opening and perhaps not open the stock at all? Is that within your authority as a floor governor?
A. Well, even if it was, having a position in the stock, I would not want to use my authority in that way. I would say if I felt in a given stock that it would be harmful to open that stock, I would go to the chairman with the recommendation and let him decide.

* * * * * *

If in buying 500 to a 1,000, 500 or 600 IBM would have allowed the stock to have opened—I would have purchased it.
Q. Why?
A. Because if I can be of help by buying a certain amount, I want to be of help. If the difference between opening a stock and not opening a stock is 500, then I will do it, even if it does not look good.

* * * * * * *

Q. In view of the fact that you have indicated you felt circumscribed because of the fact that you had a position, and that you might acquire a further position on an opening, why did you supervise activities at all?
A. It is a good question. I would say mainly because I felt that I was needed. I had been there trading for a few days, I had spent a good deal of time there trading, and with everybody so busy I felt that being there I could help. I think I would have been better advised, possibly to have been some other place.

Thereafter the Exchange began an inquiry into whether the specialists in IBM "properly fulfilled their specialist functions." At the conclusion of the inquiry the specialists were called before the chairman of the board and were informed that price continuity was satisfactory, but that this was due "in great part to the fact that floor governors had been directing the conduct of the market." The opening on May 29 was not analyzed or made the subject of comment.

The events surrounding the opening illustrate several points. First, the specialist had wide discretion in determining whether to participate in the opening and the extent of such participation. Second, even when a governor supervises the opening, his role seems to be quite limited. In this connection, a former chairman of the board testified that it is up to the specialist to tell the governor "where he thinks he can open * * * [A governor] doesn't tell [the specialist] because that would certainly be going far beyond any duty or power [the governor] might have." In the IBM opening, the governor involved was circumscribed by the fact that he had a large position in the stock and that he intended to participate in the opening if necessary.[320] The Exchange staff, in the person of the executive vice president, was seemingly concerned only with the mechanics of handling orders and not the substantive decisions.

It is evident that, in many circumstances, specialists have the power to set and control prices, unilaterally. The decline of competing specialists removes the restraining effect that competition might provide and make it imperative that there be adequate surveillance. The regulatory program, should include measures designed to preserve the arms'-length quality of transactions on the Exchange, and should specifically include limitations on the specialists' control over opening prices.

7. CONFLICTS OF INTEREST

a. The inherent conflict

As noted above, a specialist holding an order is in a fiduciary relationship with the ultimate customer which entails several obligations. As an agent, he has a duty to act solely for the benefit of his principal in all matters within the scope of his agency. If he acts as an agent for persons with conflicting interests, the law requires that he act fairly with regard to all parties, and if he acts for his own account adverse to or in competition with his principal,[321] he must have the consent of that principal. The Restatement of the Law of Agency states on these points:

> Merely authorizing an agent to act in a particular market does not manifest to the agent that the principal assents to a custom of the market by which the agent can properly buy from or sell to the principal in disparagement of the fiduciary relation. If, however, the principal is adequately protected as he is by the current rules of most exchanges the custom may validate such a purchase or sale by the agent.[322]
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> * * * * * * *
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> An agent employed to purchase unspecified goods in the open market can properly purchase goods of the same kind for himself or for someone else if such purchase does not affect the price or prevent the required amount from being purchased for the principal.[323]

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[320] No criticism of the governor is intended. It should be noted that on May 29, a day which recorded the second largest volume in exchange history, only a floor official (such as the governor involved here) who was not a specialist or commission broker would have time to supervise an opening delayed as long as the opening in IBM.

[321] "Restatement of the Law of Agency (Second)," secs. 389, 387, 393 (1958).

[322] "Restatement of the Law of Agency (Second)," sec. 389, comment d (1958).

Rules 75 and 91 of the NYSE are designed to regulate the conflicts of interest in situations where the specialist (or any other floor member) holds orders on opposite sides of the market for different customers and wants to match one against the other or to buy from or sell to a customer for his own account. The rules require that a member attempt to execute the order in the open market at a better price than the one at which he intends to consummate the transaction. In a case where the member wants to buy the customer's securities at 50, he must first offer for the customer in the open market at 50⅛. In such a case, he must, immediately after the transaction, notify the broker who forwarded the order to him and obtain his consent to trade. The procedures are generally known as "crossing" although the term is more accurately used to describe the situation where customers' orders are matched with one another.

[323] "Restatement of the Law of Agency (Second)," sec. 393, comment b (1958).

The ordinary daily work of the specialist involves him in manifold inherent conflicts. He represents many customers on opposite sides of the market. He deals for his own account in competition with, and often adversely to, his customers. Furthermore, he has responsibilities to the market in general, in his capacity as market maker, to maintain price continuity. Since this function often amounts to setting market prices, it is difficult to find a reference point from which it may be determined whether his contemporaneous dealings with his principals were fair. More than most other kinds of agents, the specialist affects the market in which his principals deal.

Specialists were asked whether they considered their brokerage obligations to be the same as the obligations of floor brokers who represent customers in the crowd; typical answers were "absolutely," "definitely," "no question about it," "undoubtedly so." However, particular transactions illustrate that these general answers fail to reach the complexities of the situations which the specialist faces.

The problem of acting for oneself and also as agent for others was stated succinctly by a former partner of a large member firm, to an official of the Exchange:

> My principal point regarding the specialist is that it is an unhealthy situation when he is looking down the throat of a buyer or the seller who places an advance order at a stated price. This is what the situation amounts to when the specialist can buy at 1/8 over the buy order price on his books or sell at 1/8 less than a sell order price.
>
> I doubt very much that you would want your orders subject to such treatment and I am certain that I do not.

Paradoxically it is this very ability to outbid and underoffer his customer which enables the specialist to assure market continuity. Moreover, the more often a specialist interposes his own bid or offer the more often he is likely to be placed in a position where he outbids or underoffers one of his own customers.

One such instance as reflected in the files of the Exchange is reproduced below:

THE FLOOR DEPARTMENT MEMORANDUM

> [A partner of a member firm] called and stated that he had a complaint concerning the specialist in [a stock]. He said that one of his institutional customers had an order to buy stock at 104. The stock was quoted 104½. The specialist bought 300 and 200 shares at 104⅛. When [the firm] checked the specialist they were told that he was covering a short position, however, he would give 200 shares up to [the customer]. [The] customer was extremely dissatisfied and stated that this was not an isolated incident.
>
> Mr. Vanderbeck was apprised of the above facts. He asked that the situation be referred to the chairman for action.
>
> I spoke to the chairman and informed him what had occurred. He spoke to [the specialist] and told him that this was not a proper way to do business, that he should have given the customer at 104 an opportunity to buy at an eighth and in any event that in a stock of this price, if he wanted to trade he should have done it at least at a quarter point above the bid.
>
> [The chairman] said to inform [the member firm] what he had done and that if they ever had a similar situation in this stock they should inform the staff who in turn should inform him.

The large bid on the specialist book indicated buying support. Since the specialist was short he decided to cover and outbid his principal by 1/8 of a point. Technically the specialist was within his rights; under auction market rules, he is only prohibited from claiming priority over his own customer at the price of his customer's

limit.[324] Here the order which was outbid was a single block and the customer was sophisticated and aware of the market situation, but in most situations the orders on the book belong to many customers, most of whom are probably unaware of the specialist's existence let alone of the fact that he is handling their orders. In this case, the Exchange apparently took the position that to outbid a customer by 12½ cents was improper but suggested that 25 cents would be a proper figure.

While this case illustrates that specialists compete with their customers, in other situations the specialist can more directly take advantage of his position as market maker to the detriment of his customers. In one such situation, the specialist, to protect his own interest as dealer, deliberately can affect the prices that public orders receive.

One incident from the floor department files shows that a specialist opened a stock 9 percent below the previous close so that he could eliminate a possible difficult situation. Before the opening of Erie Railroad on March 9, 1960, the specialist had public market orders to buy totaling 1,100 shares and public market orders to sell also totaling 1,100 shares; the stock had closed the night before at 9⅝. Although this exact "pair off" indicated that the public demand and supply were in balance, the specialist opened the stock at 8¾, down ⅞.[325] On the specialist's book was a stop order to sell at 8¾ for 1,200 shares, which was executed when the stock opened at that price and was purchased by the specialist. The specialist subsequently stated that there was also a limit order to sell, which had already been reduced in price and which he was afraid would be further reduced, placing him in a difficult situation. In light of this limit order on his book, the specialist deliberately opened the stock down 9 percent to enable him to "clear up the stop order." Had the limit order been reduced and the stop order not been "cleared up," the specialist might have had to purchase the stock represented by the stop order and the limit order at the same time, thus committing more of his capital than he wished—he already had an inventory of 2,000 shares. Before the specialist opened the stock, he obtained approval from a governor. The governor later stated that he misunderstood the facts. Be that as it may, the customer whose stop order was entrusted to the specialist would have been surprised to learn that the order he entered as his protection against a price decline had itself caused a price decline, and was executed only because the specialist was protecting himself.[326]

As a result of a member firm complaint, the floor department made an inquiry into the situation. The vice chairman informed the specialist that he had used extremely "poor judgment" and that he should have opened the stock at a price higher than 8¾. Vanderbeck testified as follows about this case:

Q. Is this an approved practice of the Exchange to open a stock down seven-eighths where this is an exact pair off?

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[324] NYSE rule 108. The specialist in one high-priced stock testified that if he wanted to buy stock for his own account he would never outbid a customer by an eighth.

[325] After the opening, which was the low for the day, the price rose and by the end of the day was above the previous day's close.

[326] Another example from Exchange files discloses that a specialist dropped the price of a stock 2½ points to pick up a 300-share stop order.

A. [The specialist] was wrong in his judgment and he was so informed.
Q. Was any disciplinary action taken against [him]?
A. He was spoken to about this.
Q. Is this considered a disciplinary action?
A. No.
Q. Was he told to make an adjustment in price?
A. No, because it was a matter of judgment on his part with respect to the price.

Other situations become quite complex and involve conflicts not only between the specialist and his customers but also possibly among customers. The following case from the files of the Exchange illustrates both points:

With the last sale at 25½, a specialist held a market order by Firm S to sell 1,200 shares. The relevant orders on the book were as follows:

BUY ORDERS		SELL STOP ORDERS [1]	
Limited price:	*Amount*	Electing price:	*Amount*
25	900 Firm A [2]	25	2,400 Firm T
24½	100 Firm B	25	100 Firm U
24¼	100 Firm C		
24	200 Firm D [2]		

[1] These orders become market orders when the electing price is reached.
[2] Actually these orders were from more than one firm, but for purposes of this example the situation has been simplified.

With a governor's approval, the specialist executed 900 of the 1,200 shares of Firm S's order at 25 against the Firm A orders. This elected the sell stop orders of Firms T and U, and converted them into market orders to sell the 2,500 shares, which, including the remaining 300 shares for Firm S, meant that the specialist had orders to sell a total of 2,800 shares. He executed 2,500 shares at 24 by buying the 400 shares of the orders for Firms B, C, and D (which had limits between 24 and 24½) 2,100 for himself. The 2,500 shares sold were those of Firm's T and U, leaving the 300 shares of Firm S's sell order unsold. These 300 shares the specialist executed in 3 subsequent sales at 24¼, 24½, 24¾. When asked by the Exchange floor department why Firm S's sell order received a better price than the sell orders of Firms T and U, the specialist replied that he was exercising brokerage judgment.

This situation indicates the kind of conflicts to which the specialist is subjected and the judgments he is called upon to make as a fiduciary and market maker. The customers of Firms B and C bought at a lower price than their limits, but this was at the expense of the orders to sell, which would have received better prices if the buy orders had been executed at their limits. The customer of Firm S, whose market order the specialist held, received better prices than did the customers of Firms T and U, although those orders were also held in a fiduciary capacity. Finally, the specialist himself chose the price (24) at which the customers of Firms T and U sold to him.

The Exchange has attempted to deal with some of the conflicts involved in this example. In certain instances approval of a governor is needed, in others the "crossing" procedure must be utilized; and behind these protections, the customer's broker is under an obligation to disaffirm an improper trade; and finally, the Exchange may act in a disciplinary context. But in this case all of these safeguards did not prevent the transactions from occurring in the manner and with the consequences described above. Before the specialist may deal

for his own account at a price which would elect stop orders on his book, he must obtain permission from a floor official and guarantee that the stop orders will be executed at the same price as the electing sale, but the governor did not require that all market orders be executed at the same price. The "crossing" procedure, which is designed to prevent any broker who holds orders on opposite sides of the market from favoring one order over another, was ineffective. Moreover, there was no complaint from the brokers of Firms B and C, at least one of whom had to be given an opportunity to disaffirm since the specialist acted as principal with respect to at least one of the two orders. Finally, although the Exchange inquired into these transactions, no further action was taken.

In fact, there is some doubt as to the adequacy of the "crossing" procedure generally, even aside from the failure of a broker to disaffirm a cross by a specialist dealing for his own account. Several specialists testified that crosses are rarely upset, for at least two reasons: First, other brokers, as an accommodation, often refrain from upsetting a cross, and second, brokers who want to cross large orders simply wait until the post is unpopulated before consummating the cross. Specialists, of course, are in a unique position to take advantage of the latter situation, since they never leave the post.

The examples just discussed illustrate the complexities involved when the specialist acts for his own account and simultaneously as agent for many parties. Additional problems are introduced when the specialist undertakes to carry out special kinds of instructions with respect to particular orders—as in the case of "not-held" orders or "stopping" stock—or undertakes to act directly for his own customers.

b. "Not-held" orders

A "not-held" order is defined by the Exchange as an order either to buy or sell a specified stock, in which the broker "*is relieved of all responsibilities* with respect to the time of execution and the price or prices of execution. * * *" [327] [Emphasis in original.] This order need not be executed as promptly as a market order, nor is the broker liable if he "misses the market" and the price moves against him. The broker handling the not-held order may withhold it from the market or represent his customer as he ses fit in the best exercise of his judgment.

Not-held orders are handled by floor brokers and commission brokers without any special problems being present, but when they are accepted by the specialist, difficulties arise. An example of the way a not-held order is handled is afforded by the last example discussed above, though it did not actually involve such an order. There, the specialist withheld one of the sell orders and eventually sold it at better prices than the others. The specialist did not have discretion because the withheld order was a market order, and he might have been liable for Firm S's customer for withholding it had the price declined below that at which the order was originally capable of execution. If the specialist has clear discretion, he is, of course, more likely to withhold the order. Indeed, as most specialists understood the directions im-

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[327] NYSE, Department of Floor Procedure, "Dealings in Stocks," p. 41 (1958). Orders with similar consequences may bear legends such as "Take time," "Disregard tape," "Do the best you can."

plied by not-held orders, under certain circumstances a specialist would be under a duty to withhold.

Because a not-held order directs the specialist to use his skill and judgment, it calls upon him to use the knowledge gained from his book for the benefit of the order—unless, as seems unlikely, he can compartmentalize that knowledge in his mind.

In order to represent such an order in the market, the specialist may on occasion outbid or underoffer the limit orders on his book. Often, when a limit order on the same side is executed, the specialist allocates a similar number of shares to the not-held order so that both orders participate equally in the available supply or demand.

Some specialists have said that holding a not-held order hampers them in their dealer function, since an Exchange rule [328] prohibits any member from dealing for his own account on the same side when holding a customer's order which is capable of execution. Notwithstanding this rule, one prominent specialist testified that he does not withdraw from the market as a dealer while holding a not-held order.

The practice of specialists' accepting not-held orders first came to the attention of the Commission in 1952, in the course of an investigation of a possible manipulation. After discussion between the Commission's staff and NYSE officials, the Exchange was informed that such orders were not market or limited price orders and, under the limitations contained in section 11, could not be accepted by specialists. On May 9, 1952, the Exchange circulated a notice to all members informing them that—

> Not-held market or limited orders, any other orders with similar qualifications such as "Disregard tape," "Take time," etc., and "scale" orders without specific amounts and prices are not market or limited price orders under [sec. 11(b) of the Exchange Act] and therefore must not be accepted by specialists.
>
> This does not preclude other brokers from accepting such orders and executing them in accordance with their terms.

With the distribution of the May 1952 circular, the matter seemed to be at rest. However, at a conference with the Commission in late 1961, the president of the Exchange submitted a proposed circular to members for the Commission's consideration. The significant portion of the text follows:

> Recently a question arose with respect to the handling of "not-held" and similar orders on the floor of the Exchange.
>
> Cases arise when a market or a limited price order for the purchase or sale of a specified amount of a stock is placed by a customer with instructions that the broker use his judgment as to time and price of execution. If the floor broker entrusts such an order to the specialist the latter may also follow the customer's instructions to use brokerage judgment as to time and price.

It appeared in the course of subsequent discussions between the Commission's staff and Exchange officials that some specialists had continued accepting not-held orders despite the 1952 prohibition.[329] In fact, it later was learned that during the period between 1952 to 1961, most specialists continued to accept such orders. Data submitted by all Exchange specialist units indicate that at some time after January 1, 1959, 73 specialist units accepted not-held orders [330] while 37 units did not. The Exchange in 1961 urged that the Commission reverse its position and permit specialists to accept orders involving

[328] NYSE rule 92.
[329] See ch. XII.
[330] In nine of the units accepting such orders, not every specialist did so.

brokerage judgment. Relying on a passage in the 1934 House committee report referring to "purely discretionary orders as distinct from market or limited price orders,"[331] the Exchange took the position that a "purely discretionary order" is one in which the broker is entrusted with discretion not only as to price and time, but also as to whether to buy or sell or what security to buy or sell. The Exchange also argued that the general concern of the Congress in 1934 was to prevent specialist participation in pools, and that this concern was inapplicable to the specialist's acceptance of not-held orders. The Commission reaffirmed the 1952 prohibition on specialists' accepting not-held orders, and in late 1961 the NYSE circulated a memorandum reiterating the ban.

It was also claimed that an increasing number of block transactions, especially those of institutional investors, made it desirable that specialists be permitted to accept not-held orders. The handling of a large order is often time consuming if it is to be kept from adversely affecting the price of the stock. Brokers desire to entrust these orders to specialists for the same reason that they give the specialist limit orders away from the market. It is also said that floor brokerage rates do not make it economically feasible for a broker to wait at the post. In short, it is argued there is no convenient way to execute not-held orders except by giving them to the specialist. An Exchange official testified in the course of the Special Study that "the handling of not-held orders by specialists would help greatly the brokers on the floor who have other business to attend to."

The major argument advanced by the Exchange as to the purpose of section 11 considers only one of the policies underlying the legislation. In addition to the antimanipulative purpose there is also the prohibition against disclosure of the book, as is also revealed in the House report, as quoted above.[332] This prohibition rested not only on the fact that "the specialist participate[d] in pools, but that there are inherent difficulties in the situation where under normal circumstances the available orders are known to specialists only—and perhaps his favored friends."

One active floor broker who specializes in the execution of large orders testified that the policy forbidding specialists to accept not-held orders had affected his method of doing business, since he often does not have the time to wait at the post trying to execute an order in an inactive stock. Consequently, some of his executions have suffered.[333] He stated, however, that when he can execute such an order, he is in a position to do a better job than the specialist:

> Q. Is there any distinction between a not-held order [held by a specialist] and the kind of judgment that you are permitted by your principals?
>
> A. There is quite a bit of difference between a type of order that I have, which is one of judgment—you can put the name of not-held on it, too, if you wish—than what the specialists gets, because the specialist is dealing with every individual broker who represents the public, therefore, he has many brokers to deal with. I, as an individual, am just dealing for one person.

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[331] H. Rept. 1383, 73d Cong., 2d. sess., p. 22 (1934); see also S. Rept. 792, 73d Cong. 2d. sess., p. 18 (1934).
[332] See sec. 5.d, above.
[333] However, it might be noted that one specialist testified that often he would be willing to give the customer a good price immediately without waiting, but that floor brokers prefer that he take time with the order so that the customer will be satisfied that brokerage judgment has been used.

Q. Are you implying by that that your judgment can, therefore, be much more free and unfettered by representing one person, instead of many people.
A. Definitely.

The distinction noted in this testimony is an important one. A floor broker who will usually hold only one order in a particular stock can exercise his judgment unfettered by the conflicting loyalties and responsibilities which a specialist is likely to have.[334]

The specialists who have not accepted such orders gave various reasons. One took the position that not-held orders conflicted with his fiduciary obligations to other customers. Another testified that he did not understand what was meant by the term "not held" orders and, being uncertain, refused to accept orders so marked.[335] Two specialists, one whose firm was directly involved in the 1952 ruling and another who remembered it, have obeyed it since.

One specialist testified that he accepted a kind of order after 1952 which, although it gave him discretion, was not within the scope of the prohibition because the order carried a limit on the "wrong side" of the market.[336] The argument seems to be that up to the "limit" price, the specialist would have discretion but that the order would qualify as a limit order and hence be acceptable under section 11 of the Exchange Act. This argument seems untenable, because under Exchange rules such an order must be treated as a market order, not a discretionary order, and must be executed promptly.

The confusion as to the definition of a not-held order which all of this seems to reflect is also found in the testimony of other specialists who attempted to distinguish between the not-held order prohibited in 1952 and the kind of order which they accepted thereafter. Those who did distinguish between the two stated that orders which were accepted after 1952 were "brokerage-judgment orders." Ten specialists testified that brokerage-judgment and not-held orders were identical; five testified that there was a difference between the two; one felt there was some confusion on the point; another found the distinction difficult to clarify. In any event, it is clear that the Exchange in its original prohibition in 1952 and in the reiteration in 1961 used virtually identical language in the circulars sent to members.

The five specialists who attempted to draw a distinction between brokerage-judgment orders and not-held orders could not articulate any meaningful differences between the terms of the two orders. Either a broker holding not-held orders or brokerage-judgment orders is liable for "missing the market" or he is not. Distinction on other grounds has been attempted, e.g., that a not-held order is "negative" in the sense that the broker is given discretion not to execute the order if he so chooses, while a brokerage-judgment order is "positive" in that the broker is instructed to execute the order when he can, but is not liable if he does not. Such a distinction has no consequences in fact and cannot provide the basis for any workable classification.

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[334] Floor brokers when faced with this problem often cross the order (see sec. 7.a), or stop one order against another (see sec. 7.c).

[335] Another specialist uncertain of the meaning of the 1952 circular continued to accept these orders.

[336] That is, this kind of "limit" order to buy would have a limit set above the market, whereas ordinary limit orders to buy fix a limit below the market, and so cannot be executed until the market declines. The orders accepted by this specialist, e.g., with the market at 41 to 42, he would accept an order to buy at 45, would be capable of immediate execution.

As we pointed out above, the large order is an increasing phenomenon on the Exchange, and thus the general problem of dealing with block transactions is a very important and real one. Whatever may be the appropriate solution or solutions,[337] further compromise of the specialist's fiduciary obligation and enlargement of his ability to control market prices does not seem to provide an acceptable one.

c. "Stopped" stock

The practice of "stopping stock" (not to be confused with "stop" orders) [338] is little understood except by the most sophisticated investors. It can best be explained by an example. The specialist is quoting a market 30 bid, offered at 30¼: the bid represents five separate orders for 100 shares each (five "singles"), the offer is for the specialist's own account, and the last sale was 30⅛. Broker A comes into the crowd with a market order to sell 100 shares for a customer. Instead of selling at the bid, the broker may ask the specialist to "stop" him at the bid. By agreeing, the specialist guarantees the broker that he will receive not less than 30 for his shares. Broker A, or more usually the specialist, will offer Broker A's stock at 30⅛, thus giving Broker A's customer a chance to realize a higher price. If Broker B comes to the post with a market order to buy, he may buy Broker A's stock at 30⅛, in which case the "stop" is terminated successfully. If this happens, the specialist's customer with priority on the book (for whom the specialist was bidding prior to the stop) does not get an execution and if the market turns away from the limit that order may never be executed.[339]

Stopped orders may not receive a price better than the guarantee: in the example just discussed where Broker A was guaranteed 30 for his stock and that stock was offered at 30⅛, if another seller had come into the market (before Broker B arrived at the post) and had executed an order at 30, the stop would have been "elected" and the "stopped" seller, Broker A's customer, would have received 30 for his share.[340]

The NYSE rule [341] governing stops seems to contemplate that they will be granted by a member, which would mean in the case of a specialist, by the specialist for his own account. However, specialists have testified, and the responses to the questionnaire corroborate, that that most often when the specialist "stops," he does so "against the book," [342] i.e., he does not assume the primary risk of the guarantee himself but he allocates limit orders on his book to fill the stopped order—he is called upon to honor the stop himself only if the allocated order, together with all other unallocated orders at the stop price, is

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[337] See the discussion in sec. 6.h, above, and the conclusions and recommendations of pt. F of this chapter.

[338] See sec. 5.a, above.

[339] On the study day of Feb. 21, 1962, approximately 60 percent of the number of stops granted (or 54 percent of the stopped shares) received better prices than the stop price (table VI–47).

[340] When a stopped order held by a specialist receives a better price than the guarantee, the specialist earns floor brokerage, but does not earn it if the stopped order is executed at the guarantee price. However, in the latter case, if the stop was guaranteed by an order on the book (rather than by the specialist as principal), the specialist would earn floor brokerage for executing the order on the book. It may be noted that when a stopped order held by a specialist does receive a better price than the guarantee, the specialist earns floor brokerage for that execution and may still have an opportunity to earn floor brokerage for executing the order on the book.

[341] Rule 116.

[342] The 1-day sample indicated that 80 percent of stops are granted against the book (table VI–47).

withdrawn before the stop is elected or canceled. In the example, he would allocate to the sell order, which had been "stopped," 100 shares of the book's 500 shares bid for at 30. The specialist then would reduce the size of the bid from 500 to 400 shares, thus in effect, removing the allocated 100 shares from the market and "reserving" them to match against the stopped order if that became necessary. If, immediately after this, Broker C should arrive at the post with an order to sell 500 shares, one of two things would happen. The specialist might buy 400 shares of the 500-share order for the 400 unallocated shares on the book and "elect" the stop against the allocated 100 shares; in this case, Broker C would sell only 400 shares and would continue to offer 100 shares. The specialist might, however, bid for 100 shares for his own account at 30 so that the full 500-share sell order would be executed in addition to the 100 shares "stopped." Whether the specialist would do this depends upon his own predilections.

Specialists, when questioned about the fairness to their customers of using their limit orders as guarantees and causing them to miss opportunities to trade, stated that the practice benefited the market as a whole by having smaller variations between sales.[343] It was felt that the customer whose order was used as the guarantee for a stop (in the example, one bidder at 30) might someday himself be on the receiving end of the stop. Specialists were asked whether, if they had properly discharged their duty to quote a fair market, they did not then have a primary duty as a broker for customers whose orders they held (in the example, the orders to buy at 30) to get them an execution if possible. The answers varied. One specialist stated that he was reluctant to grant a stop if the quoted market was a fair one. Some specialists recognized that there were fiduciary problems and were reluctant to stop against the book; i.e., to use customers' limit orders. One stated the reason for this:

> Because, I think the primary function is, when you hand me an order and * * * trust me, that is my first obligation, to get that stock for your account. * * *

The others said that they conceived it to be their duty to get as good a price as possible for anyone in the market, whether customers on their book or not. Typical examples of this testimony follow:

> A. * * * [W]e try to satisfy most of the people most of time, even though we are bidding [for a customer] and my responsibility is to the bidder. I still feel that it is in the best interests of the market itself to stop that seller at that point. * * *
>
> * * * * * * *
>
> Q. * * * You testified earlier that you believe that you have the same obligation to a customer on your book that a broker does who is holding an order in the crowd. In the hypothetical situation we are speaking of * * * haven't you at that point deprived the customer on your book of an execution * * *?
>
> A. At that point, yes.
>
> Q. If the stopped order does better * * * the customer on your book may not get an execution * * * at all?
>
> A. Right.
>
> Q. So that this is a case where your obligation is less intense to your customer than is that of a broker holding an order in the crowd; is that correct?
>
> A. * * * [I]n half of my function, yes, it is less intense.

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[343] The market quoted in the example—30 to 30¼—should be sufficiently close to one which would yield reasonable price continuity. The specialist is under an obligation as a market maker only to quote a market in which an execution at the bid or offer would involve reasonable price continuity.

Q. Why should there be any difference if you are holding an order for someone with a limit * * * [and you are then bidding for him] why shouldn't you try to get an execution for him * * * if a seller comes into the crowd?

A. Well, I have an obligation to make a market and make as good a market as I can * * *.

Q. You mention that you would like to give the other broker's customer an opportunity to do better. Of course, he represents that customer—you don't. Is that correct?

A. He is representing him at that time.

Q. And you are representing the customer on the book?

A. That is true, but I feel that any order that comes in before the Stock Exchange has to be considered, and I think we have an obligation to all of these people.

Q. In other words, you believe that your obligation [as a specialist] is to serve the market as a whole, in your particular stocks?

A. Absolutely.

One leading specialist stated that there were two reasons that he stopped stock:

Q. You indicated earlier in your testimony, that conventionally [the floor broker] would leave the [stopped] order with you.

A. I would say 99 times out of a hundred with the [floor broker] * * * that came to me * * *. As soon as I offer a stop, whether it is a two-dollar broker or not, he turns the order to me.

Q. You get the commission?

A. If I execute the order at a better price I get the commission. If I do not get a better price then he gets it without any commission.

Q. So as you indicated before, the motivation is to build your commission business as well as to make a better market.

A. Yes.

It is clear that in this area many specialists do not consider it to be their fiduciary obligation to their customers to get them as favorable executions as possible, but rather are motivated by a sense of obligation to benefit the market as a whole or by a desire to increase their commission income. As noted, at least one specialist felt that for him to stop stock against the book would be to compromise his fiduciary duty. One knowledgeable specialist not of this view stated that there has always been some question about the practice, and observed that "the subject * * * has been discussed * * * many times * * * [and] has never resolved itself to an answer." Despite the recognition of the problem and diversity of views and practices, the Exchange seemingly has no policy in this area. Rule 116, dealing with stops, does not touch upon the fiduciary aspects of the matter.

There is a further problem of a different kind in connection with stopping stock. In certain situations the practice leads to omissions of transactions from the tape. In the example given, where 500 shares were being bid for at 30 and the specialist stops Broker A's 100 shares against the orders on the book, the size of the bid may be reduced to 400 shares. When Broker C then comes to the post with 500 shares to sell and sells 400 shares to the book (assuming that the specialist did not purchase the remaining 100 shares at 30), the stop is elected and the allocated 100 shares on the book are executed against the stop. Broker C has 100 shares left to sell, and in such a situation, only 400 shares will be printed on the tape at 30, although actually 500 shares were traded at that price (400 for Broker C and 100 for Broker A).[344]

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[344] An omission from the tape would result even if the specialist stopped stock as principal.

There was a great diversity of views among specialists as to why the full 500 shares traded would not be printed as 400 and 100. A few seemed to believe that the transaction itself took place outside the usual auction market rules and that if the tape showed the fact that 500 shares had actually been sold at 30, then the selling customer could hold his broker (in the example, Broker C) to a price of 30 for his last hundred shares. Their line of reasoning is this: for the execution to be printed on the tape there must be an execution under the rules of the auction market. In a situation involving a stop, an auction market execution would require a "cross" (since the specialist holds both the allocated order and the "stopped" order) and the crossing procedure requires that the buy and sell orders be publicly offered. Since if a cross were attempted, it might be "upset" by the broker holding the subsequent order, there is no cross and thus there can be no print.

Some specialists thought that the omission from the tape of the 100 stopped shares was merely to relieve Broker C of the necessity of explaining to his customer why his full 500 shares were not sold at 30. When it was pointed out that other floor situations [345] resulted in the necessity for explanation, the usual reaction was that custom in this area was otherwise.[346]

The Exchange [347] expressly permits an omission of stopped stock from the tape. It is usually said that tape volume is understated by 5 to 10 percent because of this practice. For the study day of February 21, 1962, there was a difference of 4.4 percent between the actual round-lot volume and reported round-lot volume. However, of the omissions from the tape on that day, only 14 percent were caused by stopped stock,[348] and 86 percent were caused by unexplained factors. An Exchange official testified that this day must have been atypical.[349]

One of the supposed benefits of exchange markets is that price and volume of transactions are accurately reported on the ticker tape. As an Exchange official testified, "* * * transactions are printed as you know on our open tape for everyone to see." Such information is not only for the purpose of informing particular investors that their transactions have been executed, or to "protect" brokers from criticism by customers, as some of the witnesses seemed to believe. The information is used by many investors to make investment decisions and it is presumably generally undertood by the public that the information is complete and accurate. To whatever extent stopped stock causes understatement of volume on the tape—whether or not by 5 percent—

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[345] E.g., "matched and lost," "stock ahead."

[346] One authority asserts that stopped stock is omitted from the tape because such transactions are "private." Bogens Financial Handbook, p. 82 (2d ed., 1962). However, this does not adequately explain why if Broker C in the example had sold all his stock, the stopped stock would have been reported.

[347] NYSE Guide, par. No. 2125 A.

[348] Thus, on the study day, 21,000 shares did not print because of stopped stock, while the difference between total reported round-lot and actual round-lot volume was 152,990 shares. The volume not printed in the years 1937–61 appears in table VI–48.

[349] In one case coming to the attention of the Special Study, the specialist was willing to buy 200 shares at a particular price, a commission broker representing the public had 300 shares to sell, and an odd-lot dealer wanted to sell 100 shares. The specialist bought 100 shares from the commission broker and the 100 shares from the odd-lot dealer although under the rules of precedence, the odd-lot dealer was not entitled to sell any in such a situation. In order not to disclose what occurred on the floor and thus "embarrass" the commission broker, only 100 shares of the 200 shares traded were printed on the tape. For a further discussion of volume data generally under present NYSE procedure, see pt. J of this chapter. For a discussion of the lack of disciplinary action where transactions are deliberately omitted from the tape, see ch. XII.

it is responsible for a serious distortion of volume at particular prices without apparent justification.

d. Public customers

Another possibility of unfair preference among customers arises where specialists deal with members of the public directly rather than limiting themselves to handling orders forwarded to them by other exchange members.[350]

It is necessary to distinguish between several different kinds of situations. Some specialists are partners in members firms which regularly do business with the public, maintaining board rooms and providing all the services usually associated with a public commission business. Other specialists introduce accounts to their clearing agent and obtain a split of commissions. At least two specialists have arrangements with mutual funds whereby all of the fund's orders are transmitted through the specialist, who then channels the orders to the member firms which are to receive reciprocal business. Finally, many specialists have a public business restricted to friends and business acquaintances, occasionally officials of the companies in whose stocks the specialists are registered. This last may be illustrated from the testimony of one specialist:

Q. Can anyone call up and give your firm an order?
A. Not without checking with us on the floor. That is why we have the phone. The order would not be accepted if we don't know the person.
Q. You have to know the person personally or one of your partners?
A. Right.
Q. Will you accept orders from any acquaintance of yours?
A. No.
Q. What is the classification of persons?
A. Intimate friends. We are not in the commission business. This is just an accommodation.

A few specialists have indicated that they have an affirmative policy against accepting public orders or introducing accounts to other firms, while others restrict such activities to family accounts, or family and friends; one excludes only friends from those whose orders he will accept.

Questionnaire EX-1 contained questions which encompassed all these situations. Specialists associated with 78 percent of all specialist units answered that at some time since January 1, 1959, they have been associated with a member firm which carried or introduced customer accounts; almost half of these firms have carried accounts for officers, directors, or principal stockholders of issuers in whose securities the respondent was registered as specialist. A breakdown of the answers showed that 13 specialist units carried accounts for 3 or more corporate insiders. In total there were 83 such accounts carried by 28 specialist units. In response to another question, 23 percent of all specialists (as distinguished from specialist units) answered that since January 1, 1959 they had accepted orders, for purchase or sale of stocks in which they were registered, directly from investors.

No matter what method was used to transmit the order to the floor, most specialists stated that they were aware when orders arriving at their posts originated through their own firm, either because the

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[350] See Amex report, pp. 29–32. Amex rule 190(a) now prohibits specialists from accepting orders from certain corporate insiders; there is no NYSE rule which prohibits specialists from accepting orders directly or from being members of a firm which has a commission business.

order slip would bear their firm's name[351] or because there would be some special notation on the form.

When specialists were asked why corporate insiders called them to execute transactions, especially in view of the fact that many of these persons resided away from New York, most professed not to know or stated that the insider did so as an accommodation.[352] One specialist who had a number of transactions in substantial quantities for corporate insiders stated that such persons dealt with him because of his reputation of bidding for substantial blocks.

Some specialists seemed to have some public customer business involving reciprocal business relationships of one kind or another. For example, one issuer wrote to the specialist registered in its stock:

> DEAR SIR: We have asked the banks who are corporate trustees of our pension funds to favor us by directing business to your firm for the account of our pension trusts. [Three banks were listed.]
>
> * * * * * * *
>
> We value highly our previous association with you and wish to take this opportunity to thank you for the many favors we have received.

In the main, transactions for corporate insiders were concentrated among the larger specialist units. There has been a continuing relationship between one specialist and a specific issuer, by which the issuer regularly has purchased stock through the specialist for its pension fund. One substantial nonmember broker-dealer apparently has made a fairly regular practice of giving orders directly to specialists.

Some institutions provided answers as to know why investors used a specialist's services directly. In questionnaire IN-4, institutional investors[353] were asked if they had ever dealt with specialists. Some of the answers follow:

> * * * [A]ny such use has been infrequent and only to obtain better executions.
>
> * * * * * * *
>
> Direct contact with the specialist is a method very rarely used. Only when an extremely thin market pertains and an otherwise orderly execution seems impossible, does the trustee make a direct contact.
>
> * * * * * * *
>
> In the general handling of listed orders, no effort is made to place stock orders direct with floor specialists or their firms. However, there could be occasions when such direct orders would insure the most efficient and advantageous executions.
>
> * * * * * * *
>
> Only twice several years ago, have we used a specialist for the purchase or sale of a security in which such specialist was registered. These two situations occurred when it seemed to be impossible to buy the stock without pushing the market up. By giving the specialist the order, we felt he would give us first chance to buy a block if it should appear.
>
> * * * * * * *
>
> Orders have been placed directly with a specialist or a specialist's firm on very few occasions. * * * [I]nfrequently, a specialist or a specialist's firm may be used when the stock being purchased or sold has a relatively inactive market and it is felt that it will be to the advantage of the fund to work through a specialist or specialist's firm because of familiarity with the particular issue.

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[351] All clearing firms' order slips bear the firm name or the name of a partner.

[352] One specialist suggested that one corporate official sold stock through him to avoid having knowledge of the transaction circulate in that official's hometown.

[353] See ch. VIII.C.

One specialist thought he knew why institutions may give orders to specialists:

Q. It doesn't make any difference to the institutional investor, as far as commissions are concerned? You have * * * to charge them a full commission?

A. They tie your hands up. If you know that they have something to do, we can't do it against them. If they have a buy order, we wouldn't buy it. We can't. As soon as they open up to us, if they say they have some stock to buy, they are going to put in 10,000 shares through us or through some other firm, we wouldn't buy a position other than just to make a market in the thing.

Q. You mean, it is the way of locking you in, by giving you the order?

A. It does. I am sure they think of that.

The Special Study did not attempt to determine whether a specialist's personal customers received preferential price treatment in any of the foregoing kinds of situations. The judgments involved in the specialist's role are often too subtle to permit determining whether a particular customer has been preferred or discriminated against, without complete market data such as the state of the specialist's book at the relevant times. However, some of the institutions quoted above seemed to believe that dealing directly with a specialist does give them "better" executions. In such a case, the better price received by the specialist's own customer may be at the expense of another customer whose order was forwarded to the specialist by another broker.[354]

Where a specialist is receiving reciprocal business through the efforts of an issuer, it is equally difficult to determine whether better markets are made in that issuer's stock than in comparable issues.

The two most recent significant disciplinary actions involving NYSE specialists resulted from orders given specialists in their specialty stocks by public customers. In one case, decided by the Exchange on January 2, 1963, the customer involved was an official and director of the issuer. The specialist, in defending his conduct, noted:

It is my understanding that it is not uncommon for employees and officers of the companies whose stock is listed on the New York Stock Exchange to carry their own accounts with specialists, as in many cases they know no other broker. My firm has done this in connection with other companies whose stock we handle, and I know of no rule or regulation against such a practice.

The more serious cases in recent years involving Amex specialists also concerned investors dealing directly with the specialist.[355]

The NYSE takes the position that "it is a perfectly proper practice" for specialists to carry, service, or introduce public accounts so long as the practice "is not abused." Apparently in recognition of the possibility of abuse, shortly after publication of the Amex report, the NYSE instituted a rule [356] requiring specialists periodically to report all transactions for public customers in their specialty stocks.

The specialists interviewed felt that their public customer business has a very small place in their total business. One experienced specialist testified as follows:

Q. Assume a rule was passed which said specialists could no longer have public customers, what would be the effect on your business of such a rule?

A. It would be rather insignificant as my transactions take place today but it would close the avenue for possible development of public business should I at some later date desire to enter into it actively.

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[354] This is not a matter of speculation. As discussed above, in many instances, especially in inactive stocks, the specialist actually "sets" prices in situations which may be quite complex and may call for a good deal of judgment in arriving at "fair" prices. See sec. 6.j. above.

[355] Amex report, pp. 29–32.

[356] NYSE rule 111; Amex rule 190(c) contains similar provisions.

This answer applies even to those who now have a public business, since that business has no connection with the function of the specialist. As pointed out above, the specialist relies on the flow of orders in the market and the book to offset his positions; he does not use his own retail customers as an outlet. There would be no harmful impact on the functioning of the specialist system on the Exchange if specialists and their firms could not deal directly with the public. On the other hand, the practice involves the basic difficulty that the specialist handles orders for two kinds of customers—those with whom he or his firm have direct contact, and the anonymous mass of investors whose orders are forwarded to him in the normal course of business. The potential for discrimination and difficulties of surveillance are so great that the practice should not be permitted to continue.[357]

e. Contacts with corporate officials

Many of the problems discussed above involve possibilities of the specialist's unfairly preferring himself or particular customers through his crucial position in the market. A direct possibility of preference to the specialist himself or to favored customers arises when he has access to corporate information denied to the general public. Such information might be advance knowledge of increased earnings, stock splits, mergers, etc. In this connection, the Exchange has a rule which prohibits specialists from being directors of companies in whose stock they specialize.[358] Furthermore, the Exchange expresses a policy [359] prohibiting specialists from acquiring "inside information."

Several specialists have testified that inside information is of no benefit to them because they service the market as the needs arise.[360] One specialist indicated that advance corporate information would be helpful to him in servicing the market.[361] Another specialist testified that most contacts with corporate officials are of little use because corporate officials are always optimistic:

Q. On the basis of [a visit to the company's plant], would your trading in the stock be influenced?

A. I wouldn't think so. One of our partners just went out to [a company] and came back and said that they were very bullish, and he was very bullish, and, the next day, I think we sold 10,000 shares short, because that is the time you want to get out, when everybody else is bullish.

Some specialists said that they can obtain all the information they need from the financial press, but others felt that they cannot get enough information from other published sources and should visit the company and its officials.[362]

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[357] This applies only to the two major exchanges in New York. The specialist business on the regional exchanges is different for various reasons, including limited volume, which makes separate treatment appropriate for those exchanges.

[358] Rule 460.

[359] NYSE Company Manual A–22.

[360] Compare the attitudes of primary market makers in the over-the-counter markets, discussed in ch. VII.C.

[361] The floor department records disclose that one specialist had been critical of a corporate official for failing to inform him of a contemplated stock split. The file in this matter reflects that the chairman of the board told the specialist that he was to treat officials of companies with courtesy when they visit the floor. The file contains no indication that the specialist was cautioned regarding his attempt to obtain inside information. Vanderbeck testified that the specialist was told orally that his attempt to get such information from a company official was improper, and further testified that he did not know of any investigation to determine whether the specialist had attempted to acquire or had acquired similar information from other companies.

[362] One specialist testified:

"Q. How much do you believe that a specialist should know about the company whose stock he trades in?

"A. I think he ought to go to see that the buildings are there. We happen to have been specialists for McKesson Robbins at one time."

The Exchange has a program of encouraging specialists to maintain liaison with the officials of companies in whose stocks they are registered. Its view is that a specialist must maintain such liaison in order to give the company and its stockholders a fair and orderly market.[363] The Exchange also believes that company officials should be kept informed of unusual market problems and should be free to call the specialist for information if a question arises about the market in the stock.[364] Pursuant to this policy the floor department has organized a specialist corporation liaison unit designed to foster such contacts between specialist and issuer. A specialist is expected to contact officials of the companies in whose securities he is registered at least once a year, and is required to report to the Exchange on the number of his contacts. The Exchange staff periodically asks specialists whether or not they have been maintaining the prescribed relationships with their companies, and also attempts to bring the specialist and corporate officials together at the Exchange whenever this is possible.

Various specialists, including two former chairmen, testified that they believed this program performed principally a public relations function on behalf of the Exchange and its specialists. They emphasized that listed companies are "clients" of the Exchange and that the Exchange should attempt to keep them informed. The following excerpt from a staff memorandum is indicative of the floor department's views in this respect:

> I told [the specialist] that he should get together with [the president of an issuer] and establish a friendly relationship with him. I emphasized that this company is one of the Exchange's customers, and that it is the responsibility of the specialist to conduct himself in such a way as to please and satisfy the officials of the company—at the same time explaining any market problems and the specialist function.

Although the floor department administers the specialist corporate liaison program, the "Department of Stock List" has principal responsibility in the area of Exchange-issuer relationships, and has an elaborate system for maintaining contact between the Exchange and listed companies. Listing representatives from this department visit issuers periodically to discuss common problems, and issuers are encouraged to confide in the listing representative assigned to their companies about corporate developments. Phillip West, vice president of this department, testified that his department by itself could adequately handle the usual problems an issuer might have with respect to the trading of its stock; e.g., whether a stock should be split. However, Vanderbeck, the vice president in charge of the floor department, emphasized that there were some market problems that only specialists were qualified to discuss with corporate officials.[365]

In administering the specialist corporate liaison program, the Exchange sets standards concerning the scope of what specialists are permitted to discuss with corporate officials. Generally, specialists are not supposed to receive inside information. Company officials may discuss matters with the specialist much as they would with "bankers, stockholders, security analysts, or anyone having a legitimate

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[363] NYSE Company Manual A-22.
[364] Ibid.
[365] This view seems at odds with the testimony of the two former chairmen who felt that contacts between specialists and corporate officials serve primarily a public relations function.

interest in the company,"[366] except, of course, that a specialist may have his discussion at a higher level than would an ordinary stockholder. The testimony of Phillip West points up the latter difference:

> To put it another way, some companies are relatively large and have hundreds of thousands of stockholders. They set up a division that deals with stockholders for the reason that the president of the company just would not have time to talk to every stockholder if he should raise a question, or to sit down with him for 2 hours every day. On the other side of the picture, as far as the specialist discussing something with the president of the company because the stock was listed on the Exchange, I think that a specialist would discuss with the president, whereas the 10-share stockholder might discuss it with the stockholder relations department, or something like that, but they should be equally satisfied.

The Exchange's program appears unrealistic. It brings together individuals each of whom may have confidential information of value to the other—on the one side corporate information and on the other technical information concerning the book and possible short-range price movements—and yet it forbids the exchange of such information. Various situations coming to the attention of the Special Study illustrate the difficulties presented.

In a period of several weeks after a "liaison" trip to the Universal Leaf Tobacco plant, various personal friends and relatives of the specialist purchased 4,400 shares of the stock through his firm; on 1 day 1,400 shares were purchased for such customers—this was 58 percent of the reported volume. The stock was then selling in the middle 30's. The specialist testified that he mentioned the stock to friends as one he was buying for himself although he denied having access to inside information. The stock rose as high as 55¾ during 1961, which he attributed to higher earnings and the recommendations of certain brokerage houses. Although it is not possible to state whether the specialist did have confidential information in this situation, such trading by his firm's public customers creates substantial questions as to whether the information acquired by the specialist was readily available to the public in general.

In the case of two listed companies, it appears that the specialists were advised by the company official of merger possibilities before they were publicly announced. In another case a leading specialist testified that in a visit to the floor by the largest stockholder of a company in which he specialized, the stockholder and the specialist discussed the splitting of that company's stock. The stock was actually split 6 to 8 months later, although the specialist stated this conversation had no effect on his trading.[367] Again, although there may not have been any impropriety on the part of the specialists in any of these situations, they illustrate the problems involved in encouraging contacts between specialist and issuer but prohibiting the exchange of information.

The Amex report illustrates that relationships between specialists and issuers were crucial factors in the problems involving Amex specialists. Indeed, two of the three major disciplinary cases in the past several years involving NYSE specialists concerned corporate insiders in one way or another.[368] In one of these cases the specialist had ac-

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[366] NYSE Company Manual A–22.

[367] The Exchange considers it improper for an issuer to give advance information about stock splits. NYSE Company Manual A–22.

[368] Problems involving the corporate insider public customer are often linked in these cases.

quired options from a corporate official, and in the second, various questionable trading activity took place in accounts introduced by a director through the specialist.[369] It is perhaps ironic that the specialist in the latter case urged this in his defense:

> It has been my understanding that it is the policy of the New York Stock Exchange to encourage a close relationship between the specialist or members of the specialist firm and the officers of the companies whose stock they make markets in. I recall a few occasions when I was requested by my floor partners to fill out questionnaire cards of the Exchange indicating which of our companies we had been in contact with, what the names and titles of the officers were, and when did we last visit them. As a result of this, my firm encouraged me to become more closely acquainted with the officers of those firms in whose stock we specialized.
>
> Accordingly, when [the director involved], whom I had met on several occasions and who had met with my father and with various officials of the Exchange, introduced these accounts * * * whom I identified either as employees of [the issuer] or of his accounting firm, I felt that a proper introduction had been made. * * *

In view of the Exchange's strong belief, which the Special Study shares, that specialists should not receive "inside" corporate information, encouraging contacts between issuers and specialists would not seem to be an appropriate or necessary way to maintain liaison with listed companies.

f. The need for increased surveillance

In the area of the conflicts of interest which arise from the specialist's unique role as both broker and market maker, the Exchange's regulatory and surveillance program has been inadequate. Until recently, almost its entire effort has been directed to expanding and regulating the dealer function without regard to the fact that high level of specialist dealer activity more often puts the specialists in situations where his customers' interests conflict with his own. There was no routine procedure to disclose conflict-of-interest problems and few standards governing specialists' fiduciary conduct. With respect to the latter, the Exchange has been content with the technical auction market rules, such as the "crossing" rule and the rule prohibiting direct competition at the same price between a member and his customer. Even when possible problems of conflicts have been discovered, the Exchange, with limited exceptions, has not enforced high standards in the handling of the cases. This is exemplified in two of the cases discussed in the text. In the instance where it appeared that the specialist gave preferential treatment to certain orders over others and in the case where the specialist deliberately lowered the price of the stock to touch off his customer's stop-loss order, the Exchange's investigation of the cases turned on poor market-making activities rather than conflict of interest and no disciplinary action was taken against the specialists.

The point is further illustrated by the length of time which passed before the Exchange discovered that many specialists had ignored the 1952 ruling against not-held orders, with the attendant fiduciary problems caused by such orders. The rule against the acquisition of inside information has also had only causual enforcement. When such problems have been uncovered, the Exchange on one occasion was more concerned with discourtesy to a corporate official and in other cases

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[369] In January 1963, the specialist was fined $5,000 for violating the "know your customer" rule (rule 405).

did nothing at all. A similar insensitivity has been displayed with respect to the practice of stopping stock, with the basic fiduciary questions it raises and about which specialists themselves have conflicting views and policies.

In recent months there has been greater awareness in this area. A newly hired examiner has been assigned on a part-time basis to work that may involve reconstructing specialist books and uncovering fiduciary problems; however, the whole process of reconstructing books remains a tedious and difficult job. The Exchange has recently required specialists to report regularly the transactions in their specialty stocks by their own public customers. But the Exchange has done little with respect to the more subtle and difficult conflicts of interest in the area of competition between specialist and customer.

It is true that many of the conflict situations involve, at least immediately, only ⅛'s or ¼'s of a point—relatively small differences—whereas the Exchange has been preoccupied with difficult problems of market making in the changing character of the Exchange market. However, the Exchange has always characterized its market as a trustworthy mechanism for all investors. It has also emphasized that the specialist system is one which insures that its markets move in small fractions. It must be borne in mind that the conflicts of interest existing within the specialist system have been flatly prohibited for centuries in other areas of fiduciary relationships. They are permitted within the specialist system because the orders available to specialists as brokers help them discharge their responsibilities as market makers to the advantage of all concerned. Nevertheless, the toleration of the conflicts is only permissible within a sensitive and effective regulatory framework.

8. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The specialist stands at the hub of the market mechanism of the NYSE and other major American exchanges. Since the inception of the specialist system about 100 years ago, the role of the specialist has increased greatly in importance. Starting essentially as a broker who had the function of storing limited price orders incapable of immediate execution, the specialist has also become a dealer who participates in a substantial percentage of exchange transactions for the purpose of maintaining a "fair and orderly market" in the securities in which he is registered.

The Special Study's examination of the NYSE specialist system has disclosed no widespread abuses or patterns of illegality. Nevertheless, serious problems have been found concerning the system itself and its surveillance and regulation by the Exchange. Certain fundamentals disclosed by the Special Study are at the core of these problems. The first is that in the last 25 years the specialist's dealer function has become as important as, if not more important than, the brokerage function—on both a quantitative and qualitative basis. The second is that the conflicts of interest inherent in any simultaneous combination of dealer and broker functions have been intensified, on the one hand, by this expansion of the dealer function and, on the other hand, by extensions of the brokerage function beyond that of handling market and limit orders for other brokers. The third is that there are wide variations in financial and other capacity, and in

performance, among the 110 different NYSE specialist units, resulting in considerable divergency in the nature and quality of markets for individual securities even apart from inherent differences in their market characteristics, and indicating that the regulatory framework permits too wide a tolerance from acceptable norms.

a. The specialist as dealer

The specialist's participation in the market as dealer has increased steadily through the years. Today, specialists are purchasers or sellers in approximately 30 percent of all exchange transactions. In 1960, approximately one-third of all specialists derived a greater part of their income from dealer profits than from brokerage commissions.

The basic dealer function, the maintenance of reasonable price continuity, is a useful one in several ways. A market which moves in small fractions probably tends to discourage undue speculative activity. Transactions in a particular stock on a particular day are likely to involve only a small number of shareholders, some of whom may have pecularily urgent needs to liquidate their positions, and a responsible dealer system can prevent sudden changes in prices caused not by changes in intrinsic worth or general market conditions but by vagaries of supply and demand at a particular moment. The specialist serves as nexus between buying and selling orders, which arrive haphazardly rather than simultaneously in a continuous auction market.

A considerable portion of specialists' dealer profits are derived from the "jobber's turn"—the profit realized by purchasing from members of the public at the quoted bid and selling to them at the quoted offer. Since the potentialities for profit are greatest in the more active stocks, specialists' dealer activities tend to be concentrated in these stocks. Furthermore, the risks of acquiring an inventory are smallest in active stocks, which have the greatest volume of market orders and usually the thickest "books"—the unexecuted orders on both sides of the market entrusted to the specialist for execution—with which the specialist can trade in order to dispose of a long or short position. Responsible professional participation is needed most, however, in the least active stocks, where risks are greater and profit potentials are more limited. The Exchange has a policy of assigning certain types of stocks to well capitalized specialist units with a high rate of dealer participation, but there is no attempt to give each unit a "balanced portfolio" so that a more or less assured dealer profit and brokerage income in stable issues can be available for volatile stocks and inactive issues. Thus there is no systematic method of allocating total capital resources of the specialist system to less profitable as well as more profitable issues.

Closely allied with the problems of assuring adequate participation in inactive issues is the great difference between the concepts under which so-called "dealer specialists" (well capitalized units with a high rate of dealer participation) and "broker specialists" (units which emphasize their brokerage function) seem to operate. The increasing importance of the specialist's dealer function for the entire market is making this gulf so wide as to threaten the image of the Exchange as a marketplace whose specialist system assures strength in all markets.

The extent of dealer participation on the part of different specialists depends in considerable degree on the adequacy of their capital, and thus an adequate capital provision is a basic prerequisite for a strong specialist system. This is true not only in respect of extraordinary demands on the system in the handling of large blocks, as discussed below, but also in respect of more routine market situations, as illustrated by those specialist units which endeavor to end each day with as small a long or short position as possible ("daylight trading"), in order to avoid risk and capital commitment. The capital requirements of specialists, designed to assure that specialists have sufficient funds to maintain fair and orderly markets, have not been increased by the NYSE for many years although they were established at a time when market conditions were vastly different from those existing at present. In terms of units of stock (but not necessarily dollars) they are lower than Amex requirements as recently increased.

Just as underparticipation by some specialists in some situations raises one set of questions, so also are these important questions of overparticipation by specialists. The latter questions had earlier recognition and emphasis in regulatory terms; under the Exchange Act, a specialist's dealer transactions are to be restricted "so far as practicable to those reasonably necessary to maintain a fair and orderly market," and this standard was early defined (in the Commission's so-called Saperstein Interpretation of 1937) as relating to price continuity and minimizing the effects of temporary disparities between supply and demand. Despite the restrictive tenor of the statute and its official interpretation, the NYSE, particularly in recent years, has emphasized high dealer participation as a general standard for specialists.

The restrictive purpose of the Saperstein Interpretation should receive new emphasis in the form of a Commission rule, while at the same time the affirmative obligation of specialists to make fair and orderly markets should also be set forth in such a Commission rule. Exchange rules should then give further content to both aspects, by expressing as specifically as practicable the requirements and standards deemed applicable to typical problems of overparticipation and underparticipation as they have arisen in respect of various market situations and among different specialist units. In particular, there should be greater emphasis on what might be termed "continuity with depth," i.e., with reasonable volume at each price level, rather than mere price continuity without regard to volume. The total aim of Commission and Exchange rules should be to focus more closely on experienced problems of each type, overparticipation and underparticipation, rather than blanketing all problems of specialist participation under a general emphasis either on minimum participation or high participation.

As specialists' dealer participation has increased, there has been a growing tendency by the Exchange to express the utility of the specialist dealer function in terms of "stabilizing" prices (as distinguished from providing transaction-to-transaction continuity). To measure specialists' stabilization performance, the Exchange uses the "tick test," under which, in general, a purchase below or a sale above the price of the last different transaction in the stock is deemed to be stabilizing. The results of the Special Study show that, under the

tick test or other tests of stabilization, the stabilizing effect of specialist trading varies considerably among specialist units and in differing cirumstances, so that aggregated data obscure wide disparities.

During the May 1962 market break, specialists as a group did not have a significant stabilizing effect on the market, though as a group they had been reducing their inventories since the end of 1961, and there were wide differences in performance among specialists. The data collected concerning the market break demonstrates that the tick test is an inadequate measure of stabilization, since it fails to take account of specialists' trading in relation to the overall trend of the market. The Exchange should not only develop more effective methods of testing specialists' performance, but should apply its regulatory authority to bring deficient specialists up to an acceptable level. It should be emphasized, however, that ordinarily the capacity of specialists to provide price stability is a distinctly limited one. No system of dealer trading can be expected to stabilize—in the sense of preventing price changes—in a market subjected to heavy public buying or selling.

Although the Saperstein Interpretation emphasized that each dealer transaction must meet a test of affirmative market necessity, some specialists have claimed that they have the right to liquidate their inventory if it becomes financially necessary to do so, regardless of the market effect of such liquidation. Connected with this is the view that a clearing firm financing a specialist has the right to instruct the specialist to liquidate his position without prior notice to the Exchange. During the May 1962 market break, a few specialists were in financial difficulties. It is not clear whether the Exchange was aware of the financial condition of these specialist units, but in any event no corrective action was taken. It is imperative that the Exchange keep itself informed of specialists' financial condition on a current basis, and that stocks registered with specialists who find themselves financially unable to perform their dealer function adequately be promptly reallocated, in order to assure the public the continuous benefits of specialists' performance.

The Saperstein Interpretation is ambiguous as to whether the policy against a specialist's "cleaning up the book" applies to liquidating a position. This ambiguity should be resolved by making the policy applicable to liquidations, and relevant standards and procedures in respect of acquiring or liquidating a position against the book should be more specifically defined.

Increasing institutional participation in the market has changed and may still be changing the kind and degree of demands on the specialist system, because the tendency of institutional investors to deal in large blocks tends to increase temporary disparities between supply and demand. Specialists vary considerably in their willingness and ability to buy or sell substantial blocks at prices close to the last sale price. To preserve the Exchange's place as a centralized market, mechanisms for orderly trading of blocks in all listed issues within the auction market should be reexamined and strengthened where possible and, to meet this specific need as well as the general need mentioned above, specialists' capital requirements must be reevaluated.

The dealer activities of some specialists are influenced by tax considerations rather than the needs of the market, especially where spe-

cialists segregate holdings of securities in which they are registered into long-term investment accounts. These accounts raise several types of questions. First, their existence is generally inconsistent with the Saperstein Interpretation, because neither the acquisition of stock for investment nor the withholding of stock for investment reasons comports with the criteria for specialists' dealings as principal. Second, they make the specialist an investor and give him a motive to support the market instead of merely performing his function of providing continuity and depth to the market. Third, specialists frequently establish these accounts by taking advantage of their exemption from Federal margin regulations, a purpose contrary to the purpose of the exemption.

Although providing market continuity and "instant" liquidity in a continuous auction market requires heavy professional participation, and the Exchange has encouraged such participation, Exchange literature has spoken of the specialist as merely a "balance wheel" between public supply and demand, a professional who buys when others want to sell and sells when others want to buy. What has not been made clear is that in many significant ways the specialist is in a position to, and does actually, "administer" the market and affirmatively influence price levels and trends—that the specialist, except in the most active stocks, may often be the market rather than a mechanism for linking buyers and sellers together.

It is in openings that dealer activities of specialists have made the clearest intrusion on the concept of a free market. The opening price of an issue is probably the single most important price of the day. Here above all, the principle of a free and open market, with prices set by public supply and demand, should govern. Except to maintain price continuity, the specialist should not interfere in openings, either by his participation as dealer or his judgment as broker. The present system of centralizing orders in the hands of the specialist, however, seems a fairer and more efficient system than the old system, where brokers individually bid and offered.

The virtual disappearance of competing specialists makes it particularly important that there be uniform standards as well as close supervision in respect of various types of situations where the specialist's ability to set prices unilaterally is particularly high. The Exchange has recognized that it has an affirmative duty to improve specialist dealer standards in this as well as in other areas. Yet the diversity among the various specialist units is so great as to indicate that existing standards are too flexible.

b. The specialist as broker—conflicts of interest

The combined functions of the specialist, acting as he does for the orders entrusted to him and for his own account as principal, involve an inherent conflict of interest. Furthermore, he acts for customers on both sides of the market, and he also has a responsibility to act on behalf of the market as a whole. In view of the benefits which responsible dealer activities can confer on the market, this conflict is tolerable, but only under a regulatory system which contains effective controls.

The general argument in favor of continuing to permit the combined functions is that specialist brokerage income, which is substantial, provides a continuous source of capital and incentive in the performance

of market-making activities. Although the force of this argument is somewhat weakened by the fact that dealer activities also generally provide a continuous profit, it nevertheless remains a strong one.

An even stronger argument is that expectations of investors, credit arrangements which depend on liquidity, and the very organization of the exchanges, to one extent or another revolve around the technical market functions of the specialist. These considerations alone would require that any such drastic change as segregation of functions should be based on a clear preponderance of the evidence. Such preponderance does not exist, although it is clear that the specialist can and does compete with his own customers and that many fine distinctions are involved in differentiating proper from improper conduct. For example, when a specialist outbids or under-offers customers who have employed limit orders, which indicate a price beyond which they are unwilling to go, he may be merely performing his dealer function of providing continuity between transactions or in some circumstances he may be competing unfairly.

The specialist's exclusive knowledge of the orders on the book and the known source of supply and demand available to him through the book give him a definite trading advantage over other market participants. This can be justified only by the benefits which the specialist confers on the market, and only if high standards of conduct in dealer and broker activities are defined and enforced.

Certain practices of specialists which exacerbate the inherent conflict of their dual role should be terminated. Specialists and their firms should not be allowed to have their own retail customers (as opposed to customers of other brokers whose orders are given to the specialist for execution). Transactions for a specialist's own customers do not affirmatively assist his market-making activities and are fraught with possibilities of abuse.

The practice of "stopping stock" against orders on the specialist's book, i.e., using an order on the book to guarantee a price to another investor, involves too great a compromise of the specialist's fiduciary obligation for personal profit without any strong offsetting gain to his market-making function. A number of transactions made pursuant to "stops" are deliberately omitted from the tape, apparently without valid justification.

There is confusion as to the precise kinds of orders that specialists are permitted to accept and their responsibilities with respect to each. Although NYSE specialists have been prohibited by the Exchange since 1952 from accepting "not-held" orders—orders allowing discretion as to time or price of execution—many specialists continued to accept them until the fall of 1961. The acceptance of "not-held" orders by specialists involves a compromise of fiduciary obligations (and in some cases market-making activities) which far outweighs any possible benefits.

c. Surveillance and enforcement

Although present NYSE surveillance procedures are in the hands of a capable and sophisticated administration, there is need for greater attention to specific problem areas and there is need for a more thorough examination procedure generally. In one particular, the surveillance process should be more sensitive to conflict of interest problems. Ideally there should be a regular method by which the sequence

of transactions, the specialist's book, and his own transactions in any stock could be quickly and conveniently reproduced. Modern data processing equipment would very likely permit this to be done, but the NYSE has shown little inclination to move in this direction; indeed, it has not yet arranged for orders to be clocked at the specialist post, a procedure that has been in effect on the Amex for some years. Also, it is difficult to see how standards of performance and risk-taking can be set without taking into account profitability as well as unprofitability, yet until the NYSE obtained data on specialists income as a result of the study's questionnaire EX-1, the floor department had no information whatsoever with respect to trading or brokerage income of any specialist unit or in the aggregate.

Whether the obligations of specialists are defined very broadly in terms of "fair and orderly markets" or are defined somewhat more specifically in relation to particular types of problems, it is clear that a large measure of judgment and discretion is involved in their application and that the administrators of the regulatory system—primarily the exchange themselves—must exercise vigilance and discrimination in evaluating performance in particular situations. A mechanical application of any or all of the tests used in surveillance (or even new tests) to come to an aggregate figure for all specialists does not discharge the duty of surveillance which ultimately is the protection of individual investors in specific transactions.

The Special Study concludes and recommends:

1. The specialist system now in operation on the NYSE and Amex is different in significant respects from the system which existed when present regulatory policies were established, and is different also from the image of the specialist system as frequently projected. In its present form, it appears to be an essential mechanism for maintaining continuous auction markets and, in broad terms, appears to be serving its purposes satisfactorily. There is a need, not for any broad and drastic change in the system, but for a number of important, specific improvements in specialist practices and in regulatory concepts and methods, as set forth in the following paragraphs. For the most part, these can and should be accomplished through changes in the rules and procedures of the respective exchanges, except that, since the Commission is not presently empowered to enforce rules of the Exchange (see ch. XII), it would be desirable to define certain basic dealer responsibilities of specialists (pars. 2 and 3, below) in rules of the Commission under section 11(b) of the Exchange Act. The limited volume of transactions on the regional exchanges and the dependence of these exchanges on the dual trading system may make it impracticable to place such responsibilities on regional exchange specialists and for the present they should be excepted from any such rules under section 11(b). Further studies are needed in the structure of regional exchange specialist systems, and questions of responsibilities and privileges of these specialists should be held in abeyance pending such studies.[370]

[370] For this reason most of the following paragraphs are applicable only to the NYSE and/or Amex although specific items may also be applicable to one or more regional exchanges insofar as they use a specialist system in respect of primary listings.

2. Section 11(b) of the Exchange Act states a policy of restricting specialists' dealings "so far as practicable to those reasonably necessary to maintain a fair and orderly market." The so-called Saperstein Interpretation promulgated in 1937 among other things limits specialists' dealer transactions to those reasonably necessary to maintain price continuity and minimize temporary disparity between supply and demand. The NYSE's policy and practice of indiscriminately encouraging specialists to increase their participation as dealers is incompatible with the restrictive tenor of these provisions. Although the changed market context since 1937 has seemingly changed the level at which the standard of "reasonably necessary" in the foregoing provisions must be applied, it is still an appropriate and desirable standard which needs restatement, in place of the NYSE's present emphasis. The relevant portion of the Saperstein Interpretation should be embodied in a rule under section 11(b).

3. While specialists should be restricted in their dealer participation to what is reasonably necessary to maintain a fair and orderly market, an affirmative obligation on their part to participate to the extent reasonably necessary to maintain a fair and orderly market should be more clearly recognized and enforced. The rules of the NYSE now merely state that such participation is "commonly desirable," and in practice the Exchange has not held individual specialists to high standards of performance, with the result that considerable unevenness in the quality of markets in individual securities has been tolerated. A rule should be adopted under section 11(b) to state the obligation positively.

4. The NYSE should increase its specialist capital requirements in recognition of current market needs and specialist obligations. Instead of the present requirement of capital sufficient to carry 400 shares of each stock in which a specialist is registered, the nature of the market in most securities would seem to require that specialists have the capital ability to carry at least 1,200 shares, and preferably a higher amount such as 2,000 shares, of each issue; the exact figure or figure may be left for future definition by the Exchange and the Commission jointly.

5. The NYSE and Amex should adopt rules relating to specialists' participation in openings and their trading as dealers, as follows:

(a) With respect to openings, such rules should be designed to prohibit specialists from participating in openings in such manner as to upset the public balance of supply and demand; i.e., from using their position as dealer, or a broker for all participating parties, to change prices. The policy of such rules would be that opening prices should move, from the previous close, in the direction dictated by public supply and demand and not against it.

(b) With respect to trading after the opening, such rules should limit the ability of specialists to "reach" across the market; i.e., buying at the offer or selling at the bid, whether such transactions are to establish or to liquidate a position. Provisions should be made for exemptions from such rules with approval of floor officials and for systematic review by the respective floor departments.

(c) With respect to the general obligation of specialists to participate to the extent reasonably necessary to maintain a fair and orderly market, such rules should give emphasis to the concept of continuity with reasonable depth; i.e., participating in reasonable volume at each price level, and should also make clear that the obligation to participate requires that all quotations be reasonable ones in view of market conditions and not merely nominal ones.

6. The NYSE and Amex should adopt rules requiring that each specialist unit maintain a single trading account. All securities in which a specialist is registered which are owned by such specialist or his unit should be maintained in such account and not segregated for tax or other purposes. No recommendation is made with respect to specialist inventory practices for tax purposes. Nevertheless, in view of the testimony of some specialists that they occasionally trade to adjust inventories kept on a LIFO basis, it should be made clear that trading so motivated is not permissible.

7. The NYSE and Amex should adopt rules governing the brokerage function of specialists and should clarify various related floor procedures, as follows:

(a) The respective exchanges should adopt rules affirmatively defining market and limited price orders and variations thereof, and defining specialists' (and floor brokers') responsibilities with respect to each type of order.

(b) The existing ban against specialists' accepting "not-held" orders should continue. If necessary, consideration should be given to increasing floor brokerage rates to compensate floor brokers adequately for their efforts in handling discretionary orders.

(c) Specialists on the NYSE and Amex should be prohibited from granting "stops" (either by allocating customers' orders or as principal) at any price at which a specialist holds an unexecuted customer's order capable of execution at such price.

(d) The present policy of the NYSE which permits executions resulting from stops to be omitted from the tape should be changed by a rule requiring that every transaction taking place on the floor be reported on the tape. The policy requiring the selling broker to report transactions should be strictly enforced.

(e) A specialist represents conflicting interests, his own and that of customers, whenever he purchases from or sells to his "book"; i.e., from or to a customer whose brokerage order he holds. Policies should be formulated to prevent specialists from dealing with or for customers at unfair prices in relation to the general market conditions or the specialists' own transactions including but not limited to situations where a specialist sells to his customer at the limit price when he knows of a large offering or buys from his customer at the limit price when he knows of a large buy order. Whenever a specialist deals with the book a floor member representing the firm which forwarded the order should initial the specialist's memorandum of each such transaction.

In its routine surveillance the exchange should systematically review transactions covered by such memoranda in light of subsequent transactions by the specialist.

(f) To keep within as narrow limits as possible the conflicts of interest inherent in a specialist's combination of functions, NYSE and Amex specialists and their firms should be prohibited from servicing the accounts of public customers, or receiving commissions on such accounts "introduced" by them at other firms.

8. No information is now publicly available with respect to specialist dealer activity in individual stocks. The NYSE and Amex should report to the Commission on a weekly basis each specialist's purchases and sales as principal in each issue traded. Such reports should be made public so as to give interested investors an indication of the degree of activity, exclusive of specialist participation, in particular issues. On the other hand, in its public statements on specialist activities the NYSE has tended to exaggerate the degree of stabilizing that specialists accomplish or could be expected to accomplish. The Exchange's "tick" test, whatever its other uses, is not by itself significant as an evaluation of "stabilizing" of the market by specialists and should not be so represented.

9. The NYSE and Amex should undertake studies, in conjunction with the Commission, as to methods or plans by which the capacity of specialists to acquire larger blocks of stock within the framework of the auction market could be otherwise strengthened. Among other possibilities, consideration should be given to (*a*) the establishment of an exchange-administered capital fund from which specialists could borrow under appropriate limits and safeguards; (*b*) the establishment of a capital fund, through contributions from the brokerage income of all specialists, that would be administered by specialists' representatives and/or the Exchange itself and would be available for taking positions beyond the financial capacity of an individual specialist; or (*c*) establishment of a system of limited self-insurance by specialists as a group. Reference is made to recommendation 4 above with respect to increasing the specialist capital requirement and the recommendation in part F of this chapter concerning the possibility of creating a category of "auxiliary specialists."

10. The NYSE and Amex should be required to report to the Commission any indication that a registered specialist unit is in violation of its specialist capital rule or has received a margin call. These exchanges should adopt rules providing in substance that any member firm which clears for or finances specialists may not terminate clearing arrangements or call for additional margin without adequate prior notice to the exchange. Where a specialist in financial difficulties cannot promptly secure additional capital sufficient to bring his account above the required margin maintenance, his stocks should be reassigned temporarily or permanently to units with capital adequate to handle them.

11. The NYSE has pioneered in the development of surveillance techniques regarding specialists' performance and has devoted considerable energy to this area. Nevertheless, its present tech-

niques are not sufficiently refined to deal adequately with certain important aspects of the specialist's role and obligations. Among needed improvements on this Exchange as well as the Amex are the following, which should be developed promptly by the exchanges in conjunction with the Commission:

(*a*) For many routine surveillance purposes it would be invaluable, but it has not heretofore been practical, to have a means of preserving or reconstructing a specialist's book for a given period; modern automation techniques may well remove the practical difficulties and should be promptly explored.

(*b*) Surveillance of overparticipation as well as underparticipation should be strengthened; as a basic check, regular reporting to the respective exchange of income of specialists, segregated between brokerage income and dealer income, should be required.

(*c*) In general, surveillance should be directed toward assuring that each specialist is performing his obligation to maintain a fair and orderly market in each security, with appropriate procedures and sanctions for enforcement and with the ultimate purpose of allocating and reallocating securities where required to assure high standards of performance with respect to all securities.

(*d*) In addition to present tests to evaluate performance, tests for evaluating specialist purchases, sales, and positions in relation to price movements should be evolved, with the object of determining the market effects of specialist dealer activities.

E. Odd-Lot Dealers

1. INTRODUCTION—THE SIGNIFICANCE OF ODD LOTS, AND THEIR HANDLING

The unit of trading in most stocks on the exchanges is the "round lot" of 100 shares. Trading in the regular auction market on the floor of an exchange is conducted in round lots, or multiples thereof.[371] An order to buy or sell a security on an exchange in any amount less than the round lot is an "odd-lot" order. Under this system, odd-lot orders do not enter the flow of buy and sell orders in the regular auction market. The business of the odd-lot dealer consists of filling odd-lot orders by buying or selling for his own account as principal. He transacts business exclusively with other brokerage firms, and not with the public.

The conduct of the odd-lot business is nevertheless very significant for the public investor, particularly the small investor, although odd lots also include any portion of a larger order that is not a multiple

[371] The minimum trading unit of 100 shares was adopted shortly after the Civil War, as a result of increased volume. (See note 380, below.) The minimum unit for the auction market has been justified on the ground that it fits that market's needs for a unit involving a sum of money adequate to represent a reasonable appraisal of a security's worth and, at the same time, conforming to the physical and mechanical limitations of the trading floor. It is also said that the trading of small units on the floor might result in a material increase in the cost of doing business and clogging of the ticker tape with reports of insignificant transactions. However, see p. 202, below.

For a relatively small number of securities traded at "active" posts on the NYSE, the round-lot unit is 10 shares. This is apart from 198 securities traded at Post 30 and known as "Post 30" stocks, all of which are considered inactive and handled differently from normal Exchange procedures.

of 100. The total odd-lot volume on the New York Stock Exchange during 1961 was 214,018,834 shares, or 9.1 percent of the total volume of shares traded on that exchange.[372] Odd-lot transactions, however, form a much higher percentage of total transactions than of total volume; in the same year, the two principal odd-lot firms on the New York Stock Exchange handled about one-half of the total number of round-lot and odd-lot public transactions on the Exchange. On the American Stock Exchange, odd lots constituted 3.7 percent of total volume for the year 1961.[373] On the principal regional exchanges too, odd lots constitute a substantial portion of the total volume, especially in dually traded stocks. In 1961, odd lots constituted 11.7 percent of total volume on the Pacific Coast Exchange and 19 percent of total volume on the Midwest Stock Exchange.[374] Thus, although odd-lot dealers do not deal directly with the public, the conduct of their business affects a large proportion of all public transactions, so that they are critical figures in the exchange markets.

Almost all odd-lot orders are executed at prices determined automatically by round-lot sales in the same securities. The odd-lot buyer pays a fraction of a point more per share and the odd-lot seller receives a fraction of a point less per share than the controlling round-lot price. This fraction is called the "odd-lot differential," and the odd-lot dealer's compensation is derived from it. A public customer purchasing or selling an odd lot pays, in addition to the differential which is passed on to him, a standard commission to his brokerage firm.

On the New York Stock Exchange, where the price of an odd lot is determined by the next ("triggering") round-lot sale,[375] the differential for stocks in which the round-lot unit is 100 shares is 1/8 of a point (12 1/2 cents) if the controlling round-lot sale is at 39 7/8 or below, or 1/4 of a point (25 cents) if the round-lot sale is at 40 or above ("quarter stocks"). Almost 99 percent of the volume of odd-lot transactions on that exchange is handled by two member firms, Carlisle & Jacquelin and DeCoppet & Doremus, who engage exclusively in handling odd lots. Both firms handle odd lots in every listed security except those inactive stocks traded at Post 30. The remaining 1 percent of odd-lot transactions on the Exchange is handled by the firms specializing in "Post 30" stocks, and by two specialist firms, in stocks traded at the posts where members of such firms are specialists.[376]

On the American, and most regional stock exchanges, odd-lot transactions are handled by the specialists in their respective stocks; most

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[372] See table VI-49 for the relation of odd-lot trading to total trading on the New York Stock Exchange during the period 1936-61.

It should not be overlooked that, to an unascertainable extent, brokerage firms receiving odd-lot orders may (if the customers approve) accumulate them in order to make up round lots, so that odd-lot volume is in fact somewhat larger than the figures show. These transactions do not involve the odd-lot dealers.

[373] See table VI-50 for the relation of odd-lot trading to total trading on the American Stock Exchange during the period 1937-61.

[374] These figures are derived from a sample of trading on these exchanges, based upon figures supplied by the respective exchanges.

In calculating the ratio of odd-lot volume to total volume, the odd-lot dealers' odd-lot volume can be included or excluded. The regional exchanges have provided the Special Study with ratios that include these figures. The NYSE, which regularly makes its figures public, does not include these figures; nor does the Amex. The study has adjusted the regional exchange data to make them comparable with those of the NYSE.

[375] Instead of waiting for the next round-lot sale, the odd-lot customer may enter an order to buy at the round-lot offer or to sell at the round-lot bid. Also, limited price orders or stop orders may be placed by specifying the price at which, or price range within which, the odd lot is to be bought or sold.

[376] Some odd-lot business in listed securities is also conducted in the over-the-counter markets. See ch. VIII.D.