exchanges have no dealers handling odd lots exclusively. The specialist odd-lot dealer fills all odd-lot orders in the securities in which he specializes, by taking for or supplying from his own account the stock involved in such orders. On the American Exchange, like the New York Stock Exchange, odd-lot orders are filled at a fraction of a point above or below the next round-lot price for active stocks,[377] and on the American and regional exchanges, the differential is the same amount as on the New York Stock Exchange.

2. SCOPE AND METHODS OF STUDY

The following discussions of odd-lot dealers and brokers concentrates on the activities of the two principal odd-lot firms on the New York Stock Exchange, with particular attention given two aspects of their business where regulation by the Exchange and the Commission has been at a minimum. The first of these concerns the setting of the odd-lot differential; the other relates to the modernization of the facilities for odd-lot transactions. The Special Study was not able to undertake an intensive study of specialist odd-lot dealers on the American Stock Exchange or the regional exchanges, and this report contains no evaluation of those dealers' performance or of their regulation by their exchanges. The report does, however, describe the relationship between the regional exchanges and the New York Stock Exchange dealers with respect to the setting of the odd-lot differential in dually-traded stocks.

In the course of this study, New York Stock Exchange officials and members were interviewed, and testimony was taken from partners and employees of the firms and their associate brokers, and from officials of certain regional exchanges. The Special Study staff also studied documents from the files of the odd-lot dealer firms and the files of the New York Stock Exchange and certain regional exchanges relating to odd-lot dealers.

3. ODD-LOT BUSINESS ON THE NEW YORK STOCK EXCHANGE

a. Structure and mechanics

Although the firms of Carlisle & Jacquelin and DeCoppet & Doremus handle almost 99 percent of the volume of New York Stock Exchange odd-lot transactions, they do not themselves handle executions on the floor of the Exchange. Each firm uses approximately 50 associate brokers to execute their transactions on the floor. These associate brokers are in effect floor brokers who work on a full-time and exclusive basis for one of the two firms. Each associate broker is a member of the Exchange, owning his own seat, but none of them are partners of the firms whose transactions they handle, and their relationships with those firms are terminable at the will of either party. Each associate broker is assigned a specific number of stocks located at his post and maintains a "book" in such stocks.

A public investor wanted to purchase or sell an odd lot on the New York Stock Exchange does not deal directly with an odd-lot firm and

[377] The regional stock exchanges, in trading dually traded stocks, which represent the major portion of their odd-lot business, employ what is known as the 3-minute rule, described in ch. VIII.E.

its assocate broker, but places his order with a commission firm, which transmits it to the NYSE floor.[378] An Exchange clerk prepares an order slip which is then sent through pneumatic tubes to the post at which the stock is traded, where it is received by another Exchange clerk who time-stamps the order and places it on a clip at the associate broker's post. The associate broker removes the order from the clip and places it in his "book," to be executed as soon as the triggering round-lot sale in the security takes place.[379] When that occurs the associate broker executes the order by selling or purchasing the shares for the account of the firm he represents. After the execution, the associate broker reports it on a slip of paper handed to the tube operator at his post. The report is then sent back through the pneumatic tubes to the booth where the telephone or teletype of the commission house is located, for communication to the office of the commission house and thence to the customer. One commentator on odd-lot procedures has noted that each transaction involves 19 different steps.[380] In all cases the execution of an odd-lot order is a purely mechanical operation, usually based upon a round-lot transaction; in many cases it is in fact handled by the associate broker's clerk.[381]

In the course of buying and selling odd lots, the associate brokers may accumulate long or short positions for their odd-lot firm's account. In order to adjust such positions, the associate brokers make offsetting round-lot transactions on the floor; these constitute about 25 percent of the total share volume of the odd-lot firms.

In 1961, the average income of an associate broker was approximately $50,000. They are paid by their firms the standard floor brokerage commissions on round-lot transactions, and from the odd-lot differential they earn 1⅛ cents per share on each transaction in securities with a price of less than $10 per share and 2¼ cents per share on transactions in securities at $10 per share or more.[382]

By contrast with the associate brokers, the partners in each odd-lot firm who hold Exchange seats execute no transactions for the firm, although many of them utilize the membership privilege to station themselves on the floor and supervise the activities of the associate brokers. The 2 firms had a total of 42 general partners (not all holding seats) as of February 1963, and about 100 associate brokers. Together, the floor partners of the two principal odd-lot firms and their associate brokers constitute about 10 percent of the Exchange's membership.[383]

Carlisle & Jacquelin and DeCoppet & Doremus, the two major odd-lot firms, trace their origins to a common ancestor, Jacquelin & DeCoppet Brothers, which in 1874 became the first dealer to make

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[378] On mechanics of the market, see pt. B of this chapter.

[379] The associate broker may observe the round-lot sale himself or may hear of it from an exchange employee, part of whose job it is to call out the sales.

[380] Hardy, "Odd-Lot Trading on the New York Stock Exchange," pp. 15–16 (1939).

[381] For details of the method of handling various types of orders and variations in the differential for low-priced, 10-share units, and called stocks, see DeCoppet & Doremus, "Buying and Selling Odd-Lots," pp. 22–42 (1962.)

[382] This is 12½ percent more than the minimum rate prescribed in the New York Stock Exchange Const., art. XV, sec. 2(c)(4).

[383] Two of the Exchange's largest commission firms, Merrill Lynch, Pierce, Fenner & Smith and Bache & Co., together had a total of 20 seats, as of February 1963. This constituted 1.5 percent of the membership.

For further data on the composition of the membership and a discussion of its significance, see ch. XII.B.

a market in odd lots on the floor of the New York Stock Exchange.[384] In the intervening years there have been various changes in the composition of the odd-lot industry, but no significant change has occurred since 1941, when a merger reduced the number of major odd-lot firms from three to two. Total gross income received by these two firms during the prosperous year of 1961 was over $35 million, and after deducting expenses (not including partners' compensation) their combined income was just over $12 million.[385] For 1959 the firms' total net income was over $9 million, and for 1960, over $7 million. During 1962, they stated that their 1962 profits would not equal those of 1961. As of January 1, 1962, their combined capital exceeded $14 million, not including 20 seats capitalized at $4,100,000.

Each odd-lot firm maintains an order service department which provides last sale service, sales recording service and adjustment service to the brokerage firms who are its customers. The cost of these services and the others rendered by the odd-lot houses is covered by the differential paid by the public odd-lot customer, although, as discussed below in section 3.d, the services are provided less for him than for the benefit of the commission houses, themselves. The order service department employs about 139 persons at DeCoppet and 106 at Carlisle, or 20 to 25 percent of all of their employees. In each firm the order service department is divided into three sections. In one section, clerks record all transactions appearing on the tape, separating them by security and noting the time of each transaction. This section supplies specific information about individual round-lot transactions to the firm's clerks working on the floor with the associate brokers; to the firm's adjustment section, described below; and to the commission houses. A second section, a battery of telephone operators seated in front of a large Teleregister board, supplies the commission houses with the last sale prices, volume, market averages, and other similar information. The average number of calls per day handled at Carlisle in 1961 was over 18,000, and at DeCoppet, as of mid-1962, the average number per day was 21,000. Finally, the section handling claims and adjustments processes errors and mistaken claims of errors in the firm's transactions. During 1961, DeCoppet adjusted 177,363 trades at a net cost of approximately $286,000; although strictly comparable figures are not available, Carlisle made 145,643 adjustments at a net cost of approximately $36,000 for all adjustments of $100 or more during the same year.

Neither firm regularly breaks down its costs by departments, although, as will emerge later in this report, the matter of these costs is significant. It can be assumed, however, that a substantial part of Carlisle's 1961 "overhead expenses" of over $6,300,000 and DeCoppet's "administrative expenses" of over $6,400,000 are attributable to the

[384] Before the 100-share trading unit was adopted after the Civil War, odd-lot trading was conducted off the floor of the Exchange on an over-the-counter basis, and in 1874 when odd-lot trading moved to the floor of the Exchange, it was handled substantially in the same manner. Brokers buying or selling odd-lots had to negotiate each transaction with the odd-lot dealer. This method later changed to a system whereby the odd-lot dealers offered to trade on the bid and offer, with the result that brokers could have their transactions automatically executed by sending them to the odd-lot firms. Ultimately the method evolved of executing odd-lot orders based upon the price of the next round-lot transaction, plus or minus a standardized differential. See Hardy, note 380, above at pp. 161–163; DeCoppet & Doremus, "Odd-Lots," pp. 5–6 (1961); Carlisle & Jacquelin, "Odd-Lot Manual," pp. 9–11 (1961).

[385] The figures cited are arrived at from the firms' income statements. No examination of their accounting methods has been made.

order service departments.[386] For example, Carlisle's overhead expenses for 1961 included more than $3,500,000 for employee compensation and bonuses, including the employees in the order service departments.

Another activity of the odd-lot houses which results in substantial benefits to their commission firm customers is their extensive borrowing of stock, mainly from other member firms.[387] As of December 31, 1961, the stock borrowing of the two major odd-lot houses amounted to a total of $61 million.[388] According to the odd-lot firms, this stock borrowing serves two purposes: first, to insure that they will be able to make timely delivery when selling odd lots to member firms and, second, to insure that certificates in small denominations are on hand so as to "make change" on deliveries by member firms.

Be this as it may, in effect, each borrowing of stock results in an interest-free loan of cash by the odd-lot houses to the firm lending the stock: no interest is paid by the lending firm on the cash deposited with it by the odd-lot firms as collateral, in an amount equal to the full market value of the borrowed stock. Some of the borrowed stock belongs to customers of the lending firms who held the stock in margin accounts; several commission firms stated that they do lend some of the firm's own securities, but mostly lend only customers' unpaid margin securities. Customers generally pay interest on the debit balances in such accounts.[389]

As of December 1961, the cost of money to the odd-lot firms in the form of bank loans, their primary source of financing, was 4½ percent, so that the total annual cost of stock borrowing, based on their December 31, 1961, stock borrowings, would have exceeded $1 million for each odd-lot firm.[390]

In addition to borrowing, the odd-lot firms also lend stock as an accommodation to member firms. The loans, however, are in smaller amounts, usually running between $2 million and $5 million per odd-lot firm. Stock which is borrowed by the odd-lot firms and in turn lent by them to other firms results in no net gain to the odd-lot firms, although they incur bookkeeping and operating expenses.

b. The regulation of odd-lot activities

The Exchange Act expressly contemplates regulation by the national securities exchanges of their odd-lot dealer members, with supervisory power lodged in the Commission. It permits the exchanges to have any rules regulating odd-lot business which are not inconsistent with the act, but does not require the adoption of any particular kinds of rules.

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[386] Partners of DeCoppet & Doremus estimated that for 1962 only about $1 million of their labor costs and $211,000 in communications expenses are attributable to their order service department. They made no attempt to break down their other administrative expenses. They also estimated that the purely service function of rendering sales information to the commission houses represents 20 percent of order room operations whereas 80 percent is part of the functioning of the odd-lot business. The method used in arriving at this estimate was not determined. However, the firm included supplying complicated sales information within the category of necessary operations of the odd-lot business.

[387] They borrow stock certificates representing round lots and exchange those for certificates in smaller denominations.

[388] The total for Jan. 1, 1961, was $54 million, and for Jan. 1, 1960, $52 million.

[389] See discussion in ch. III.D.

[390] To the extent that the bank loans are made under the exemption of regulation U, 12 C.F.R. 221.2(k), the stock-borrowing activities must be "for the purpose of financing such member's transactions as an odd-lot dealer * * *."

Section 11(b) provides:

When not in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, the rules of a national securities exchange may permit * * * a member to be registered as an odd-lot dealer and as such to buy and sell for his own account so far as may be reasonably necessary to carry on such odd-lot transactions, * * *

Section 19(b) of the act confers further jurisdiction upon the Commission as follows:

The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange * * * by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of such matters as * * * (9) the fixing of reasonable rates of commission, interest, listing, and other charges; * * * (11) odd-lot purchases and sales; * * *.

The New York Stock Exchange has on file with the Commission a registration statement [391] which contains the following answer to the question "whether the Exchange provides for odd-lot trading":

Transactions in odd-lots are effected on this Exchange under methods which have been prescribed by the odd-lot brokers and dealers with the acquiescence of the Exchange.

The word "acquiescence" suggests an essentially passive role. For a number of years, the Exchange had a standing committee with jurisdiction over odd lots, having "general supervision over dealings in lots of stock of less than 100 shares" and empowered to "formulate and submit to the governing committee for its adoption rules and regulations with respect to said matters and [to] require the observance thereof, when adopted." [392] As is noted below,[393] the Exchange is clearly of the view that it does possess broad jurisdiction over the odd-lot business, although in the last 25 years it has for the most part chosen not to exercise it, and its officials have said they see no reason for action now. However, the Exchange has adopted a few rules applicable to odd-lot dealer and broker activities. Rule 101 of the Exchange provides for the registration of odd-lot dealers and brokers, rule 102 prohibits odd-lot dealers and their firms from acquiring an interest in any option in any stock in which the odd-lot dealer is registered, and rule 94 contains certain limitations on participation in joint accounts by odd-lot dealers. The foregoing rules were adopted

[391] Pursuant to sec. 6 of the Exchange Act.

[392] NYSE Const., art. X, sec. 1, "Ninth" (1934). This jurisdiction dated back to 1922; see Comm. & Fin. Chron., Apr. 15 and May 20, 1922, pp. 1593, 2191, and issues of Apr. 1 and Apr. 8, pp. 1357, 1481. Compare NYSE Const., art. IX, sec. 5 (1938) ("[The Committee on Floor Procedure] shall have general supervision of the activities on the floor of specialists and odd-lot dealers and may disapprove of any member acting as a specialist, odd-lot dealer, or odd-lot broker."). Standing committees were abolished in 1941, and today's NYSE constitution does not provide for regulation of odd-lot trading.

The president of the Exchange said in 1922, in a speech to the Association of Stock Exchange Firms:

"This fact [the enormous growth in the amount of dealing in odd lots] creates a new obligation for the Stock Exchange. It is our profound duty to throw around transactions for small amounts, or on behalf of inexperienced investors, even greater protection, if possible, than around the larger transactions, where those concerned, through skill or experience, are better able to take care of themselves. I believe that the Stock Exchange itself must share the responsibility for establishing rules governing transactions in odd lots, * * *." Comm. & Fin. Chron., Apr. 15, 1922, p. 1593.

[393] See p. 181.

by the Exchange pursuant to specific recommendations by the Commission in its report to Congress in 1936 on the feasibility and advisability of the complete segregation of the functions of dealer and broker.[394] In addition to these rules, each odd-lot firm is required by the Exchange to report the aggregate share volume of its odd-lot purchases and sales each month,[395] and rule 435 applies the short selling rule to customer odd-lot trading.[396] The foregoing rules constitute the entire formal regulatory control imposed by the Exchange upon odd-lot dealers and brokers. The rules relating to floor trading have not been applied to the offsetting round-lot transactions of the odd-lot brokers.

There is, however, one further restriction on the activities of odd-lot dealers which has not reached the status of a formal rule. The Exchange has made one determination of policy which significantly affects the differentials charged by members transacting odd-lot business. The history of this policy is noteworthy.

In 1932, as a result of the enactment of higher transfer taxes, the principal odd-lot houses determined, when selling odd lots, to pass this tax on to the purchaser, although the formal incidence of the tax was upon the seller. However, the smaller specialist odd-lot dealers, then four in number, did not pass the tax on to the purchaser but paid it themselves.[397] Since the differential charged by these dealers was otherwise the same as that charged by the principal firms, a public purchaser saved money when his odd-lot orders were executed by a specialist odd-lot dealer.

In 1938, the volume of business conducted by the four small specialist odd-lot dealers amounted to 2½ percent of all odd-lot business on the Exchange. Price competition from the smaller dealers aroused the principal odd-lot dealers in September 1938, to request the president of the Exchange to institute a study of specialists' acting as odd-lot dealers, and the president asked the Committee on Floor Procedure to conduct such a study. The committee received briefs from the interested parties and also solicited comments from commission houses. The proceedings were conducted on a confidential basis to avoid publicity.[398]

The principal odd-lot firms argued that the public interest required that the functions of odd-lot dealers be segregated from the functions of specialists. However, this argument apparently received less consideration by the committee than the odd-lot firms' argument, unanimously supported by the commission firms which appeared before the committee, that the commission firms' obligation to obtain the best market for an odd-lot customer conflicted with their desire to obtain for themselves the services offered only by the principal odd-lot firms (and not by the specialist dealers). The committee stated:

> The commission houses heard by the committee, without exception, expressed the view that the independent odd-lot dealers should not be allowed to deal on

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[394] SEC, "Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker" (1936).

[395] NYSE form 600–A, prescribed pursuant to rule 440. See NYSE Guide, par. 2440J.

[396] The restriction applies only tot he customer's sale: the odd-lot dealer is excepted from the rule's operation (but is not entirely exempt from the Commission's short selling rules). On short selling generally, see pt. H of this chapter.

[397] Comm. & Fin. Chron., Oct. 14, 1933, p. 2731.

[398] The introduction to be read to those appearing before the committee was as follows: "* * * Unfortunately, this matter was aired in the newspapers some weeks ago and we have no desire for any further publicity. Our conversation today, therefore, will be regarded as entirely confidential between yourselves and the committee."

different terms from the segregated dealers. The commission houses stated that the tax-absorbing practice of independent dealers was a cause of embarrassment and inconvenience.

Some houses have felt that the service rendered by the segregated dealers is so valuable and efficient that, except when specifically instructed to give particular orders to tax-absorbing independents, they have given the segregated dealers all business in stocks handled by the tax-absorbing independents. Some of the houses have been embarrassed in explaining to customers why they went to the more expensive segregated dealers * * *.

Other houses, though conceding the value and efficiency of the service rendered by the segregated dealers have felt a duty to customers to go to the best market and have accordingly given all their odd-lot orders in the stocks handled by tax-absorbing independent dealers to those dealers. The price advantage obtained was apparently the principal, in most cases the only reason, for giving the business to the independent dealers. And, except for one house, each of these houses checks prices, etc., and obtains loans of stock, not from the independent dealers, but from one of the segregated dealers.

The consensus of opinion among the houses was that the existing situation was contrary to the best interests of the members of the Exchange and the public.

The committee followed the suggestion of the commission firms and resolved the conflict by ruling out the possibility of cheaper executions for public customers. It concluded:

The committee does not believe that an enforced segregation of the odd-lot dealer function from other functions is necessary or desirable, nor that an odd-lot dealer should be prohibited from dealing only in a limited number of stocks. The committee does feel, however, that the differentials at which odd-lot dealers do business should be the same. The committee believes that price competition between odd-lot dealers is detrimental to the best interests of the Exchange and a cause of embarrassment and inconvenience to a substantial number of members.

The committee believes it preferable that the Exchange avoid fixing all odd-lot differentials. The present differentials are not felt subject to criticism; the difference in the differentials is the thing to which objection is taken. Accordingly, the committee feels that the appropriate action to take is, under its power to withdraw its approval of any member acting as odd-lot dealer (rule 248), to withdraw the registration as odd-lot dealer of any member who transacts odd-lot business at differentials less than those at which the odd-lot business of the Exchange is usually transacted.

This committee action constituted Exchange policy, amounting to a prohibition of price competition by members in their differentials, but the Exchange did not make it public and never filed an amendment to its registration statement with the Commission or, apparently, otherwise officially advised the Commission of the policy. Since its adoption the business of the competing specialist odd-lot dealers declined to about 1 percent of Exchange odd-lot volume. Today, sales by odd-lot dealers to customers are excepted from New York and Federal transfer and documentary stamp taxes,[399] and according to the Exchange, the 1938 committee action no longer is of any effect.[400]

The Commission's supervisory regulation of the odd-lot business has been passive and limited. It has never formally exercised its regulatory authority under sections 11(b) and 19(b) with respect to

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[399] N.Y.S. Tax Law sec. 270(5)(a); 26 U.S.C. sec. 4322(b).

[400] An Exchange memorandum for the Special Study said:

"* * * the committee believed that the Exchange should avoid fixing all odd-lot differentials. However, the committee felt that in view of the objections raised on the dual system of dealing, all odd-lot dealers should deal on the same basis. Though the report uses the word 'differential' it seems clear from the context that all that the committee was considering was the tax absorbing practice of the odd lot specialist firms.

"By 1959 the stock transfer on odd-lot sales had been repealed. It would seem, therefore, that inasmuch as the attention of the committee was focused on the absorption of the tax, that the action that the committee took in 1938 has been of no effect since 1959 when the transfer taxes dropped out of the picture."

any odd-lot dealer activities. In 1936–37, internal staff studies were done of odd-lot trading on the regional exchanges. In 1938, the Commission considered making suggestions to the Exchange about changes in the odd-lot system, and decided that a study of that system might be considered jointly by the Exchange and the Commission. That year, the Commission's staff did study customers' total transactions on the NYSE, and, in 1940, the effect of odd-lot dealers' offsetting round-lot trading, and in 1941, the income and expenses of the major NYSE odd-lot firms. The Commission has never formally decided the extent of its jurisdiction over the odd-lot business generally. However, there have been informal staff expressions of doubt, seemingly quite baseless, as to whether jurisdiction existed over the differential.

In 1941, the odd-lot dealers increased the differential charged on stock selling below $1. The Exchange notified the Commission of the increase and the Director of the Commission's Division of Trading and Exchanges replied: "If the Exchange approves of this action, I assume that a public announcement will be made of these increased charges." In reply to the Director's letter, the Exchange wrote as follows:

> The Exchange has not had, nor does it now have, any rules fixing the differential at which odd-lot dealers in 100-share unit stocks should deal, since this has been and is regarded solely as a matter between the odd-lot dealers and the commission houses with which they deal. Therefore it is felt that it would be inappropriate for the Exchange to take any action with respect to either approving or disapproving the present proposed change. So far as an announcement of the change is concerned, you will note that the odd-lot dealers in question have stated that they propose to send a notice of such change in the differential to all commission firms, which is a practice which has been followed in the past.

The immediate response by the Division to the above statement was a reiteration of the request that a public announcement of the increase be made since the matter concerned charges to nonmember customers, and the odd-lot firms did send the announcement to the press as well as to member firms. However, there is no indication that the Division had any knowledge of the 1938 policy eliminating the possibility of price competition.

In 1950, another Director of the Division of Trading and Exchanges wrote to the Exchange: "[W]e feel that the Exchange should consider the advisability of adopting rules, regulations, or interpretations, reduced to writing, which would govern the existing operational methods" of the odd-lot dealers. The executive vice president of the Exchange replied that the Exchange would give prompt consideration to the advisability of adopting such rules. He and the Exchange's chairman then met with the Division's Director about several matters, including this one, and the Exchange agreed that, although somewhat reluctant, they would give the subject further consideration. The executive vice president thereafter wrote the Director that they were considering it, and sent him copies of DeCoppet & Doremus's booklet, "Buying and Selling Odd-Lots." There is no evidence that the matter was discussed further with the Exchange or given any extensive consideration by the Commission. Partners of both the principal odd-lot firms have testified that the Exchange, to their knowledge, never discussed with them the possibility of adopting Exchange rules governing their activities, and that they were not aware of the correspondence between the Exchange and the Commission.

The New York Stock Exchange apparently is the only registered national securities exchange which does not attempt to regulate the amount of the odd-lot differential.[401]

In an interview during the course of the Special Study, the president of the Exchange stated that the Exchange has jurisdiction over the odd-lot business but has seen no reason why it should adopt rules on the differential, offsetting transactions, or other matters relating to the methods of operation of the odd-lot firms. Specifically with respect to the odd-lot differential, he stated that the Exchange prefers leaving it to the determination of the odd-lot firms, which have their own money at risk. Competition between the principal odd-lot firms he described as "fierce," particularly in the service rendered to commission houses by the order service department of each firm.

Certain aspects of this policy, and its consequences, are considered in the following subsection.

c. The differential

From 1932 to July 1951, the standard differential for all odd-lot transactions in 100-share-unit stocks was 1/8 of a point. The differential is not charged as a commission but is part of the price paid or received by the customer, although there is no reason why the odd-lot charge should not be stated in terms of a service charge.[402] The one-eighth differential equals the smallest fractional division of the dollar that the Exchange permits for trading in general.[403]

On July 25, 1951, the odd-lot houses jointly announced an increase in the differential, effective August 1, from 1/8 to 1/4 on stocks selling at $40 or more. At the same time all regional exchanges except Boston announced a similar change for dually traded stocks. Boston followed suit approximately three and a half months later. This increase in differential was a result of coordinated action primarily among the principal New York odd-lot firms and the Midwest Stock Exchange.

The idea of increasing the differential originated in the two major New York odd-lot firms. Since 1947 they had been discussing with each other the feasibility of such an increase. In December 1950, they finally agreed to raise the differential to 1/4 point on all stocks selling over $60. The New York Stock Exchange was informally advised of the proposal and Exchange officials reportedly expressed the view that the Exchange had no jurisdiction over the differential and would not oppose the increase.[404]

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[401] See, e.g., the Midwest Stock Exchange's art. XXV, rule I; the Pacific Coast Exchange's rule II; the Boston Exchange's rule 38. The American Exchange's Committee on Floor Transactions has set the amount of the differential.

[402] Indeed, in April 1948, Carlisle & Jacquelin considered the possibility of billing a service charge, but rejected this for the following reasons, according to an intra-office memorandum: "No doubt there would be much unfavorable reaction to an increased differential in certain categories but today's headline soon passes into history. It is for that reason that a change in differential appears to be more practical because the charge becomes merged in the price whereas a service charge on a share or trade basis would necessarily have to appear on customer confirmations and would be a constant source of irritation."

See the recommendation regarding confirmations of odd-lot transactions, in pt. I of this chapter.

[403] See NYSE rule 62.

[404] The Commission was so advised by counsel for the two odd-lot firms. A 1961 memorandum from the Exchange's Floor Department to the Board of Governors noted that "The records do not indicate that the increase was ever considered by the Advisory Committee or the Board of Governors of the Exchange."

While in 1950–51 the Exchange may have believed it lacked jurisdiction, today it asserts jurisdiction, as noted above. And in 1927, for inactive ("Post 30") stocks, the Exchange adopted a 10-share unit of trading and prescribed the odd-lot differential. In 1932, the Exchange increased the differential on stocks in such units. But in 1942, the Exchange stopped setting that differential and told the odd-lot firms to handle the matter.

The two odd-lot firms jointly retained an attorney to represent them at the Commission. When he presented the proposal for the increased differential, the Director of the Division of Trading and Exchanges expressed some doubt as to the Commission's jurisdiction in the matter. The Commission declined to decide the jurisdictional question but stated that it had no objection to the proposal. It is to be noted that neither the Exchange nor the Commission asserted jurisdiction, the former denying its jurisdiction and the latter expressing doubts, yet each informally acquiesced in the increase.

The odd-lot firms next turned to the regional exchanges, realizing that the failure of any regional exchange to increase its differential on dually traded stocks would result in the loss of odd-lot business on the NYSE to such exchange. Around the end of January 1951 representatives of the firms traveled to Chicago to present their plan to the Midwest Stock Exchange, the largest regional exchange. Midwest participants consisted of the president, James E. Day; the chairman of the board of governors; and representatives of one of their largest specialist odd-lot dealers. Although the Midwest group favored an increased differential, they were not in complete agreement with the New York plan. They had been considering a change to a decimal system, under which they would have lowered the differential to 10 cents a share on some stocks while raising it to 20 cents a share on others. The Midwest group felt that an increased differential on stocks selling above $60 would not affect a sufficient number of issues traded on their Exchange, and some of their members countered with a proposal for a $20 breakpoint. The meeting ended without resolution of the question but with the New York firms' proposal still pending.

The Midwest group was apparently unable to come to a swift and definite conclusion. As time went on, this indecision annoyed the New York firms, as did the possibility that the Midwest Exchange might adopt a decimal system which would in some cases offer cheaper odd-lot service to the public customers. The New York firms agreed to consider modification of their plan by lowering the breakpoint from $60, in spite of their considered conclusion that that level would provide appropriate profits, and their reluctance to take the matter to the Commission again. The New York firms also told the Midwest Exchange of an alternate plan to raise the differential only in stocks not actively traded on a regional exchange, to show that they could increase their own revenues without providing any benefit to the regional exchanges. The Midwest Exchange then abandoned its consideration of the decimal system and worked jointly with the New York odd-lot firms to consider a breakpoint which would be beneficial to the Midwest dealers, and finally the breakpoint of $40 was agreed upon.[405]

On July 12, Day presented the matter to the Commission, which indicated on July 16 that it would not object to a $40 breakpoint. The Midwest Exchange and the New York firms immediately agreed to go ahead with the increase.

On July 20, Van R. Halsey of Carlisle & Jacquelin and Howard C. Smith of DeCoppet & Doremus met with Cecil MacCoy, vice president

[405] The odd-lot firms testified that John Coleman, a governor of the Exchange, had urged them, during the course of discussions with the Midwest Stock Exchange, to go ahead with a $40 rather than a $60 breakpoint.

of the New York Stock Exchange, to discuss the proposed release on July 25 of the notice of the increase. MacCoy suggested that the announcement be postponed to Friday, July 26, because such timing would have a tendency to bury the notice, but the announcement was sent out on the 25th anyway [406] because Day could not be reached to agree to the change. MacCoy apparently wished to disassociate the Exchange from the announcement and suggested that the odd-lot firms deliver it directly to the press, but he nevertheless made the Exchange facilities available for answering anticipated questions from the public, and he requested that the odd-lot firms provide him with a memorandum of background material for this purpose.

A few days before the effective date of the increase, the small specialist odd-lot dealers on the New York Stock Exchange were first advised of the plan. One of these firms did not want to associate itself with the action and refused to sign the announcement. However, by virtue of the policy of the Committee on Floor Procedure adopted in 1938, it would appear that his firm had no choice but to impose the increased differential. It should be noted that the costs of the specialist odd-lot dealers on the New York and regional stock exchanges are not necessarily the same as those of Carlisle & Jacquelin and DeCoppet & Doremus.

In the spring of 1951, the other regional exchanges had been brought into the discussion. It is worth reiterating that on the regional exchanges, earnings from the handling of odd lots are important to all specialists rather than a handful of exclusive odd-lot dealers; and on exchanges such as the Boston, odd-lot business constitutes 48 percent of the share volume.[407] Day had agreed to contact the western exchanges, while the New York firms were to contact those in the East. Only Boston posed any problem. The Boston Stock Exchange was interested in the passage by the New York State Legislature of the Mitchell bill, which would have exempted certain transfers on out-of-State exchanges from the New York State transfer tax. When the odd-lot firms had originally proposed their plan to the Boston Exchange, Harry W. Besse, president of that Exchange, had taken the position that—

> * * * at the same time that we considered whether we should change our odd-lot differential, we wanted the New York odd-lot dealer representatives to indicate to us some willingness or friendly disposition toward cooperating in obtaining relief, for dealers outside New York State, from the New York State transfer tax.

On July 9, 1951, Besse called an informal meeting of the Boston odd-lot dealers on the floor of the Boston Exchange. They unanimously endorsed the position that Besse had taken and indicated:

> * * * that as a separate question, there was no present disposition on the part of the odd-lot dealers in this Exchange to revise the differential upward, notwithstanding the fact that it might be revised upward in New York and elsewhere.

The New York odd-lot firms were aware that the Boston Exchange might not increase its differential at the same time, but the concern

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[406] The announcement was made in the form of a letter signed by the two major odd-lot firms and two of the three specialist odd-lot dealers and addressed to the members and member firms of the Exchange, with the following explanation of the change:

"Due to the tremendous increase in the cost of doing business since June 1932 when the present odd-lot differential was established and having a prudent regard for the financial security of the present odd-lot dealer system, the undersigned Odd-Lot Dealers on the New York Stock Exchange have come to the conclusion that a change in the differential is necessary."

[407] See also p. 181, above.

they might otherwise have felt was alleviated by Besse's representation to them on July 19 that the Boston Exchange was not going to permit its dealers to advertise the lower differential to obtain business. That representation apparently reflected the Boston Exchange's apprehension as to retaliatory steps that might be taken by the New York Stock Exchange at the instance of the odd-lot firms. Besse has testified that this apprehension dated from 1940, when the New York Stock Exchange attempted to restrict the use of its member firms' funds for financing odd-lot dealers on regional stock exchanges. In addition to the dependence of many of the Boston dealers upon New York Stock Exchange members for financing, many also rely upon the clearing facilities of dual members and depend upon the availability of Exchange quotations.

After the differential was increased elsewhere, some rise in odd-lot transactions was noticed on the Boston Exchange. The New York firms began to contact members of the Boston Exchange, and the unanimous opinion of the Boston odd-lot dealers and its governing committee in favor of retaining the one-eighth differential began to weaken. On the other hand, a group headed by James H. Goddard, chairman of that Exchange's Committee on Public Relations, began to urge general advertising of the lower differential in order to obtain more business. On August 10, 1951, Besse sent the following memorandum to members of his governing committee:

> Our Committee on Public Relations has requested your counsel on the matter of whether part of their advertising appropriation should or should not be utilized to publicly advertise the recent development relating to the odd-lot differential. The Committee on Public Relations favors such a course.
>
> Others have recommended against any course which would serve to further antagonize the odd-lot dealers on the New York Stock Exchange or embarrass member firms who are studying the Boston Exchange with the view of using its odd-lot facilities.
>
> Will you kindly indicate on the space available below your thinking on this subject?

On October 8, 1951, the Boston Governing Committee, delaying a decision on publicity, decided to poll all members on the question of retaining the one-eighth differential.

Word of the possibility of a publicity campaign reached Day in Chicago and he notified the New York odd-lot firms. Charles F. Samson of Carlisle & Jacquelin, and Henry I. Cobb, Jr., of DeCoppet & Doremus, promptly took the matter to Chairman Richard Crooks and Executive Vice President Edward C. Gray of the New York Stock Exchange. In a memorandum to the members of his firm written at the time, Cobb reported that the Exchange officials were no more prepared to support the Mitchell bill than previously; they felt it was more Besse's and Day's problem than their own, and they saw no reason to help them. Besse has testified also that some members of the Boston Exchange felt that the dual-member commission firms would be embarrassed if the availability of cheaper execution were advertised in Boston, as had been the case in 1938 in regard to the specialist odd-lot dealers. When the results of the Boston poll were tabulated, they showed that 42 members favored the retention of the one-eighth differential and 41 favored following the New York increase. Nevertheless, the Boston Governing Committee two days later voted to increase the differential to one-fourth point on dually listed securities selling above $40. At the meeting, it was pointed out that those dealers who favored adopting the higher differential did 75 percent of the odd-lot business.[408]

In light of the New York Stock Exchange's non-regulation of the amount of the differential, purportedly because that is a matter for negotiation by the odd-lot houses and the commission firms with whom they deal, it is interesting to note that the only apparent contact between the odd-lot firms and the commission firms as such in connection with the 1951 increase was a statement made by Cobb of DeCoppet & Doremus at the annual meeting of the Board of Governors of the Association of Stock Exchange Firms in May of 1951, which was attended by only 30 or 40 members. The reason for making the statement was given as follows:

> * * * several of our governors and one of our past presidents have intimated to us the diplomatic necessity of discussing our proposed change in the differential with our customers before deciding to make such change. It is in deference to these opinions that the two odd-lot houses have instructed me now to bring you up to date on the whole matter.

No reference to the raising of the differential was made in the president's report of the meeting, although it was in the minutes. The only public protest against the increase, from within the industry, was a release to the press by the Association of Customers' Brokers (salesmen-employees of the commission firms), who also wrote to DeCoppett & Doremus urging that the increase be reconsidered and complaining sharply about the lack of prior publicity and opportunity for debate.

Apparently with the thought of benefiting fully from past experience in the event of a future differential increase, Cobb of DeCoppet & Doremus wrote a memorandum dated September 26, 1957, entitled "Suggested Procedure To Be Followed by DeCoppett & Doremus and Carlisle & Jacquelin in the Event That It Becomes Necessary To Raise Our Differential." It follows in its entirety:

> The steps should be taken in the order listed.
>
> 1. *Midwest Exchange.*—Suggest to the President of the Midwest Exchange the advisability of reducing the breakpoint to $30.
>
> A. If he approves, consult with him on the best approaches to
>
> a. The other regional exchanges.
>
> b. The Securities and Exchange Commission.
>
> B. If he disapproves, consider the advisability of raising the differential to three-eighths, and/or reducing the breakpoint on stocks not traded on Midwest Exchange.
>
> 2. *New York Stock Exchange.*—Address a joint letter to the New York Stock Exchange stating our intention to reduce the breakpoint in the near future giving reasons in full. This letter is for information only.
>
> A. Examine (in advance of this letter) with our lawyers what powers the Exchange has to prevent such action on our part and what recourses we have, if any.
>
> 3. *Securities and Exchange Commission.*—Address a joint letter to the Securities and Exchange Commission in Washington stating our intention to lower the breakpoint naming the date of the lowering. This letter should not go out until we have sufficient evidence that the New York Stock Exchange will approve and it is subject to the advice of the President of the Midwest Exchange. (The regional exchanges have considerable influence as a group with the Securities

[408] Among the Boston Exchange's active members who were not NYSE members as well and who did not deal in odd lots, more than two-thirds favored retention of the one-eighth differential. The odd-lot dealers, who by Nov. 5, 1951, favored arising the differential, by 18 to 11, were not classified as to NYSE and non-NYSE members. However, many of the odd-lot dealers on the Boston Exchange who are not themselves members of the NYSE are financed by NYSE members.

and Exchange Commission). *This letter is for information only.* [Emphasis in original.]

A. Examine with our lawyers what powers the Securities and Exchange Commission has to prevent our action and what recourse we have, if any.

4. *Customers.*—Inform customers in joint letter similar in form and content to the one of 1951.

This memorandum is written to provide a starting point for discussion among ourselves and with Carlisle. Proposed drafts of letters are attached.

The odd-lot differential has not been increased since 1951, and there has been no occasion to follow the "suggested procedure" outlined by Cobb. However, on February 20, 1958, representatives from the two major odd-lot firms and the presidents of the Midwest, Los Angeles, San Francisco, and Boston Stock Exchanges did attend a meeting described as a "purely exploratory examination of the possibility and the timing of lowering the breakpoint." The meeting was of a general nature and no specific action was agreed upon, but it was decided, in the words of Halsey's report, "* * * that if, as and when commissions are raised another meeting of the same group should be held to consider the situation as of then."

d. Services performed by the odd-lot dealers

Unlike the odd-lot differential which has been arrived at cooperatively, the services offered by the odd-lot firms do constitute a form of competition between them.

Mention has already been made of the extensive order service department maintained by each of the principal odd-lot firms, through which they compete for business. Competition here takes the form of supplying as much information as possible to meet requests of the commission firms, especially their heavy demand for last sale information.

Another competitive service is the liberal adjustment policy of the odd-lot firms,[409] pursuant to which adjustments with commission firms are frequently made where the commission firm and not the odd-lot firm has made the error in the order.[410]

The stock borrowing activities of the odd-lot firms are a third competitive service. Although the odd-lot firms assert that borrowing stock is necessary to enable them to meet their delivery commitments and to "make change," evidence suggests that competition in furnishing interest-free financing to their customers is at least an equally significant aspect of the practice. Thus, though the odd-lot firms claim that the borrowing results from pressure for prompt delivery, they opposed the establishment of a central depository which would have alleviated this problem. Furthermore, even after borrowing substantial quantities of stock, the odd-lot firms are responsible for a

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[409] The Midwest Stock Exchange minutes for October 1954 stated:

"The President reported to the Committee with regard to his recent visit to the odd-lot dealers of the New York Stock Exchange. He advised that New York odd-lot dealers break odd-lot transactions without exception upon the request of members. It was their opinion that the breaking of trades is good advertising, although in some cases it is expensive."

"Breaking" refers simply to canceling the transaction.

[410] A partner of one of the odd-lot firms testified:

"On the basis of what we sent you in 1961, these are round figures, these are adjustments of over $100, the number [of errors] that the customers made was 1,200. The number that we made was 500, so that the majority were customer errors. Could I correct that by saying they are not all errors. You see a tremendous amount, as I say, of money orders, but we couldn't accept the order that way. We did accept the order, but we accepted it on the number of shares, but it was adjusted later."

large number of fails-to-deliver.[411] Moreover, while one of the three commission firms interviewed on this subject believed that borrowing was done to facilitate delivery, the other two explicitly discounted that explanation; one firm said that borrowing for that purpose would be too costly a practice.

The commission firms agreed that one would not choose between the odd-lot firms on the basis of their services, which one commission firm partner described as "exactly alike; like the soap you use—a matter of personal preference." Except for a few small brokers, firms split their business between the two odd-lot houses equally, or, if unequally, the allocation rests on nonbusiness considerations such as favors, friendship, and family. The commission houses' switching is regular and integrated so that neither odd-lot firm will at any time be flooded or starved. However, Cobb did testify that DeCoppet & Doremus had obtained business by pointing out the advantages of lending stock. One of the small odd-lot dealers testified that though he did not engage in stock borrowing operations, he did not get complaints from customers about delivery; he borrowed only to meet actual needs and not "to do [the commission firms] a favor," and thus borrowed very infrequently and in very small amounts. Indeed, both firms acknowledge that stock is borrowed from member commission firms in direct proportion to the amount of business received from them.

Although the odd-lot firms use their services to compete, the chief competitive impact of such services lies in their deterrent effect upon firms which might otherwise enter the odd-lot business, and their effect on the business of the specialist odd-lot dealers on the New York Stock Exchange and the regional exchanges. All the services provided by the odd-lot firms entail considerable expense, and for order service and stock borrowing, a substantial capital investment or access to financing.

These services are only indirectly and partially provided for the public odd-lot customer, who, through the differential, bears their cost. Interest-free loans provided by the stock borrowing activities of the odd-lot firms result in no direct benefit to the public odd-lot customer. The liberal adjustment policy may on occasion benefit an individual public customer who places an erroneous order with the commission firm, but it is impossible to determine how frequently this occurs as compared to the frequency of errors made by members and employees of commission firms. Round-lot price information may benefit public odd-lot customers. However, the odd-lot houses widely advertise the availability of their order services to their commission firm customers, and they service such customers in all cases without regard to whether the service is directed toward an odd-lot or round-lot transaction. The fact that odd-lot transactions account for half of total public transactions indicates that the odd-lot customer receives only a portion of the services provided by the order service departments.

With occasional exceptions, the commission firms which benefit by but do not pay for the services provided by the odd-lot firms have not

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411 As of June 1962, Carlisle & Jacquelin had $10 million worth of fails-to-deliver; the May market break meant, however, that conditions were abnormal. Normally, fails-to-deliver run between $2 million and $4 million for DeCoppett and around $1 million for Carlisle. On fails-to-deliver as a general matter, see ch. III.E.

been concerned about their cost. Indeed, as seen above,[412] in 1938 the seven commission firms which appeared before the Committee on Floor Procedure unanimously urged the committee to prohibit the charging of a smaller differential where services were not provided.

The New York Stock Exchange apparently has never taken a position in regard to the services furnished by the odd-lot houses, except in 1940 when those services competed with the Exchange's own quotation service and consequently threatened to impinge on Exchange revenues, and the Committee on Member Firms ruled that the odd-lot houses were to cease their quotation service.

e. Methods and problems of handling round-lot offsets

As already noted, the odd-lot firms offset their positions acquired in the course of taking or supplying stock for odd-lot executions by effecting round-lot transactions on the floor of the Exchange. During 1961, these offsetting round-lot purchases and sales constituted 3 percent of total round-lot purchases and sales on the Exchange and 12.4 percent of members' round-lot purchases and sales for their own accounts.[413] The gross income of the odd-lot firms has remained fairly constant at about 90 percent of the total amount realized from the differential, which indicates that round-lot trading results in a loss to the odd-lot firms.[414]

In earlier years it was the policy of the odd-lot firms to maintain large long or short positions—sometimes amounting to 3,000 or more shares—but they now try to keep positions as small as possible. Nevertheless, positions in individual stocks frequently exceed 1,000 shares and individual round-lot transactions in lots of several hundred shares are common. For example, both odd-lot firms had long positions in excess of 1,000 shares of Sperry Rand Corp. on March 23, 1961, a situation which gave rise to a round-lot sale of 500 shares by DeCoppett & Doremus, and two 300-share round-lot sales and a 700-share round-lot sale by Carlisle & Jacquelin on that date. At various times in January 1961, DeCoppet & Doremus had a short position of up to 1,776 shares of National Theaters and 1,000 shares of Goebel Brewing, and a long position of up to 4,264 shares of Atlas Corp. Both of the odd-lot firms have established position limits for individual securities, but one of the firms has relaxed its policy within the last year or two. Moreover, associate brokers do not always follow a trading policy geared toward maintaining an even position, as illustrated by the testimony of one of them:

> * * * I went on my own to play these things. Where I thought that they should be played closer I played them closer, and if I thought that we wanted to extend, if the market acted exceptionally well, and I was long on some stock, and they were still selling us more, I would get a partner and say "Here, Bill, this acts as though it may want to go higher. What is your wish?" He may go along with me or he may say no. That is just the picture there.

Any gains or losses resulting from trading activities accrue to the odd-lot firms rather than the brokers, but the firms keep records of the trading gains and losses of individual brokers and may use such rec-

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

[413] See table VI–51 for the relation of offsetting round-lot purchases and sales by odd-lot dealers on the New York Stock Exchange to total round-lot purchases and sales during the period 1936–61.

[414] The 90-percent figure was arrived at by comparing the two firms' actual gross income with their "potential" gross income, a dollar amount calculated from the number of shares traded at the one-quarter differential and the number traded at the one-eighth differential.

ords as the basis for assigning stocks to them. Unlike the usual floor brokerage situation, the associate broker ordinarily has wide discretion as to whether, when, and how much to offset, within the established position limits. Thus an associate broker's interest in offsetting is not limited to earning a commission but also involves maximizing profits and minimizing losses. Accordingly, it appears that some of the elements of floor trading are present in some degree in the round-lot activities of the associate brokers.

Like the floor trader, the associate broker's round-lot trading has the advantage of continuous, intimate, and immediate contact with the stocks in which he is interested. This was graphically described in 1956 by DeCoppet & Doremus in the course of arguing for the necessity of maintaining associate brokers on the floor: [415]

> Under our present system of trading the broker develops an intangible quality called a "feel of the market." At the post his eyes and ears become attuned to the sights and sound of the marketplace. Here he picks up information regarding the stocks he is trading in. Here he can act with spilt-second speed and reflect in his own trading the action of the tape. Here he makes friends with the specialists and other brokers and traders who impart to him their combined thoughts and advice and who are helpful to him in the execution of his round-lot trades made for the purpose of offsetting his positions. [If] our broker would no longer be able to remain at the place of auction * * * [that] would, in our opinion, cost our firm many hundreds of thousands of dollars in the effectiveness of his round-lot trading. When you consider that last year our firm traded 20 million shares in round-lots, the importance of this factor becomes immediately apparent. Even the minimum variation of one-eighth poorer on these transactions would result in a loss of $2,500,000.

Because of the way in which the Exchange floor is physically constructed, an associate broker is assigned stocks which are traded at a particular post. This coincides with the manner in which stocks are allocated to specialists, with the result that an individual odd-lot broker will have the "book" in many of the same stocks as an individual specialist, and various mutual accommodations develop. Frequently the odd-lot brokers hold back offsets to accommodate the specialists,[416] or turnover orders to the specialist. And the specialist

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[415] See sec. 3.f, below, on modernization of facilities.

[416] An associate broker testified:

"Q. What I mean is, if you see that a specialist is having to absorb a good deal of stock would you, as an accommodation to the specialist, hold back stock that you might otherwise have sold?

"A. Yes, we have done that on occasions too, on many occasions.

* * * * * * *

"Q. Are you generally aware of the specialist book or situation?

"A. No, we are not permitted access to the specialist books.

* * * * * * *

"Q. Does the specialist have access to your bible or book?

"A. No.

"Q. So neither of you ever knows what the other's situation is?

"A. That is true.

"Q. But on the other hand, in order for you to accommodate the specialist in the kind of situation which we were just discussing, wouldn't the specialist tell you what his situation is?

"A. Then he would have opened up and said, well, here, for the love of something or other, I am getting murdered here.

"I will say, all right. So am I, but we will step aside, but remember that I need stock, you need stock.

"Or we have to sell stock or you have to sell stock.

"Let's work together on it and let it be for the best.

"Q. In that situation, he is really showing you his book.

* * * * * * *

"A. He is not showing me his book actually. He is telling me that he is over long or over short and he has no book.

"Q. What is it that he shows you? Just his own trading position?

"A. It is just what he tells me. He just tells me—he doesn't show me anything. He said, 'Oh, please, I am up to here in this,' or 'I am over short' or something like that, and, there is no offer in the book. He could tell me that—which has happened on many occasions."

will frequently stop stock[417] for the associate broker, and on occasion give up brokerage commissions to the associate broker on orders executed by the specialist for the associate broker.

In less active stocks, especially, a number of odd-lot orders may accumulate between round-lot transactions. An associate broker who has accumulated orders on one side in excess of 100 shares might find it profitable for his firm to buy or sell a round lot at a price *less* favorable than he otherwise might obtain, to "trigger" execution of the odd-lot buy orders to be met from his firm's account. For example, if he has orders to buy 345 shares in odd lots, a high triggering price is to his interest, though not to his customers'. Rather than waiting for a round-lot transaction that may occur between the bid and asked, he could himself buy 100 shares at the asked, then sell the 345 shares at that price (plus the differential). To prevent this, the odd-lot firms have ruled that whenever the broker gives a round-lot order and has on the same side of his books a greater number of shares to be triggered by that round lot, he must give the round-lot order to the specialist rather than buying or selling for his firm.[418] (Under the rules of the Exchange, the specialist is obligated to execute the round lot at the best price obtainable.) Thus the transaction that triggers the odd-lot customers' orders will be executed by a party presumably in no conflict of interest with those customers. However, if the specialist wants to meet the round-lot order from his own account, he and the odd-lot broker have a mutual interest that conflicts with that of the odd-lot customers' buy orders: for example, the specialist's interest is to sell the round lot high, the broker's, to have a high triggering price. In such cases, the specialist must advise the broker that he is dealing for himself, and the approval of a governor must be secured.[419]

The Exchange, taking the position that the round-lot trading of the odd-lot firms is not analogous to floor trading, has provided no special rules for such round-lot trading, and does not receive reports of the round-lot transactions or exercise direct supervision of any of the matters discussed above.

f. Modernization of facilities

In order to study and improve its floor operations, the NYSE in early 1956 retained Ebasco Services, Inc., an engineering consultant firm. At the same time the Exchange appointed a special committee of members (the "Piper Committee"), on which representatives of both odd-lot firms served, to work with Ebasco. Ebasco's studies were divided between the round-lot market and the odd-lot market. The history of that segment of the Ebasco survey dealing with odd lots is treated here.

Ebasco began work in the early part of 1956 by studying the existing methods of operation of the odd-lot dealers. This study entailed numerous meetings with members of the odd-lot firms as well as

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417 See pt. D.7.c, above.

418 "Odd-Lot Trading Rules of the Odd-Lot Dealers on the New York Stock Exchange," p. 52 (1951).

419 Id. at 53. When asked about this problem of offsetting round-lot transactions, Exchange Vice President Willard K. Vanderbeck, in charge of the floor department and responsible for oversight of specialists even if not of odd-lot brokers, said: "I have from time to time had occasion to read the booklets which prescribe the methods that are used by the odd-lot firms in executing odd-lot orders. As to this particular part of it, I can't honestly say that I have been conscious of that particular part of their own regulations." He also said, speaking generally, "We have no particular system for observing or enforcing any rules as we have none concerning the activities of odd-lot dealers."

observation of actual activity on the floor. Ebasco tended to think in functional terms in defining the requirements of odd-lot service, and the odd-lot firms pointed out the need for considering "public relations." In a memorandum reviewing a meeting of Douglas Nicholson of Ebasco Services with Bernhardt P. Schmeil of Carlisle & Jacquelin and James Campbell of DeCoppet & Doremus, it was noted:

> Mr. Nicholson felt that the functions and requirements of the odd-lot dealer system could be achieved if the four following categories were adequately provided for:
>
> 1. Execution of the order.
> 2. Reporting the trade. His expression was "letting the world know."
> 3. Control of inventory.
> 4. Service for the above, plus customer service. He called it "service to the floor population * * *."
>
> During this discussion Mr. Nicholson kept talking about the odd-lot dealers' work space. Toward the end of the discussion we said to him that we assumed that this work space would be on the floor of the Stock Exchange. His reply was "I didn't say that * * *." Without giving him much time to augment his reply, we went into a long explanation of the reasons it was necessary for the work space to be on the floor.

The odd-lot representatives described the process of executing odd-lot orders and explained that their public relations program had for many years been based on the importance of their brokers being on the floor. The memorandum then concluded:

> At this time Mr. Nicholson said he was making a fifth category. (We don't know whether he made this category after our explanation or already had it down, but just hadn't mentioned it.) This fifth category was titled: 'The ideal odd-lot work space must be located on the floor because of its public relations value.'

On August 2, 1956, Ebasco presented two plans for modernization of odd-lot service. "Plan A" was summarized in a memorandum of the same date in the files of DeCoppet & Doremus:

> 1. The odd-lot order is teletyped directly to the post from the commission house.
> 2. The associate broker and his clerk are together in the same work space near the auction market.
> 3. The odd-lot report goes directly from the post to a mechanical transmission center, whence it is relayed both to the odd-lot house and to the commission firm.[420]

Ebasco estimated that Plan A would save approximately $1,500,000 net per year. This system threatened no inroads on either the existence, function, or location of the associate broker. The odd-lot firms characterized this plan as "evolutionary" and at one time favored it primarily because it proposed positioning the odd-lot clerk with the associate broker at the post. To date, it has not been adopted by the Exchange.[421]

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[420] The present method of handling the orders is described in sec. 3.a, above.

[421] At the present the clerk must remain near the telephone booths along the periphery of the floor. An associate broker questioned on the arrangement testified:

"A. I wish they [the clerks] were at the post, * * *. It would be a help for me.

"Q. Your clerk there, does he keep walking over to you to tell you what is going on, or do you communicate by phone?

"A. No. We communicate by voice. You know, you holler over.

"Say, the room—this room is not large enough. If I am in the corner there, and I will say, 'Henry. Tobacco sold 31⅞,' knowing that he has orders to put in at 32.

"Q. And he says you just sold 300 shares?

"A. Yes minus 300. That would be the word."

However, the Exchange is apparently giving consideration to stationing the clerk at the post in its preliminary planning for a new building.

Plan B, which the odd-lot houses labeled the "revolutionary" plan, contemplated complete mechanization of (1) entry of the odd-lot order (directly from a machine in the broker's office to a master machine), (2) execution of the order (by a master machine), and (3) the filling out and routing of reports. The contemplated machines could not handle certain "odd ball" or unusual orders,[422] nor could they execute offsetting round-lot transactions. The net result of this automation, as foreseen by Ebasco, was to be that only about 14 associate brokers would be necessary to handle the "odd ball" orders and the offsetting transactions. The estimated net saving for Plan B was $3,250,000 per year, accomplished by a reduction in associate brokers from 87 [423] to 14, and a reduction from 192 to 47 in the total number of Exchange and odd-lot firm employees involved in executing odd lots. Cobb wrote his partners: "It was intimated by Ebasco and by [Exchange Vice President] Vanderbeck that the New York Stock Exchange would own the computer [and] would rent it to whoever wanted to use it. * * *"

The odd-lot houses immediately attacked Plan B. On August 6, 1956, 4 days after presentation of the Plan, Carlisle & Jacquelin drafted a written statement of arguments to the Piper Committee. On August 9, DeCoppet & Doremus presented a similar statement. In these statements they argued that computer execution of odd lots would not save the commission firms any expenses, that still it would be necessary to have a large number of associate brokers on the floor in order effectively to execute offsetting round-lot transactions, that a complete breakdown in the machine would necessitate the closing of the Exchange, and that if a large number of associate brokers became unnecessary "* * * every other owner of a seat on the Exchange would also suffer an important decrease in the value of his asset." DeCoppet & Doremus concluded: "[W]e do not believe Plan B will work."

Eight days after Ebasco had presented its proposal, a subcommittee of the Piper Committee met with representatives of the odd-lot firms. The conference is summarized in a memorandum in the files of DeCoppet & Doremus, from Arthur H. Lamborn to his partners on August 13:

> Dick Crooks did most of the talking for the Committee. He told us the subcommittee met the day before with Calcord and Nicholson of Ebasco and that they, the Committee, were fully informed about the problems we had discussed with them. He said that he and the Committee realized that of primary importance was the necessity for the odd-lot broker to be at the place of auction. Also, that we were the only ones who could judge the number of brokers we needed to service our trading. He also said that the Exchange would never put limitations on these two requirements of the odd-lot firms * * *.
>
> In conclusion, it would seem to me that we can count on having our brokers at the place of auction and that we can use any number we feel necessary in order to adequately function.

Although the DeCoppet & Doremus statement to the Piper Committee had concluded that Plan B would not work, an office memorandum also written on August 13 by Lyster C. Reighley, their senior partner, reveals a different attitude. He was clearly concerned that the plan would work and that competition would force a reduction of

[422] These amount to about 5 percent of all odd-lot orders.
[423] Now about 100. See sec. 3.a, above.

the differential, the number of associate brokers, or both, despite the assurance that the Exchange would not compel such reduction:

It seems to me that Plan B as proposed by Ebasco is practical if the machines will do what is claimed for them and not be too subject to errors or breakdowns. One can imagine running the odd-lot business exactly as we do today with two or more associate brokers at each post receiving commissions for the odd lots done on their books on execution of orders mechanically transmitted, executed, and reported. The associate broker would place or execute round lots to control the firm's positions. He might not be as aware as he now should be as to what his position averages roughly and probably would not therefore execute his hundreds quite as well as he now does. But he could handle the hundreds probably in a sufficiently satisfactory manner. We would then have the amazing situation of 80 or more members of the Exchange receiving over $3 million a year for business that they did not originate, execute, or have anything to do with—and this burden would have to be borne ultimately by the public.

At this point the matter of competition arises. It would seem that a specialist or, for that matter, any member of the Exchange could hook into the machines and use them for competing with us in odd lots in the stocks in which they specialize or probably in all issues listed on the Exchange. They would undoubtedly try to get business by executing quarter stocks at an eighth differential and perhaps even by absorbing the tax as well. The present dealers to protect themselves would be forced to trade all issues at an eighth. I am not up to date statistically but my recollection is that we feel the quarter stocks (on which the differential is 25 cents rather than 12½ cents) have improved our net earnings by approximately 2 cents a share. To offset the loss of this additional revenue the dealers would immediately stop paying brokers commissions for business they had nothing to do with. This would effect savings of almost 2¼ cents a share or about the amount that would be lost from not having quarter stocks. The dealers would then be in about the position they now are in respect to earnings.

Whether competition would develop and force us to reduce the differential or not—it seems that the odd-lot dealers are not going to continue long to pay $3 million a year in commissions to a group of members who have practically nothing to do and have no part in the receipt, execution, and reporting of transactions that they have no control over. Certainly a broker is not going to make from $30,000 to $50,000 a year for executing a few scattered hundreds in the open market. If he did it would be the "cushiest" job I have ever heard of.

The memorandum continued with an evaluation of the master machine's probable effects on the structure and size of DeCoppet & Doremus:

What would probably happen would be that the firm would concentrate the execution of hundreds in the present floor partners and 5 or 10 associate brokers, who probably would be taken into the firm. In my opinion, one member could easily place with the specialist or execute all the hundreds at one post and the firm would therefore need at the most 14 brokers or partners to be in the crowd. It should also be borne in mind that under the new setup there would be literally nothing for our present telephone clerks to do. Some of them might be able to assist in the placing of hundreds and reduce the number needed to one to two posts. Probably the range tables (sheets prepared from the NYSE tape, showing for each stock the time and price of each execution, but not the number of shares) would be unnecessary for the conduct of the odd-lot operation. I can imagine it would no longer be necessary to have an order room. The clearance sheet department could probably be run by one or two clerks, as the only thing it would have to do is strike off the stock balances. The rest, extensions and money balances—would be done on the master machine—probably with an auxiliary tape setup.

The net foreseeable result of the switchover would seem to be that 60 or more members would have to secure other connections or sell their seats and it is hard to imagine what would happen if 50 seats came on the market for sale. In addition, our whole telephone department, both office and floor would be out of jobs and practically all those engaged in the preparation of clearance sheets. The dealer firms would be in about the positions they are now in, except that they would be much more vulnerable to competition.

As to space requirements, it would seem to me just on a guess that we would need less than half the space we now have at 63 Wall Street and if the central depository is put into effect, which I am sure it will be before too long—we will not need much more than an auditing department.

However, in spite of all these dire forebodings, I think the scheme could be adopted and probably made to work and not to the point that it would put the odd-lot dealers out of business.

Shortly thereafter several DeCoppet & Doremus partners developed a plan whereby the odd-lot firms, rather than the Exchange, would own the odd-lot machines. The Carlisle firm adopted a different position. Samson, its senior partner, felt that the Exchange would not consent to ownership by the odd-lot firms. Moreover, he was unwilling to concede half the business to DeCoppet & Doremus, since Carlisle & Jacquelin did slightly over 50 percent. On August 22, he wrote to his partner, Halsey, regarding DeCoppet & Doremus' proposal:

* * * [I]t seems like a fairly ingenious plan to confine all the odd-lot business to the two houses by offering to pay for the equipment, which I am sure the Exchange would never countenance, thereby freezing out all competition. Secondly, I am not sure he didn't have in mind that if D. & D. were to pay half the cost, they would be entitled to half the business, possibly by zoning the floor, which of course we wouldn't want, would we? * * *

But all in all, now that our immediate problem of the brokers has been successfully solved, I can't get too perturbed about the future for whatever plans are suggested, it seems to me that they would face so many obstacles, discussions and probable amendments on the part of your committee, and later by the Board, that it will take a long time before any system that will be satisfactory to all the interested parties can be put into effect.

He wrote further on September 21, also to Halsey:

* * * [T]he more I think about, the more I believe that an announcement on our part that we wish to incur all the expense of the machine would cause a roar of protest over the obviously monopolistic intent on our part that would have a most damaging effect on our business, and would force the Exchange, even if they had been willing to go along with this plan, to refuse its consent and perhaps even the SEC might be roused to action.

The strategies of the odd-lot firms thus developed along two lines. One line contemplated the feasibility of odd-lot firm ownership of the master machine. The other involved drawing up comprehensive lists of requirements, interposing numerous objections and raising arguments against the workability of Plan B. In separate and joint statements to the committee, the firms raised many points, as follows:

An objection strongly urged was that the machine would have a reliability factor of 99 percent, leaving a 1-percent failure factor that would result in erroneous handling of approximately 60,000 odd-lot orders per year. A joint memorandum of the odd-lot firms to the subcommittee noted: "This degree of tolerance for odd-lot operations we feel would be completely unacceptable to the financial community." By way of comparison it should be noted that the present human error amounts to approximately 3½ percent of total transactions, and adjustments in 1961 exceeded 300,000. Of course, the reliability factor and the error factor are not strictly comparable. The 1-percent failure factor apparently does not include errors from faulty input, and a machine breakdown would stop all odd-lot trading for the period of the breakdown. There was no suggestion of developing Exchange rules or alternative methods for handling the problem of computer breakdown. It may be noted here that on May 29, 1962, when methods for transmitting odd-lot orders to the odd-lot brokers collapsed, the Exchange together with the odd-lot firms did devise a method to handle the problem.[424]

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[424] See ch. XIII.

The odd-lot firms also pointed to the necessity for keeping their associate brokers constantly aware of actual firm positions and orders awaiting execution. When Ebasco indicated that this information could be provided through a computer, the odd-lot firms objected to the paper on which the information would be produced.[425] They also objected that when information was required in a number of stocks at one time, there might be a slight delay in obtaining it. In this connection, it should be noted that under the present system an odd-lot broker will actually miss three to five executions a day because he is preoccupied with other stocks and not immediately aware of sales in stocks in which he has orders awaiting execution.

A number of additional arguments of varying substantiality were presented to the Piper Committee. The point was made that computer execution of odd-lots would not save the commission firms any expense, and a DeCoppet & Doremus partner has indeed testified that the commission firms were little interested in the plan, which would involve no savings for them. It was argued that a large number of associate brokers would still be needed to execute offsetting round-lot transactions, although the DeCoppet & Doremus internal memorandum of August 13, 1956, quoted above, suggests a contrary conclusion. It was objected that the rules of the Exchange require every order to be executed by a member [426] and that the personal human factor is essential to the execution of the odd-lot orders, although, as has already been pointed out, an odd-lot execution is purely a mechanical operation in which the associate broker exercises no discretion, and no compelling reason appears why the Exchange could not modify its rule in the public interest. A legal question was raised concerning the handling of the transfer of property by machine, but no legal advice was ever sought on this point. The odd-lot firms doubted that cancellations could be handled by machine, but Ebasco indicated that they could program a computer which would handle cancellations. Ebasco also said later—the problem was raised by the odd-lot firms, apparently for the first time, at a meeting on November 1—that it could design a machine that would handle a large number of odd-lot orders arriving simultaneously, as might occur near the close of the market. They said that depending on comparative savings, machine capacity or reserve manual help would do. The machine proposed by Ebasco would have handled ten orders per second, as compared to the 1956 average of one and one-fifth orders per second.

While discussions continued, DeCoppet & Doremus partners developed their plan for ownership of the machines. Halsey of Carlisle & Jacquelin outlined this development in a letter of September 5, to his partner Samson, stating that some of the DeCoppet & Doremus partners—

> * * * strongly support the idea * * * that if the machines are ultimately approved by the Exchange, then each of the two odd-lot firms should own and

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[425] One of their partners testified:

"Then he could design one that could give us little rolls of paper on an adding machine sort of affair, and we thought that would be very complicated because somebody would have to tear them apart and file them in the right place. We proved, I think, that it would take more handling of this roll than there would be in our present orders.

"Then there was a little machine that would chop it off as it came out so they would fall in a pile. Maybe it would work. From my experience I never thought it would work as well as the broker actually seeing the order from his customer that he is going to take care of."

"[T]he broker actually seeing the order" presumably refers to his reading of the order slip. See sec. 3.a. above.

[426] NYSE rules 54 and 394. Limited exceptions are recognized in the rules.

operate the executing machines. Each machine operated by one firm would act as a standby in case of the breakdown of the other firm's machines.

The plan appears to us to have certain merit and certainly has the long-range advantage of virtually freezing our present competitive situation which thought, I have no doubt, will not escape the members of the governing committee. Obviously, a very key point will be the economic factors, the chief of which will be the cost of the machines, both initial and operating. As I pointed out * * * until we have some idea of these factors it seems unwise to get ourselves committed to the plan of owning and operating them, even if otherwise desirable. They seem to be taking the view that within a month or so Ebasco will ask us to agree "in principle" to their continuing study including plans and specifications for the automatic execution of odd-lots, and at this point Doremus seems to be saying they want to make the ownership and operation of said machines a sina qua non * * *.

Samson's reaction, in a letter to Halsey on September 8, was as follows:

* * * I can't conceive the possibility that the Exchange will allow the two houses to control the whole mechanism of handling the odd-lot business * * *. Certainly I do not see any immediate reason to be stampeded into acquiescing in the plan as proposed by them. So, if requested to express our opinion as to their plan, our answer should be that we are not prepared at the present to give our support.

Now in regard to our dealings with Ebasco, if they should want our views about proceeding with some plan like "B," I think you are quite right in your view that our present knowledge, both as to the capability of the machine and its cost, are much too scant to allow us even to agree "in principle" to further development of that method. All we should do, in my opinion, is to say that they are quite at liberty to develop it on their *sole* responsibility and then after due study, to receive our reaction, but without any intimation from us that we will approve of it or not when it is brought up as a definite enterprise. [Emphasis in original.]

By October 1, Samson was able to write Halsey, characterizing the situation as "very encouraging" and describing the picture as follows:

* * * I can only foresee a long period of debate and compromise before anything is finally adopted by the Exchange both in regard to the round-lot market, as well as odd-lots * * * I was also surprised to hear that at the meeting of the Piper Committee that you attended, Ebasco was still planning on the reporting side of the problem for that was the topic discussed at the meeting I attended in July in your absence. If that is still under debate, God knows how long it will take them to do the whole round-lot plan, to say nothing of our end of it * * * Ebasco has more to worry about than we have * * *.

The Samson approach acquired some support in DeCoppet & Doremus. On October 9, Halsey met with their senior partner and reported the sense of the meeting as follows:

He thinks that our best argment is to point out to the committee and the governors that under machine execution the odd-lot dealers will operate with a lot fewer brokers. This line of argument which is of course similar to the argument we propounded in our original brief he believes will have sufficient weight to kill the plan. He is of the opinion that there exists in the committee a feeling that under machine execution we will operate with the same number of brokers as at present.

* * * In other words, his view is the same as ours; namely, that we have not enough facts upon which to base a conclusion and that until we do have such facts it would be unwise to take any stand now.

As of October 11, however, some of the partners of DeCoppet & Doremus were still quite alarmed over the prospects of automation, as revealed in a memorandum authored by Cobb:

A. Everybody agrees that for us to be forced out of business after 65 years would be by far the worst thing of all.

B. Everybody agrees that, if the NYSE owns a machine that executes odd lots, we are threatened with being forced out of business.

C. Everybody agrees that, if we own the machine, not only are we not threatened with being forced out of business but we are further entrenched in our business.

Now, therefore, it should be agreed that all other considerations are *secondary*. Some of such considerations are:

1. We might irritate some big customers.
2. The machine may not work.
3. There may never be a machine.
4. We don't know what the machine is yet.
5. If we try to buy the machine, we are buying a pig in a poke.
6. If we try to pay for the machine, it will hasten its advent.
7. Let's not get excited, it will all take a long time to work out.
8. Some governor says we have nothing to worry about.
9. Somebody gives it as his opinion that the whole matter is dead already.
10. There are several ways by which the proposal to build the machine can be killed, such as by pointing out the adverse effect on seat values.
11. We can prove sooner or later that the machine won't work.
12. It looks now as though Ebasco is compromising on a proposal that will be uneconomical and will fail.

To repeat, the above listed considerations, important as they may seem, should be considered of *secondary* importance.

TIMING

Everybody agrees that if a machine ultimately executes odd-lots, we should own the machine.

The disagreement is on when the fight to own the machine should be started.

Most of Carlisle partners and some Doremus partners think the time is not yet. Most of the Doremus partners feel that the time to start a fight, in which the very existence of the business is at stake, is now. In fact we feel that, if we had only had the foresight, we should have started it months ago.

Further, most of the Doremus partners feel that the more time that elapses, the more time and money the NYSE spends on the development of the machine, the more difficult it will be for the NYSE to relinquish the machine to others.

Remember, that right up to today Ebasco is still working on a machine that will execute odd lots and be owned by the NYSE.

In dealings with Ebasco, however, the Samson strategy prevailed, and was ultimately successful. In effect, Plan B apparently was doomed on August 10 when the Piper Committee stipulated that the number of associate brokers would be left to the determination of the odd-lot firms.[427] That made any computer system of doubtful economic advantage, as the odd-lot firms pointed out at a November 1 meeting with Ebasco, reported in a DeCoppet & Doremus memorandum:

Samson then brought up the point that in the first report about $2½ million of the indicated savings were achieved through a reduction in odd-lot commissions. Since that portion of the savings had now been ruled out, he wanted to know where were the savings to come from that were going to pay for the machine. Colcord answered that the total financial benefits had not been fully evaluated. He felt this meeting was not primarily concerned with this subject but ought to be restricted to the mechanics of machine operations and not extended to cover the financial aspects * * *.

Samson expressed the opinion that no more time and money should be spent on something the odd-lot dealers wouldn't swallow. * * * Lamborn said that * * * his firm has studied this Plan thoroughly and sees no savings or advantages to ourselves or to our customers in automatic executions. Therefore, this Plan doesn't look as if it's something we would want to accept.

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[427] The limitations imposed on Ebasco ultimately became more general and were not confined to associate brokers. A partner of DeCoppet & Doremus testified:

"I think I can remember that it was decided eventually that one of the areas in which they [Ebasco] could not move was the elimination of members and the member function."

The Ebasco representatives were "not at this moment ready to justify the cost of Plan B by the savings on the floor alone." Instead, they adopted a suggestion by Lamborn and labeled it Plan C. Whereas Plan A would have involved no computer but merely outlined an improved communication system for associate brokers and Plan B would have eliminated most associate brokers in favor of computers, Plan C contemplated no change in the present method of transmission and execution of odd-lot orders except the electronic handling of reports of completed transactions. This represented an extension to odd lots of Ebasco's proposals for the round-lot market, which they were studying simultaneously.

On April 26, 1957, a meeting of the full Piper Committee was held to discuss Ebasco's progress report. The odd-lot firms submitted a 39-page joint brief arguing that Plan B was undesirable. Lamborn reported on the meeting:

> * * * I then told the Committee that I thought the odd-lot dealers were better judges than Ebasco in regard to how odd-lot orders should be processed. Also, that we would be unwilling to take the risk involved under this method of executing odd lots under Plan A. I said that we were told that such a machine might cost in the neighborhood of from $3 million to $5 million [428] and that if the Committee wished to go ahead with this Plan over our serious objections, that was for them to decide. At this point Mr. Piper said we should drop the discussion of Plan B, [formerly labeled A] and consider Plans A, [formerly labeled B] and C.
>
> Very little time was spent discussing Plan [A]. We then went on to Plan C and after considerable discussion it was decided to recommend Plan C to the Board of Governors for further study by Ebasco.

On May 8, 1957, the Piper Committee formally recommended to the Board of Governors that "future studies and planning by Ebasco in the odd-lot area be directed to Plan C." [429] The effect of this recommendation was to eliminate consideration of mechanizing the execution of odd-lot orders or their transmission to the market; eventually, the Ebasco study in general came to concentrate less on possible mechanization of functions and more on direct problems of space and physical facilities. The fully mechanized plan and the "evolutionary" plan were dismissed by the Piper Committee—the former due to the opposition of the odd-lot houses, the latter because it offered no "substantial advantages to commission firms over the present system." Nothing in the minutes of the Board of Governors indicates any board response to the Committee recommendation. According to Exchange Vice President Charles Klem, the studies ended "with a feeling on the part of the Exchange that we just weren't getting anywhere," and they were filed; reportedly, they are now being used by Exchange engineers.

While Ebasco's study was going on and thereafter, the Exchange held discussions, through its staff rather than a committee of members, with IBM, the New York Telephone Co., and other companies, in an

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[428] Ebasco estimated a purchase price of approximately $3 million, and as an alternative an annual rental cost of $670,000 plus operating costs of $300,000.

[429] By this time even Cobb appeared to have become convinced that it would not be profitable for the odd-lot firms to encourage computer development. In an outline entitled "Rough Notes on Ebasco" dated Feb. 13, 1957, he noted as "point 13":

"*Revolution for What?* The 200 member firms have a good business. Why wreck it? At its very best the machine might put a lot of members out of work, at its worst it will drastically reduce their earnings. Ebasco's 'future expanded volume' will cause only income tax headaches. Floor congestion can be handled by more floor. If some members have to run from one end of the big floor to the other they will be getting paid $50,000 a year to do it. Let's not engineer ourselves out of business."

attempt to devise a system for the automatic reporting of transactions. In 1960, the Exchange formed a Department of Operational Development and Planning, which took over the project. The system ultimately proposed, as announced by the Exchange in October 1962, is in many respects similar to the proposals recommended by Ebasco in its round-lot study. When operative in 1965, it will have several effects on the operations of odd-lot firms and their associate brokers.

The proposed system provides for a central computer which will cause a report of each round-lot transaction to be "printed out" at the post at which the stock is listed, and will announce the sale on the floor over loudspeakers, two of which are located at each post. Associate brokers will be able to execute odd-lot orders upon the announcement of the round-lot transactions over the loudspeakers, and to check their executions against the floor print-out. The feasibility of checking executions against the automatic print at the post highlights the fact that execution of odd-lot orders is completely mechanical and need not take place at any specific location on the floor, or, indeed, on the floor at all. The computer will enable the Exchange to provide last sale information as part of its quotation service.

The proposed system, with the last sale service and the print-out, should make the great bulk of the odd-lot order service departments unnecessary. The Exchange has not yet considered any regulation limiting the continuation of the service by the odd-lot firms, although any such continuation, especially if the no-charge policy also continues, will mean strong competition with the services to be offered by the Exchange, presumably for a fee.

There is in the proposed system no provision for the automatic execution of odd lots nor for the clearing of transactions. Although the Exchange has stated that the system may lead to developments along those lines, it is not giving any consideration at this time to any such provisions.

4. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

About 10 percent of the share volume on the New York Stock Exchange, and a much higher percentage of the transactions, is represented by odd lots—trades in fewer shares than the minimum round-lot unit (in most stocks, 100 shares). The two member firms of Carlisle & Jacquelin and DeCoppet & Doremus for many years have jointly dominated the handling of odd lots on the NYSE, doing about 99 percent of the business. An odd-lot customer deals with these firms only indirectly, through his commission firm. The odd-lot order is executed with the odd-lot firm at a price determined by the price of the next round-lot sale in the security, plus the "odd-lot differential" of a quarter or an eighth of a point (or, for the seller of the odd lot, minus such an amount). The execution of odd-lot orders, which is purely mechanical and in fact is often done by a clerk, is carried out by about 100 floor brokers who work exclusively for one or the other of the two odd-lot firms. The seats held by these brokers together with those held by the odd-lot firms' partners account for about 10 percent of the NYSE membership; in contrast, the two largest commission firms have about 1.5 percent of the membership.

The Exchange has allowed the odd-lot differential to be established by the odd-lot firms themselves rather than by Exchange rule, apparently on the theory that a price differential as distinguished from a fee or commission is a matter for negotiation between the odd-lot firms and other member firms. Price competition has not existed between the two major firms for decades, and limited price competition from other member firms was effectively discouraged by a uniform price policy adopted by the Exchange in 1938. Certain of the regional stock exchanges, which theoretically might be a competitive factor with respect to dually traded stocks, have acceded to pressure for uniformity exercised by the New York odd-lot firms and the dual members.

There has indeed been some competition between the two New York firms in the rendering of services such as providing current market information, liberally adjusting transactions to correct errors, and making interest-free loans by means of borrowing large amounts of stock. All of these services, however, are provided by the odd-lot firms to other member firms, particularly the commission houses who provide their odd-lot business, and are only indirectly and partially for the benefit of public odd-lot customers who bear the cost.

The commission firms could hardly have been expected to champion the interests of public customers with respect to the amount of the differential. Indeed, where there has been occasion for them to be heard, their principal concern has been to avoid the embarrassment of having to choose between better prices for their customers and better services for themselves. Hence it does not seem realistic for the Exchange to go on the theory that the differential for odd lots is purely a matter for negotiation between trading firms, since this ignores the reality that the differential is established unilaterally and is borne solely by the odd-lot investor. Likewise, it does not seem realistic to rely on competition in rendering services to the commission firms, since this ignores both the deterrent effects upon actual and potential competition and the passing of the whole cost burden to the public odd-lot customers, who are only the partial beneficiaries of the services.

A duopoly dominating a large and important public business would seem a classic case for rate regulation, and the Exchange has clear statutory authority to regulate, yet it has failed to exercise its jurisdiction and thereby disavowed responsibility. Nor has the Commission ever formally exercised its authority under sections 11(b) and 19(b) of the Exchange Act with respect to the differential or other aspects of odd-lot dealer activities.

As to the other aspects of odd-lot operations, though the Exchange formerly had a standing committee with jurisdiction over odd lots and though it acknowledges that it has full power to regulate odd-lot trading, it has chosen not to exercise that power in the last 25 years. The Commission's suggestion in 1950 that the Exchange consider adopting special rules and regulations did not produce any results. If the handling of odd-lot transactions is essentially mechanical, the handling of offsetting round-lot transactions involves possibilities of special advantage that would seem to call for surveillance if not affirmative regulation. This has received congressional recognition in section 11(b), where it is provided that exchanges may permit (subject to the Commission's residual power of veto or amendment) an odd-lot dealer to buy and sell for his own account, with this explicit limitation: "so far as may be reasonably necessary to carry on such odd-lot transactions * * *." At a minimum, the transactions should be systematically reported, as floor traders' transactions are now reported, and the Exchange should itself supervise the handling of odd-lot brokers' "triggering" round-lot transactions.

The matter of automation is of a different character but is not less a matter of public concern. In 1956 the Exchange employed the firm of Ebasco Services, Inc., to make a study of possibilities for automation on the Exchange. The Special Study has reviewed the history of their proposals concerning the handling of odd lots and of the odd-lot firms' attitudes and actions in regard to them. It is clear that the two firms regarded the possibility of automation as a grave threat to their duopoly, and it is difficult to escape the conclusion that they succeeded in warding off a consideration of the merits by emphasizing the potential impact on seat values for all members and otherwise beclouding the real issues of economy and efficiency. More particularly, they almost immediately succeeded in establishing the principle that the full complement of associate brokers, with their approximately 100 stock exchange seats, was sacrosanct; and once this principle was accepted, the potential for substantial savings vanished and automation was doomed. Automation, whether of factories, railroads, or securities markets, always presents difficult problems and conflicting interests—often including the public interest—but it is unusual to have the problems and conflicts resolved with the factor of cost-savings eliminated at the outset.

That the odd-lot firms themselves would resist any plan for modernization which would reduce their profits, eliminate many associate brokers, and make it easier for competition to develop is not surprising. It is regrettable, however, that the Exchange was so ready to accept their contentions and that the commission firms did not feel called upon to voice the interests of public odd-lot customers, whose business both the Exchange and the firms actively solicit. Finally, it is to be noted that the Commission apparently was not advised of the Ebasco proposals at any point, and there was no governmental representation of the public interest in any stage of the deliberations.

This history has significance reaching beyond the specific subject of odd-lot automation. In an age in which electronic means of communication and data processing are being constantly improved and expanded, there are certain to be many valuable new techniques for the securities markets, if not in the next year or two then in the next decade or two—"certain," that is, if the possibilities are not stifled in private discussions among those with vested interests to protect. Securities markets are not inherently more immune from featherbedding than any other business.

If the securities markets are to be truly public institutions, as they have been under the law for 30 years, the public interest in questions of automation must have a voice. The Commission should equip itself to keep abreast of electronic and computer developments in the securities industry. Otherwise, these may be neglected or suppressed for want of any consideration of the public interest.

The Special Study concludes and recommends:

1. Although existing problems in the handling of odd-lot business on the New York Stock Exchange and its regulation by the Exchange and the Commission can be pointed out with considerable specificity, it has not been feasible nor would it have been

appropriate for the Special Study to undertake the detailed studies required to arrive at specific answers, as distinguished from pointing out the kinds of studies still needed in order to make appropriate and effective improvements. Especially because the problems revealed affect the small investor, it is important not only that they be recognized, but that the Exchange and the Commission move with dispatch toward their resolution. In the absence of prompt and effective action by the Exchange, the Commission itself should directly undertake the needed measures.

2. The New York Stock Exchange should recognize and meet its responsibility to regulate odd-lot differentials. As a first step to that end, it should immediately undertake, with such participation of the Commission as may be found appropriate, a cost study of the odd-lot business. In such study, costs should be appropriately allocated so that odd-lot customers will not be charged for services rendered to others, including the odd-lot firms' cost of stock borrowing and of information services that benefit commission firms or their round-lot customers. As in the case of commission rates on round-lot transactions (see pt. I of this chapter), the Commission should undertake a more affirmative role of oversight in connection with the determination of relevant costs and the fixing of differentials.

3. The Exchange should promptly adopt (i) appropriate rules governing the handling of odd-lot transactions and offsetting round-lot transactions (including but not necessarily limited to the problem of "triggering" round-lot transactions by odd-lot dealers, and the relationships between odd-lot dealers and specialists), and (ii) systematic reporting requirements and surveillance procedures concerning such offsetting transactions.

4. The Exchange should be directed to advise the Commission in writing at an early date (and from time to time thereafter so long as the Commission considers the question open) as to the feasibility of automating the execution of odd-lot orders and as to the possible effects of automation on floor operations, costs, and odd-lot differentials. In connection with its current plans for automation of certain functions and facilities, the Exchange should promptly advise the Commission in writing whether all or any part of the information services now rendered by the odd-lot firms to the Exchange and its members can and should be eliminated, modified, or replaced in any manner. The Commission should make such further studies of its own or in conjunction with the Exchange, and take such further measures, as may be indicated in light of the Exchange's advices on each of the above matters.

5. Inasmuch as the Special Study's consideration of the odd-lot business was essentially limited to the NYSE, the Commission should, in conjunction with the American Stock Exchange and the regional exchanges, undertake studies of the methods and costs of handling odd lots on those exchanges.

6. Reference is made to the recommendation in part I of this chapter with respect to disclosure of the odd-lot differential in customers' confirmations of odd-lot transactions. Reference is made, also, to the recommendation in chapter VIII.B with respect to possible reduction of the round-lot unit.

F. Floor Traders

1. INTRODUCTION

Members participating in the trading of securities on the floor of the NYSE are of four types: specialists, odd-lot dealers and their associate brokers, floor brokers, and floor traders. In the ranks of these floor members the floor trader is unique, for he is the only such member who is not assigned, and does not assume, any responsibility in the handling of orders on the Exchange. Floor brokers and specialists must meet fiduciary standards of behavior in executing agency orders. Associate brokers consider themselves obligated to fill every odd-lot order placed with them. Specialists must, in certain situations, buy stock from or sell stock to willing sellers or buyers. The floor trader, on the other hand, is no one's agent, and under no conditions is he required to buy or sell stock. His presence on the floor is dictated only by his personal desire to trade profitably, for his own account, on the floor of the Exchange.

In acting on a pure profit motive, the floor trader is on firm free enterprise footing. Highly controversial, however, is the propriety of his trading *on the floor*, in view of the fact he is not assigned any role in the execution of orders on the Exchange. Critics of floor trading maintain that his competitive trading advantage is unwarranted, and that floor traders accentuate price movements by selling stock on price declines and purchasing stock on price rises. The Exchange, on the other hand, has contended that floor traders produce certain beneficial "byproducts," enumerated as improved market liquidity, stability, and continuity, which warrant their presence on the floor.

In evaluating these conflicting views the Special Study staff has reviewed floor trading materials in the files of the Commission, including numerous statistical studies, reports, minutes of conferences, and public releases of the Commission. Also reviewed were statements of the NYSE with respect to floor traders, as well as a study of floor trading conducted for the Exchange by an independent engineering firm in 1945. Testimony was taken from NYSE officials and floor members concerning various aspects of floor trading.

Although the statistical studies conducted by the Commission have produced consistent results, the Special Study staff repeated certain of these studies, and added others, for three 1-week training periods ended January 27, March 24, and June 16, 1961. Data were obtained primarily from Form 82 reports which each member of the Exchange who effects floor trades must file daily with the Exchange, which in turn files copies with the Commission. These forms include for each reported floor trade the date and time of execution, the name of the stock, the price, the number of shares traded, whether the trade was a purchase, a "long" sale, or a short sale, the trader's position at the opening of the trading session, and whether the transaction was effected on a "plus tick," a "zero-plus tick," a "zero-minus tick," or a "minus tick." [430] Results of these studies are included in the text. Summarized or excerpted results of many of the earlier studies are contained in appendix VI–H.

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[430] These terms are defined in pt. D, above. A sample form 82 appears in app. VI–G.

This study of floor trading is limited for the most part to the NYSE. Floor trading on Amex, as material in appendix H confirms, is similar in most respects to floor trading on the NYSE. Regional exchange floor trading, as noted at the end of this part, requires additional study.

2. THE NATURE OF FLOOR TRADING

a. Floor traders and floor trading defined

A "floor trade," according to NYSE regulations, is any transaction initiated by a member, while on the floor of the Exchange, for his own account or for an account in which he or his member organization has an interest, except for transactions effected by a specialist in stocks in which he specializes or by an odd-lot dealer in stocks in which he is registered. A floor trade may thus be effected by a specialist in stocks in which he is not specializing, by an odd-lot dealer in stocks in which he is not registered, by any floor broker, by a "floor trader" or by any other member who happens, for whatever reason, to be on the floor. In classifying members, the Exchange designates them as "floor traders," "floor brokers," etc., according to each member's principal activity. When evaluating the propriety of floor trading, however, it is necessary to include all member trading on the floor, with the exception of specialist and odd-lot dealer trading in stocks in which they are registered. Hereafter in this part of the report, the terms floor trader and floor trading are used in this broader sense.

b. Number of floor traders, and amount of floor trading

As of October 31, 1935, 31 individual members of the NYSE were engaged primarily as floor traders, and 4 member firms maintained active floor trading accounts, so that there was a total of 35 "major" floor trading accounts. This figure has since ranged from a low of 30 in 1950 to a high of 48 in the years 1951, 1952, and 1961, excluding the years 1942 to 1949 for which data are not available. In only 2 of the years for which data are available has the number of individual members engaged primarily in floor trading fallen below 28 or exceeded 34. Active member firm accounts, on the other hand, numbering only 4 in 1935, totaled 18 in 1961.[431]

In addition, the NYSE has reported annually to the Commission, since 1950, the number of members engaged "intermittently" as floor traders, with apparent reference to those members engaged primarily in other activities who effect a significant number of floor trades. The number of such members has shown a steady increase from 68 in 1950 to 150 in 1961. Many other members engage in floor trading on a sporadic or infrequent basis, but their number is not annually reported. Judging from the number of members reporting floor trades during periods covered by studies, the total number of members effecting floor trades exceeds 300 per year.

Although the number of members engaged primarily as floor traders has remained relatively constant and the total number of members engaging in floor trading appears to be increasing, the volume of floor trading has declined since 1937. As indicated in appendix VI–H.1, floor traders' purchases and sales have declined from 61 million shares in 1937 to 44.7 million in 1961, or from 6.8 percent of total Exchange purchases and sales to 2.1 percent.

[431] For more detail on the number of floor traders, see app. VI–H.1.

c. Characteristics of floor trading

Prior studies by the Commission indicate that most floor trading on the NYSE tends to be done by a relatively small number of floor traders.[432] Data complied by the Special Study confirm this fact. The 15 most active floor traders accounted for 49.8, 55.5 and 56.2 percent of all floor trading volume during the weeks ended January 27, March 24, and June 16, 1961, respectively (tables VI-52 to VI-54). The respective percentages for the 30 most active floor traders were 71.30, 72.89 and 73.75 for weeks in which total floor traders numbered 175, 193 and 162. Although the 30 most active accounts were not the same over each of the 3 weeks, several accounts—including the E. H. Stern, and E. H. Stern & Co., accounts—consistently ranked among the leaders. Together the 2 Stern accounts represented between 12 and 16 percent of total floor trading in each of the 3 weeks. A total of 15 accounts were among the top 30 in all 3 weeks, and 14 accounts were among the top 30 in 2 of the 3 weeks.

A more significant fact is that floor trading has traditionally concentrated in the more active stocks. During a 25-week period in 1935, floor trading in 20 selected active stocks accounted for 14.8 percent of the total reported purchases and sales in those stocks, whereas floor trading in all other stocks amounted to 8.5 percent of the total reported purchases and sales in such stocks. A similar study covering 2 weeks in 1938 found that floor trading accounted for 10.8 percent of total volume in 20 very active stocks, but only 4.7 percent of total volume in all remaining stocks. Over a 4-week period in 1952 floor traders dealt in 527 issues, 84 of which accounted for 32 percent of total reported Exchange volume and approximately 70 percent of total floor trading volume. For the week ended April 3, 1959, floor trading in the 100 most active stocks accounted for 75 percent of all floor trading.[433]

Data for the 3 weeks in 1961 confirm these earlier findings. During this period 50 percent of all "stock days" [434] were days when volume was less than 1,800 shares, and only 10 percent of the stock days in which floor traders participated are included among these relatively inactive stock days (chart VI-3). That is, 90 percent of all stock days in which floor traders participated were those above the median in activity (as measured by share volume). Floor trading tends to gravitate to the more active stock days to such an extent that approximately 70 percent of all stock days in which floor traders participated

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[432] See app. VI-H.2.

[433] See app. VI-H.3.

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

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

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

were among the top 25 percent of active stock days, and approximately 50 percent of all stock days in which floor traders dealt were among the top 13 percent of active stock days over the 3 weeks.[435]

As measured by share volume, over 80 percent of all floor trading was concentrated in each of the 3 weeks in less than 11 percent of the stocks traded on the Exchange, which stocks accounted for between 22 and 37 percent of total reported round-lot volume (tables VI–55 to VI–57). These were the approximately 110 to 150 stocks in which floor traders accounted for more than 2.5 percent of total purchases and sales. The data also show that between 35.8 and 51.5 percent of all floor trading in each week was concentrated in less than 38 issues, and that in each of these issues floor traders accounted for more than 7.5 percent of all purchases and sales. That is, approximately one-third to one-half of all floor trading each week was concentrated in less than 3 percent of the issues traded on the Exchange, which issues accounted for between 7 and 10 percent of total Exchange volume. On the other hand, in a majority of the issues which they traded at all, floor traders accounted for less than 2.5 percent of total volume in those stocks. These issues represented in the 3 weeks respectively 15.7, 19.5, and 10.7 percent of the total number of issues traded on the Exchange, and accounted for 38.8, 29.1, and 30.2 percent of total reported round-lot volume.

Concentration of floor trading in the 25 most active stocks was very high in each of the weeks studied (tables VI–58 to VI–60). For the week ended January 27, 1962 the 25 most active stocks accounted for 19.6 percent of total Exchange volume, but 42.2 percent of all floor trading. For the weeks ended March 24 and June 16, the 25 most active stocks accounted for 22.1 and 19.7 percent of total Exchange volume, but 50.4 and 39.6 percent of all floor trading, respectively.

Whether measured by stock days or share volume, floor traders tend to concentrate their activities to a far greater degree than any other class of Exchange member. Specialists traded less than 16 percent of their total volume in the 25 most active stocks, and odd-lot dealers less than 21 percent, in each of the 3 weeks. These lower rates of participation are due largely to the fact that the functions of such members require broader participation in the market. However, floor-trader concentration in the 25 most active stocks in each of the 3 weeks was at least 9.9 percent greater than that of members off the floor,[436] who are under fewer restrictions with respect to their trading than any other class of members.[437]

Testimony taken from 19 Exchange specialists confirmed this statistical evidence of floor trading concentration in the more active stocks, and contributed additional insights into floor trading patterns. Thirteen of the specialists concurred in the view that floor traders generally trade in the more active stocks. Four of the remaining six did not feel that floor trading was generally concentrated in active stocks, but did testify that they rarely saw floor traders in their inactive stocks.

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[435] See also chart VI–4, which shows a slightly greater concentration of floor trading in active stock days when stock day activity is measured by number of transactions rather than by share volume.

[436] Trading by members off the floor is described in pt. G, below.

[437] For the weeks ended Jan. 27, Mar. 24, and June 16, 1961, respectively, members off the floor did 27.9, 36.1, and 29.7 percent of their trading in the 25 most active stocks (tables VI–77 to VI–79). For comparisons of member classes' concentration by stock days, see charts VI–3 and VI–4.

Another characteristic of floor trading is that it often develops or increases in a given stock when the stock experiences unusual activity. The specialist in Sperry Rand Corp., when asked why that stock attracted "very heavy floor trading during the early part of 1962," testified:

> Sperry Rand has a big market. It had a rise up to 35½ after doing nothing for years. It was one of the few electronic stocks that did nothing for a long, long while and then it suddenly went up as high as 35. Since that time, it has gone down quite a bit and maybe that activity—I can't answer that, why it is. I don't know why people buy stock.

Another specialist, when asked whether he had experienced any concentration of floor trading in any of his stocks, answered:

> I hadn't lately. Before, when Ampex was active over the last 4 years, we had floor traders; also in General Tire. They generally go to stocks that are active and that have had a break or rally.
>
> They go to the glamour-type stocks.

The specialist in Reynolds Metals Co. noted that this stock "occasionally" attracts floor traders. Asked when this happens, he stated: "* * * it could probably happen when the so-called aluminum group became active in volume."

Some specialists, however, testified that floor traders are sometimes active in relatively inactive stocks, if such stocks are volatile. One, for instance, testified that floor traders are active in Spartans Industries, Inc., a relatively inactive stock that he described as "very volatile." The specialist in Beckman Instruments, Inc., a somewhat more active stock, testified that floor traders become most active in Beckman "when the stock is most volatile." The specialist in U.S. Smelting, Refining & Mining Co., noted that this stock is attractive to floor traders, an attraction he explained as follows:

> Because it has a very thin market. It is one of these stocks that is worth a hundred dollars a share in book value. There are only 500,000 shares of it outstanding, and it has got gold, lead, zinc—everything under the sun. It has great speculative value, but it has a quick move, and then everybody comes dashing in and buys it, and then nothing happens, and it goes down again. They only trade it when they see something like that going on. They get in and out very quickly.[438]

It appears, however, that unless the volatility is of a type that will sustain a rally or break for at least a period of time, floor traders will not participate in the trading. This was clearly expressed by the specialist in a very inactive stock marked by what he described as "wicked movements." He was asked whether these moves attract many floor traders, and the testimony continued as follows:

> A. No; * * * just as if we were floor traders we would shun it like the plague.
>
> Why trade in something of that character? You would not do it and I wouldn't do it.

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[438] This testimony, given in late July of 1962, has been borne out by subsequent events. Between July 9 and Dec. 27, 1962, the price of U.S. Smelting increased from 26⅜ to 42½ (touching a high of 43⅝) on a total published volume of 355,600 shares or a daily average of 2,988 shares over the 119 trading sessions. During this period, floor trader purchases and sales totaled 40,500 shares, or 5.7 percent of the total purchases and sales in the stock. On Dec. 28, 1962, the daily volume jumped to 43,500 shares, exceeding the total trading in the stock over the 15 preceding trading sessions. Between the opening on Dec. 28, 1962, and the close on Feb. 21, 1963, the price increased from 42½ to 70¼ (down from a high of 88⅜) on a total volume of 1,526,200 shares, or a daily average of 39,133 shares over the 39 trading sessions. During this period floor trader purchases and sales totaled 467,300 shares, or 15.3 percent of the total purchases and sales in the stock. See table VI–61.

Q. Because of the——

A. There is no possible chance of having a sustained move or a percentagewise—it is a stock that can be invested in, I think, very attractively, but certainly no trading in it. * * *

Q. You rarely see floor traders in a stock like that?

A. We have seen them, but our comment is that they ought to have their heads examined.

Q. They are active in American Motors?

A. That is an attractive stock.

Q. What distinguishes American Motors from——

A. The volume.

Q. The volume of trading?

A. Yes.

Q. Whatever you buy you can always sell?

A. Yes, you have an excellent market.

One may conclude, therefore, that even in the relatively inactive stocks in which floor traders trade because of the volatility, in most cases the stock must be sufficiently active to sustain a moderate price trend and provide opportunity to cover a short position or liquidate a long position rapidly.

3. OBJECTIONS TO FLOOR TRADING

The objections to floor trading that have been most frequently advanced are: (1) floor traders enjoy a competitive trading advantage over all other traders, and (2) floor trading accentuates price movements.[439]

a. Competitive trading advantages of floor traders

All members of the Exchange have a trading advantage over nonmembers by virtue of their lower commission costs. The floor trader enjoys two further advantages which stem from his ability to represent himself in all trades: elimination of the costs of floor brokerage and an opportunity to observe and act upon floor developments instantaneously.

The cost advantage of the floor trader may be illustrated as follows with respect to trades which are made and reversed during the course of a single trading session, a form of trading—described as "in and out" or "daylight" trading—which accounts for a large percentage of total floor trading. If a nonmember purchases 100 shares of a $25 stock in the morning and sells the same 100 shares later in the day, he must pay a commission of $63 ($31.50 on the purchase, $31.50 on the sale). A member trading off the floor can effect the same purchase and sale at a commission cost of $7.30 in floor brokerage plus a clearance fee (if the member is not a clearing member) of $2.75. The member trading on the floor does not incur floor brokerage costs, and may therefore effect the transaction at a total commission cost of $2.75, the cost of clearing the purchase and sale. The commission costs of the nonmember, member trading off the floor, and the member trading on the floor are therefore $63.00, $10.05, and $2.75, respectively. Adding Federal transfer taxes of $1, New York State transfer taxes

[439] Because many floor members act as both floor traders and floor brokers, it has also been argued that a potential conflict of interest exists; such members may compete as principals with orders they hold for customers, or allow concern for their own trading to interfere with prompt and careful performance of their broker functions. Although these problems cannot be dismissed, evidence that they do exist is lacking. The former objection appears to be met by rule 92 of the Exchange, which provides that members may not purchase stock for their own account while holding a customer's market order to buy stock, and may not sell stock while holding a customer's market order to sell.

of $4, and SEC fees of $0.05 to each of these transactions produces total costs of $68.05, $15.05, and $7.80, respectively. The price rise necessary to offset these costs is therefore $0.68 or more than ⅝ of a point per share for the nonmember, about $0.15 or slightly more than ⅛ of a point per share for the member trading off the floor, and less than $0.08 or less than 1/10 of a point per share for the floor trader. It is evident, therefore, that a member trading for his own account on the floor is able to trade with greater frequency, assume commitments at smaller cost, profit from smaller price changes, and incur less risk of loss than a nonmember or a member trading off the floor.[440]

The floor trader's "place" advantage was described as follows by an early Commission report:[441]

> He sees instantly the outbreak of activity in a stock, the nature of the trading, and the direction of prices. He is in a position to discount or revise his market appraisals almost instantaneously. Upon the basis of information which he derives while on the floor he can increase, decrease, or cancel his orders more rapidly than a nonmember to whom the same information is only made available at a later time. This is particularly true when the "tape is late," i.e., when reports of transactions which are conveyed to the outside world by means of a ticker system are delayed because of unusual activity on the floor. During such periods the member on the floor has immediate knowledge of the latest prices while the nonmember must rely upon prices which may no longer be current. Since there are no news tickers on the floor, members contend that important developments in industry, finance, or politics affecting the course of security prices are revealed more expediously to persons outside the trading premises. It should be noted, however, that such tickers are found immediately adjacent to the trading premises, that news of this character may be relayed to members on the floor by their office partners or employees almost as quickly as it appears and that the reaction of the investing public as expressed in increased buying or selling orders is quickly manifest to members on the floor.

The Exchange has denied that floor traders enjoy any "significant" trading advantages, stating, for example:

> There has been a tendency, on the part of some people in the past, to try to spell out "advantages" a Floor Trader may have over the public. On analysis, it appears that there are differences—but they do not amount to significant advantage. For example, it has been said that the Floor Trader has a cost advantage. But this ignores his costs: capital investment in membership; initiation fee; interest on investment; annual dues; contribution to gratuity fund; office space; clerical help; clearance charges; Federal and State transfer taxes; SEC fee; value of time spent in conducting his business; and, Federal and State income taxes.
>
> It has also been said that the Floor Trader may gain an advantage by reason of his presence on the Floor. This ignores the fact that there are no news tickers on the floor. It is true that a Floor Trader may obtain a bid and offer or observe a transaction occurring on the Floor, thus learning of that quotation or transaction before someone who must depend upon the quotation system or the tape for such information, but such knowledge on the part of the Floor Trader is extremely limited as to the number of stocks at any one given time. He must watch the tape for information concerning transactions in stocks not in the particular locality where he may be at the moment, and must go to the Post

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[440] Adding the floor trader's "fixed" costs—interest on investment in membership (approximately $11,000 per year), annual dues ($1.500 per year), a "floor privilege fee" ($500 per year), the initiation fee ($7,500, or $750 per year over 10 year amortization period), and small incidental costs—does not diminish the floor trader's cost advantage to any significant extent. Placing the average number of purchases and sales for the average member account engaged solely in floor trading at roughly 14,000 shares per week or 728,000 per year results in a fixed cost per share of less than $.02, or less than $2 for each purchase or sale of a round lot.

[441] SEC, "Report on the Feasibility and Advisability of The Complete Segregation of The Functions of Dealer and Broker," pp. 16–17 (1936). (Hereinafter cited as "Segregation Report.")

where the stock in which he is interested is traded in order to obtain the bid and offer.

Another fact which is most important is that THE FLOOR TRADER HAS NO MORE KNOWLEDGE THAN ANYONE ELSE OF WHAT IS GOING TO HAPPEN IN THE MARKET IN A STOCK AFTER HE MAKES A PURCHASE OR SALE. Floor Traders do not get rich over night. They take calculated business risks and certainly they are not always right.[442] [Emphasis in original.]

These Exchange views appear to be inconsistent with those of certain members with intimate knowledge of floor activities. In 1956, for instance, one of the odd-lot firms, protesting Exchange consideration of a plan to remove associate brokers from the floor, argued:

Under our present system of trading the broker develops an intangible quality called a "feel of the market." At the post his eyes and ears become attuned to the sights and sound of the marketplace. Here he picks up information regarding the stocks he is trading in. Here he can act with split-second speed and reflect in his own trading the action of the tape. Here he makes friends with the specialists and other brokers and traders who impart to him their combined thoughts and advice and who are helpful to him in the execution of his round-lot trades made for the purpose of offsetting his positions. The fact that our broker would no longer be able to remain at the place of auction * * * would, in our opinion, cost our firm many hundreds of thousands of dollars in the effectiveness of his round-lot trading. When you consider that last year our firm traded 20 million shares in round-lots, the importance of this factor becomes immediately apparent. Even the minimum variation of one-eighth poorer on these transactions would result in a loss of $2,500,000.

Members on the floor have access to much greater and more current market information than individuals relying on tape reports and quotation systems. Floor members see and hear what is going on and they can react immediately. They know in many instances that a given broker represents certain institutional investors, and may follow his activity closely as he begins to buy or sell large amounts of a stock. They appreciate the trading patterns that generally prevail during acquisition or disposition of large blocks of stock. They are familiar with the trading techniques of different brokers or specialists. They may obtain from fellow brokers or traders general or specific evaluations of investor tenor, in terms of limit or stop orders placed, short sales effected, or orders cancelled. These and other factors that are not reflected on the tape contribute to the "feel" of the market development by floor members. Most certainly factors such as these account, at least in part, for the following testimony given in a non-SEC proceeding by a prominent floor broker:

* * * I would not want any people * * * to think that I am a prognosticator of the market. I never have been. But I do think that I know fairly well what the market will do from hour to hour.

* * * * * * *

That is quite essential for a person handling discretionary orders.

More specifically, this floor broker testified:

A. * * * As your business builds up and your customers become convinced of your ability as a broker, they more and more lean on you to execute the orders in your fashion, because let's face it, they're upstairs and I'm downstairs, and many times I know things that my customers do not, and that is why they will give me discretion.

Q. When you say they are upstairs, you mean they are off the floor and you are down there?

A. They're in their offices and I'm on the floor.

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[442] Prepared statement of the NYSE, submitted to the Commission and apparently circulated to members, dated May 20, 1959.

Not only are floor members in the most advantageous position to evaluate general market conditions and the market in individual stocks, but in addition they are in a position to react immediately to developments affecting such markets. Unexpected announcements concerning earnings, dividends, mergers, contract awards, litigation, etc. often create sudden activity and price changes. The floor trader is but seconds away from such trading. Other speculators or investors have both a time disadvantage and the handicap of having to designate an agent to represent them at the post.

The floor trading in Sperry Rand Corp. on Wednesday, January 25, 1961, illustrates the significance of these floor trader advantages. Just before noon, the board of directors of Sperry Rand Corp. decided to declare a 2-percent stock dividend in lieu of the quarterly cash dividend on its common stock.[443] This decision was made known to the NYSE by 1:48 but the announcement, which also noted a substantial decline in net earnings, did not appear on the Dow Jones "broad tape" until 2:32 that afternoon. In order to relate this announcement to the activity of floor traders and the price action of the stock, every transaction in the stock during the day was plotted, and transactions by floor traders and specialists were identified (chart VI-5).[444] These data were then summarized by six periods which reflect the significant price movements and floor trading activity in relation to the dividend announcement (table VI-62).

Between the opening and 1:30, the price declined from 23⅜ to 22¾ on a volume of 24,800 shares, as floor traders purchased 600 shares and sold 9,500. The great majority of the floor trader sales throughout the day were effected by the E. H. Stern and E. H. Stern & Co. floor trading accounts, which had no purchases in Sperry Rand Corp. for the day. Between 1:30 and 2:21 the price suffered its greatest decline of the day, dropping off 1 point to 21¾ on an accelerated volume of 20,800 shares, as floor traders purchased 1,000 shares and sold 9,400. At about 2:22 the stock began its only rally of the day; by 2:32 it had regained ⅝ of a point to 22⅜ on a volume of 6,400 shares, as floor traders purchased 1,500 shares and sold 900. The dividend announcement at 2:32 did not immediately reverse the rally; the price remained at 22⅜ as of 2:36, having briefly touched 22½. While the price held between 2:33 and 2:36 floor traders made no purchases and sold 1,700 shares. Between 2:37 and 2:45 the price fell ⅜ of a point to 22 on a total volume of 9,900 shares, as floor traders bought 300 shares and sold 8,100, or 81.8 percent of all shares sold. Thereafter floor traders virtually abandoned the stock, purchasing 800 shares and selling 800 as total volume ran to 30,600 shares—or 31.5 percent of the day's total

[443] On Wednesday, Sperry Rand closed at 21⅝, off 1⅞ on a total reported volume of 97,200 shares. On Monday of that week, the stock had closed at 23¾, off ⅛ on a total reported volume of 21,900 shares, as floor traders purchased 1,200 shares and sold 2,000. On Tuesday the stock closed off ¼, as floor traders purchased 2,200 shares and sold 800 out of a total reported volume of 32,200. Volume suddenly soared on Wednesday as the stock suffered a large price decline, and on this date floor traders purchased 4,300 shares or 4.4 percent of all reported purchases and sold 30,400 shares or 31.3 percent of all reported sales. On Thursday, volume increased again to 138,200 shares as the price declined ¾, and floor traders continued to sell on balance, purchasing 11,000 shares and selling 14,800. As the stock recovered 1¼ on Friday to 22⅛ on a reported volume of 90,300 shares, floor traders became purchasers on balance, purchasing 5,300 shares and selling 4,400.

[444] All transactions for the day are taken from the daily publication "Stock Sales on the New York Stock Exchange" by Francis Emory Fitch, Inc. This source indicates a total volume of 97,000 shares in Sperry Rand Corp. on Wednesday while the Wall Street Journal reported 97,200 shares. A 200-share discrepancy thus appears in the various tables, depending on the source used.

volume—in the final 45 minutes of trading. The heavy volume after 2:45 indicates that it was not until this period, after the floor traders had virtually completed their sales for the day, that the public reacted to the news.

The Special Study made no inquiry into the circumstances surrounding sales in Sperry Rand Corp. before the dividend news was publicly disseminated. It is clear, however, that floor traders utilized their time and place advantages in the moments following the announcement to react quickly to the news. Between 2:33 and 2:45 they sold 9,800 shares, or 32.2 percent of their total sales for the day, while a total of 14,400 shares traded. Not only were the floor traders able to sell large amounts of stock before the public reaction became evident at the post, but in addition those floor traders who had been trading in and out were able to realize profits in the sale of stock bought just prior to the announcement. Six of the first eight floor trader transactions after 2:32 involved the sale of stock purchased between 2:23 and 2:31 during the brief rally, and not one of these transactions was effected at a loss:

TABLE VI–1.—*Selected sales by floor traders in Sperry Rand Corp. between 2:33 and 2:45 on Jan. 25, 1961*

Time of sale	Number of shares sold	Sale price	Purchase price [1]	Number of shares purchased	Time of purchase
2:34	200	22½	22¼	200	2:31
2:34	200	22½	22¼	[2] 200	2:30
2:37	200	22⅜	{ 21¾	100	2:23
			21⅞	100	2:23
2:38	100	22⅜	22⅛	300	2:25
2:41	100	22⅜	22¼	[2] 100	2:30
2:42	100	22¼	22¼	[2] 100	2:30

[1] Purchase price was deemed to be the last price at which the floor trader had purchased Sperry Rand Corp. stock.
[2] One floor trading account purchased these shares in one 400-share transaction at 2:30.

Floor traders, in short, exerted a depressing influence on the stock prior to the adverse news, and—reacting more quickly to the news than other investors—further contributed to the price decline in the moments immediately following the news by selling more heavily than in any similar period during the day.

As was noted at the outset, the floor trader is the only member of the Exchange who has no special function and undertakes no obligations in relation to the operation of the market as a public institution. In light of the governing statutory scheme of the last 30 years, this fact, in itself, raises a fundamental question of public policy as to the extent to which a public market may be permitted to shelter such private trading activities, even apart from serious questions as to the net impact of floor trading on the orderly functioning of the market. An examination of that impact is the subject of the next section.

b. The relationship of floor trading to price movements

On at least 15 separate occasions over the past 27 years, the Commission or the Division of Trading and Exchanges has systematically collected and analyzed data which show that floor traders as a group are usually buyers when the market is rising and sellers when the market is declining, and that they are generally sellers in declining stocks and buyers in rising stocks. Thus, another most serious objection to floor trading is that it is inimical to orderly functioning of the market because it accentuates price movements in the market as a whole and in individual securities; i.e., it is a significant destabilizing factor in the market.

The design of these studies has taken various forms. The Division of Trading and Exchanges has computed floor trader net purchase or sale balances (the extent, measured in number of shares, to which floor traders purchased more than they sold, or vice versa) during various market trends as indicated by one or another of the market indicators, e.g., Dow Jones, Standard & Poor's, SEC, etc. Many of these studies are set forth in condensed form in appendix H.4.

In order to determine the relationship of floor trading to price trends in individual stocks, the same type of studies have been conducted for individual stocks or small groups of stocks, utilizing price movements in the stocks involved rather than overall market indicators. These studies, a few of which are set forth in appendix H.5, show that floor traders tend to trade with the price trend in individual stocks or small groups of stocks.

In addition, the Division of Trading and Exchanges has on numerous occasions analyzed the timing of floor trades. In both chart and table form, floor trades have been plotted in time sequence against price movements (in both individual stocks and the market as a whole) and total trading volume. These charts and tables provide additional evidence of the destabilizing impact of floor trading on price movements.[445]

In the following subsections, more detailed attention is given to the relationship of floor trading to price movements in the market as a whole, and to price movements in individual stocks.

(1) *Relationship of floor trading to market trends*

The relationship between market trends and floor traders' net balances has been tested and stated in various ways. No matter what the scope of the study or form of presentation of results, the studies have consistently shown that floor traders trade predominantly with the trend, thereby accentuating market movements. When there is little change in the market indicators, this tendency is not pronounced and floor traders will often trade against the trend. As the market movements increase in size, however, the tendency for floor traders to trade with the trend becomes marked. The length of test periods has ranged from five minutes through hours, days, weeks and periods of major index trends (e.g., changes of more than 20 points in a standard index) which cover many months. The studies have included periods of rising, declining, relatively stable and hybrid market prices. They have variously tested the net balances of all floor traders, the 50 most active floor traders, and all floor traders who purchased or sold more than 500 shares during a 1-week period. They have included both the NYSE and Amex.

Results have been stated in several ways. Some studies compare the number of days during the test period on which floor traders traded with the trend and the number of days on which they traded against the trend. Other studies indicate the net number of shares

[445] See app. VI–H, charts 1 through 11, and tables 13 and 14.

purchased or sold by floor traders over given periods of rising or declining market movements. Many studies combine both forms of presentation by (1) breaking test periods into several groups of days, the first group containing days of greatest price rise and the last group days of greatest price decline; (2) computing for each group the number of days on which floor traders traded with the trend or against the trend; and (3) computing the average daily purchase or sale balance of floor traders for each group.[446]

In every period of major market trends studied by the Division of Trading and Exchanges in which the market fell to any significant extent, floor traders were sellers on balance. In all but two studies of significant index rise, floor traders were purchasers on balance.[447] These two exceptions may be attributable to floor trading rules then in effect on the NYSE, and will be treated in more detail in the subsection on regulation, to follow. Studies of the relationship of floor trading to daily market movements have also consistently shown floor traders to trade with daily trends, the only exception occurring during one of the major rising market trends noted above.[448] Similarly, studies have shown that floor trading tends to follow hourly and 5-minute changes in market indicators.[449]

A study of floor traders' net daily balances over the 2-year period from November 2, 1959, to November 1, 1961, confirms the fact that they tend to trade with the trend of daily market movements (table VI-63). In 21 of the 24 groups of days (classified by changes in a standard market index) covering the 2-year period, floor traders traded more shares with than against the daily index trend. Moreover, their net daily balances tend to be larger when they trade with the trend than when they trade against it. Thus, their average daily balances with the trend were larger than their average daily balances against the trend in 16 of the 24 groups of days.

In the three 1-week periods studied, floor traders traded with the daily market trend on 11 days, against it on 4. The net daily balances were further refined for 4 of the days on which floor traders traded with the trend, by computing separately floor trader net balances in rising stocks and declining stocks. The results, covering 2 days when the market index increased and 2 days when it declined, are as follows:[450]

TABLE VI-m.—*Breakdown of aggregate floor traders' balances*

[In shares]

Date	Standard & Poor's index	Floor traders' aggregate balance	Floor traders' balance in rising stocks	Floor traders' balance in declining stocks	Floor traders' balance in stocks unchanged
Jan. 23, 1961	+.33	+15,920	+20,700	−5,880	+1,100
Jan. 27, 1961	+.62	+19,280	+21,080	+700	−2,500
June 13, 1961	−.35	−24,030	−400	−17,330	−6,300
June 15, 1961	−.29	−33,120	−2,100	−25,420	−5,600

446 See, for instance, app. VI-H, table 8.

447 Periods of major trends studied by the Commission are noted in apps. VI-H.4.b and VI-H.4.g. The periods in which floor traders were found to be trading against a rising trend are noted in app. VI-H.4.g.

448 Many examples of floor trading with daily market movements are noted in app. VI-H.4. The exceptional result is noted in app. VI-H.1.h.

449 See apps. VI-H.4.e, VI-H.4.f, and VI-H.4.j.

450 See tables VI-64 to VI-67 for a more complete presentation of data.

These results indicate that daily net balance data tend to understate somewhat the effect of floor trading on rising stocks, and similarly tend to overstate to a degree its effects on declining stocks, but overall provide meaningful indicators of the effect of floor trading on market movements.[451]

(2) *Relationship of floor trading to price movements in individual stocks*

When individual stocks or stock days are considered, the tendency of floor traders to follow the trend of price movements becomes even more salient. This tendency was studied for stock days in which floor traders had a high participation rate, for stock days in which high floor trader participation occurred in conjunction with wide price movement and high trading volume, and for all stock days in which floor traders traded, taking into consideration the size of their balances.

Over the 3 weeks there were 50 stock days in which floor traders accounted for 25 percent or more of either all purchases or all sales in a given stock (table VI–70). Floor traders traded with the trend in 40 of these cases, against the trend in 6, and in 4 cases were heavy buyers or sellers in stocks that were unchanged on the day. That is, when floor traders accounted for 25 percent or more of the purchases or sales of a stock on any given day, they traded with the price trend of that stock in 80 percent of the cases.

Floor traders accounted for at least 10 percent of either all purchases or all sales in stock which experienced a price change of 1 point or more on a volume of 10,000 shares or more, on 40 stock days over the 3 weeks studied. On four of these stock days floor traders' purchases exactly equalled their sales. Of the remaining 36 stock days, floor traders traded with the trend in 23 cases, or 64 percent of the stock days, and against the trend in 13 cases, or 36 percent of the stock days (table VI–68).[452] Moreover, their balances were far larger on the average when they traded with the trend than when they traded against the trend. Thus, their purchase and sale balances with the trend totaled 70,700 shares, or an average of 3,074 shares per stock day, while their balances against the trend totaled only 14,500 shares, or an average of 1,115 shares per stock day. Floor trading in these stocks in most instances tended to increase relative to total volume on days when total reported volume increased, and to show a relative decrease as total reported volume decreased (table VI–69). In many cases—two of which follow—this pattern was particularly conspicuous. On March 21 floor traders traded 1,000 shares of Lear, Inc., out of a total volume of 28,400 shares, but on March 22 they traded 16,000 shares as total volume increased to 75,300 shares. On January 24 they traded only 400 shares of Food Giant Markets, Inc., out of a total volume of 7,500 shares, but on January 25 they traded 20,100 shares as total volume soared to 108,700 shares.[453]

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[451] Compare the contrary results obtained in a breakdown of specialist net balances in pt. D, above.

[452] Although these 36 stock days represent only 1.6 percent of the 2,274 stock days on which floor traders traded over the 3 weeks, the 284,600 shares they purchased and sold on these 36 stock days constitute 9.2 percent of the total shares (3,091,270) they purchased and sold over the 3 weeks. Their purchases and sales for the 23 stock days on which they traded with the trend accounted for 6.8 percent of their total purchases and sales over the 3 weeks.

[453] A third example—trading in Sperry Rand Corp. on Jan. 24 and 25—has already been noted.

Just as floor traders concentrate the bulk of their share volume in a relatively small number of the stocks in which they trade,[454] they also concentrate a high proportion of their share balances in a relatively small number of stock days. Thus, over the 3 weeks they posted stock day share balances of 500 or more shares in only 675, or 30 percent, of the 2,274 stock days in which they participated, but these balances accounted for 83 percent of their total stock-day share balances over the 3 weeks (table VI-71).[455]

The stock-day share balances of less than 500 shares posted by floor traders over the 3 weeks were about equally distributed between those that were with and those that were against daily price trends. Balances of 500 shares or more, however, were posted more frequently with than against price trends. Moreover, as the following table indicates, when the size of the balances was 1,000 shares or more, there was an even higher percentage of stock days with the trend than in the case of balances between 500–999 shares.

TABLE VI-n.—*Relationship of floor traders' stock day balances to stock day price trends* [1]

	Size of floor traders' balances					
	0 to 499 shares		500 to 999 shares		1,000 shares and over	
	Number	Percent	Number	Percent	Number	Percent
Stock days with trend	582	36.4	176	49.6	180	56.2
Stock days against trend	600	37.5	134	37.7	104	32.5
Stock days neither with nor against trend [2]	417	26.1	45	12.7	36	11.3
Total	1,599	100.0	355	100.0	320	100.0
Shares with trend	112,870	44.7	114,250	50.3	534,490	54.6
Shares against trend	111,078	43.9	85,400	37.6	275,510	28.1
Shares neither with nor against trend	28,740	11.4	27,500	12.1	168,850	17.3
Total	252,688	100.0	227,150	100.0	978,850	100.0

[1] See table VI-71 for a more complete presentation of data.
[2] Includes stock days of no price change and stock days of zero balances.

Not only was there a relationship between the direction of the price trend and the size of floor trader balances, but there was also a relationship between the size of the price change and the size of balances. This latter relationship is seen in the following table, which shows the statistical correlation between stock day price changes and floor traders' stock day balances, as well as a statistical measure of the probability of the indicated correlation occurring by chance.

[454] See sec. 2.c, above.
[455] Floor trader stock day share balances (including purchase and sale balances, both with and against price trends) totaled 1,458,688 shares over the 3 weeks (table VI-71).

TABLE VI–o.—*Correlation*[1] *between floor traders' stock day balances and stock day price changes*

Size of floor traders' balances	Correlation coefficient	Statistical probability of correlation occurring by chance[2]
0 to 499 shares	−.0137	(2)
500 to 999 shares	+.1108	.05
1,000 shares and over	+.1853	.001
All balances	+.0901	.001

1 The correlation, which was computed on the basis of paired observations, using a computer, determined the extent to which price trends were related, in size and direction, with floor trader balances.
2 This statistical probability is measured by the F ratio, a standard statistical test used to measure the reliability of a coefficient of correlation. For balances between 0 to 499 shares, the ratio is 0.30, too small to have any statistical significance. For balances between 500–999 shares, the F ratio is 4.34, which is statistically significant at the 5-percent level; this means that the probability of such a correlation occurring by chance was less than 5 out of 100. For balances of 1,000 shares and over, the F ratio is 11.24, which is statistically significant at the one-tenth of 1 percent level, indicating that the probability of such a correlation occurring by chance is less than 1 out of 1,000. The overall correlation was similarly significant at the one-tenth of 1 percent level.

For balances of less than 500 shares, no statistically significant correlation exists. As the size of share balances increases, however, the correlation becomes larger and statistically significant. For balances of 1,000 shares and over, the correlation is highly significant; that is, the probability of such a correlation occurring by chance is extremely small. Although the correlation is not a strong one, it substantiates the tendency of floor traders to trade with price movements, particularly as the size of balances increases.

Overall, floor traders traded with the trend on more stock days than they traded against it (938 to 838), posted larger share balances with than against the trend (761,610 to 471,988), and showed a positive correlation between the size and direction of stock-day balances and the size and direction of stock day price trends. In short, it is clear that floor traders tend to trade with price trends, and that this tendency is particularly conspicuous with respect to their larger stock day balances which may be expected to have the greater impact on price movements.

Prior studies by the Commission and the Division of Trading and Exchanges are consistent with this analysis of floor trading. In January of 1945 the Commission released a report on floor trading prepared by the Division of Trading and Exchanges.[456] A significant portion of this report ("1945 Report") consisted of detailed studies of floor trading in individual stocks or small groups of stocks, for periods ranging from one trading session to 12 weeks. Most detailed was a study of floor trading in five low-priced automobile stocks during the spring and summer of 1944. This study constituted an investigation into the reasons for sporadic bursts of volume and concurrent price movements of unusual range in these stocks. Records of member and nonmember transactions during these periods were obtained, a sample cross section of public buyers was interviewed, and a compilation was made of rumors concerning these stocks which had appeared in public print. One brief segment of the report, which is representative of the materials compiled for the five stocks, related the following facts with respect to trading in Graham-Paige Motors

456 SEC, "Report to the Commission by the Trading and Exchange Division on Floor Trading," Jan. 15, 1945. (Hereafter cited as "1945 Report.")

Corp. during the first week of August, when the price rose from 2⅞ to 7 and closed at 6½. On August 1 the stock acted normally until 5 minutes prior to the 3 p.m. close, the public trading approximately 7,600 shares and floor traders purchasing 600 shares, all at 2⅞. Between 2:55 and 3 p.m., 29,500 shares were traded, and of these specialists bought 8,000 at 3 and floor traders bought 8,400 at 3, purchases which almost equaled the approximately 10,000 shares purchased by floor traders for the entire month of July. During the first half hour's trading on August 2, floor traders purchased 30,600 of the 59,100 shares traded, and the price moved to 3⅛. The price fluctuated between 3⅛ and 3¼ for the remainder of the day, with floor traders purchasing a total of 37,400 shares while selling 17,200 out of a total trading volume of approximately 131,000 shares. Floor trader purchases again exceeded their sales on August 3 as the price moved to 3⅝, and floor trader holdings reached 46,350 shares, up more than 42,000 shares from July 31. A record volume of over 190,000 shares was set on August 4 by extraordinary public buying, and floor traders sold 35,000 shares on balance as the price reached 4⅝ and reacted to 4. On August 7, the next trading day, floor traders sold 10,900 shares on balance as the stock opened at 7 and closed at 6½ on a total volume of over 170,000 shares. Of the 56 public buyers of this stock who were asked for their reasons for buying, 26 gave "market activity" or "ticker tape action" as their reason, indicating that the price movement was accentuated directly by the trading of floor traders, and as well by the trading of other investors attracted by the floor traders.

Based on this and similar studies the report concluded that the evidence:

> * * * simply demonstrates in greater detail what less extensive studies by the Commission had already plainly indicated. In the course of its enforcement of the antimanipulative sections of the Securities Exchange Act, the Commission had frequently traced spectacular price movements and unusual volumes to the activities of members on the floor. Cases of this kind in the Commission's files cover the entire 10-year span since the passage of the Securities Exchange Act.[457]

The report went on to recommend the abolition of floor trading. The response of the Exchange to this recommendation, treated below, included having Cole, Hoisington & Co., an independent engineering firm, prepare a rebuttal report ("Exchange Report") in defense of floor trading. Highly critical of the Division's statistical methods, this report nonetheless conceded:

> In concluding our comments upon the Division's report of January 15, 1945, we wish to restate that we are in agreement with the conclusion that, in certain low-priced motor stocks last summer, floor trading was conducted in a manner and degree, which, on some occasions, were not in the public interest. We believe that practical methods, short of complete abolition of floor trading, can and should be devised and made effective, so as to preclude a repetition of comparable situations.[458]

Subsequent studies by the Division, a few of which are noted in appendix H.5, have revealed numerous situations where floor traders concentrated their activities in volatile price situations. The most recent full scale study of floor trading on the NYSE by the Division occurred in 1959. It was there noted:

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457 Id. at p. 29.

458 Cole, Hoisington & Co., "Report to the New York Stock Exchange on Floor Trading," p. 39 (May 3, 1945). (Hereinafter cited as "Exchange Report.")

An analysis of trading in American Motors during a 2-week period in October 1958 reveals that under the present restrictions on the Exchange floor traders were able to accentuate price movements and at times to dominate the market. This analysis shows that during a selected 2-week period floor traders were responsible for 10.1 percent of the volume in the stock; that for certain 2-hour periods floor traders were responsible for 25 percent of the volume of purchases or sales; and that for certain shorter periods floor traders appeared to have dominated the market. The analysis found that 15 members were responsible for 82 percent of all floor trading in American Motors during the 2-week period. During certain periods it was found that floor traders bought heavily at the beginning of a sharp price rise and then liquidated their positions at or near the peak of the rise.[459]

Several of the specialists interviewed by the Special Study confirmed the fact that floor traders trade with price trends. One specialist, formerly the chairman of the NYSE board, when asked whether floor traders trade in a stabilizing fashion in a bull market, noted: "They trade the trend a lot. Whether they make stabilizing bids or offers, I wouldn't know."[460] Another specialist and former chairman testified as follows:

Q. When the price of Brunswick is going up, let us say, do you find that most floor traders are buying or selling?
A. They will be buying if they care to last.

A third specialist, asked whether floor trading is "generally with the prevailing trend" in the stock traded, replied: "You could say usually, but some of them might buck it, some of them might go against it."

Edwin H. Stern, one of the most active floor traders on the Exchange and a member of the board of governors of the Exchange, was asked to state his view on whether any of the floor trading rules "should be changed in any respect." He replied:

I would say that the only recommendation that I would make, and this * * * has not been well thought out at all, but in the areas of increased stabilization, so that at all times, floor traders had at least half of their trades stabilizing trades.

Although this statement apparently refers to stablization in terms of "tick" standards rather than "net balance" standards, it is significant that one of the most important floor traders recognizes that floor trading poses a present problem in the area of stabilization.

It is clear, and indeed confirmed by various members of the Exchange, that floor traders tend to trade with price movements, thereby accentuating price movements. One specialist, questioned in formal proceedings by the Exchange as to his handling of the stock of American Telephone & Telegraph Co., expressed this view perhaps

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[459] See app. VI–H.5.c.

[460] The distinction drawn here between trading with the trend and making stabilizing bids and offers reflects the existence of two distinct systems for measuring the effect floor trading has on price movements—(1) net balance studies, and (2) "tick" studies. According to the "tick" approach, a purchase or sale is considered to be stabilizing or destabilizing according to its relationship to the preceding transaction in the stock involved. A purchase at a price lower than the preceding transaction is considered to be stabilizing, while a purchase at a price higher than the preceding transaction is deemed to be destabilizing. Conversely, a "plus tick" sale and a "minus tick" sale are considered stabilizing and destabilizing respectively. Purchases or sales at the same price as the preceding transaction ("zero-plus tick" or "zero-minus tick" purchases or sales depending on the last *different* preceding price) are considered to be indirectly stabilizing or destabilizing in the same fashion. The respective merits of the net balance and "tick" approaches to stabilization are treated in detail in pt. D, above, and again—briefly—below.

more clearly than any other. In a letter to the Exchange he noted: "* * * I cannot stress too strongly that, at the present time, Telephone has become a speculative electronic stock, attracting more traders, both floor and office, with consequently more erratic moves."

4. Defenses of Floor Trading

The justifications of floor trading that are frequently advanced are that it contributes (1) liquidity, (2) continuity, and (3) stability to the market.

a. Market liquidity

The defense of floor trading most commonly raised is that it increases the liquidity or "marketability" of stocks by increasing the number of individuals engaged in trading. As a general proposition, permitting members to trade on the floor in all probability does encourage some trading that would not be attempted off the floor, thereby adding to the liquidity of the market. A closer look at this defense of floor trading, however, reveals three reasons why this added liquidity is of limited value: (1) It vests largely in the active stocks rather than in the inactive stocks where it is most needed, (2) it tends to develop primarily on the buy side or the sell side in a manner that accentuates the imbalance of buyers and sellers, and (3) it disappears when it is needed most. As expressed by the Segregation Report:

> * * * [F]loor trading, as disclosed by the evidence, reveals a tendency, on the average, both to concentrate in stocks where activity is already present and to accentuate price trends. The liquidity it creates is too often superfluous. It misleads, for under stress it vanishes.[461]

That floor trading, 26 years after the Segregation Report, still concentrates in the active stocks and tends to accentuate price movements has already been shown. This fact severely diminishes the value of the liquidity added by floor traders to the market. The specialists who testified felt, nonetheless, that this liquidity is useful. One, for instance, testified:

> Q. * * * [A] really inactive stock has no attraction for a floor trader?
> A. That's right.
> Q. Do you think that floor traders are in any way helpful to the market?
> A. Yes.
>
> * * * * * * *
>
> I think, particularly, when the stock is—they will keep things very, very close * * *
> Q. But they tend, as you say, to concentrate their activity in the more active stocks?
> A. That is right. They want a stock where there is something doing.
> Q. But those are the stocks which are pretty liquid already?
> A. I guess you have to say they are; yes. It is like everything else. I think the floor traders do a certain amount of good, because they make a good market.

Another specialist, a former chairman, testified:

> A. Any liquidity or any volume in a stock adds to the public interest, in my opinion. Take Polaroid today, when it is active. A buyer or seller can buy or sell a lot of stock within a very short range.
> Q. Do you think it is in the public interest to add to liquidity, volume and public speculation, at times during a period of wild bull markets?

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[461] Segregation Report at p. 110.

A. It certainly helps the seller. Anything that creates activity in a stock, rather than false activity, is good for the market. The larger the marketplace the better to have it all in one place.

* * * * * * *

Q. Isn't it the stock like * * * [an inactive stock] that needs a better market?
A. Well, they [floor traders] have to make money or they wouldn't be in business. There is no sense tying your money up in [the stock]. It might go down. There might be a seller there, and it might take you a week to get out.
Q. Isn't a stock like Ampex [in which floor traders were active] generally a liquid stock, without the floor traders?
A. It could be, but he makes it more liquid.

* * * * * * *

Q. Do you think that is a stronger consideration than * * * whether he is on balance a buyer of the stock in a period of a rising market?
A. Well, then the seller is ahead. The more volume you have in any stock, the more liquidity in any stock and the more chance the public can do whatever it wants to do.

Another prominent specialist testified that floor traders " * * * add greatly to the liquidity of the market." He noted, however, that floor traders were most active in Litton Industries, his most active stock, but that he could recall no floor trading in the last few years in Best & Co., a very inactive stock. He explained the absence of floor trading in Best & Co. as follows:

There is very little opportunity for it because the transactions are so sparse that it would be almost—well, it seems impossible for a trader to stand around and wait for 100 shares of Best that might happen to be there.

That floor trading tends to abate or disappear under stress conditions was affirmed by the specialist in International Business Machines Corp. who testified as follows with respect to that stock during the May 28 market break.

Q. Did you have bids in substantial quantities within 20, 30, 40, or 50 points of the market?
A. There was no substantial bid anywhere, and in a case like this you couldn't get help from people. Nobody wanted to buy anything.
Q. The floor traders were not too interested?
A. They weren't interested at all. They had seen the light.[462]

There is, then, general agreement that floor traders contribute to the liquidity of the market. It is clear, however, that the liquidity they provide is in most cases marginal, for they tend to enter the market only when other investors have already provided activity, a fact that poses the interesting question, "Who is providing liquidity for whom?"

It is indeed probable that on occasion the liquidity added to the marketplace by floor traders constitutes a positive disservice to the public by creating a misleading impression of a given stock's actual liquidity. Thus investors who purchase a stock with a view to liquidity may find in stress situations that the floor traders, who are under no obligation to maintain fair and orderly markets, have abandoned the stock, and its liquidity has been impaired when it is most needed.

b. Market continuity

Another defense of floor trading that is often raised is that floor trading improves the continuity of the market, or provides a "closer"

[462] Floor traders had a net sale balance in International Business Machines Corp. of 1,600 shares on May 28.

market. That is, the presence of floor traders is said to increase the probability that transactions in a given stock will be effected at or very close to the price of preceding transactions in the stock. Thus, if a stock is quoted 50 to ½ following a transaction at 50¼ in a relatively stable market, a floor trader may narrow the quotation by offering stock at less than 50½ or bidding more than 50. This narrowing of the spread will ordinarily result in a transaction closer to the last sale than if the market remained 50 to ½.

This defense of floor trading, however, is subject to the same qualifications that deprive the liquidity defense of much of its weight. Since floor traders concentrate their activities in the active stocks, their contribution to continuity is limited for the most part to securities which suffer least from lack of continuity.[463] Moreover, the continuity supplied by floor traders is attributable to trading that generally tends to accentuate price movements and thereby impair price stability.

In fact, this tendency to accentuate price movements may manifest itself in a manner that has a directly negative effect on price continuity. As has been noted, floor traders tend to avoid stable markets, preferring to trade in "stocks that are active and that have had a break or rally." Here floor traders are more apt to add to the imbalance of buyers and sellers than to bring them into balance, thus accentuating the price movement. If, for instance, a stock is quoted 50 to ½ following a transaction at 50 in a rising market, floor traders may intensify the competitive biding so as to drive the price up to 50¼ or higher, thus impairing both price stability and continuity.[464]

Moreover, as the exchange has often publicly explained, it is primarily the specialist's obligation, and not the floor trader's, to maintain price continuity. This is as it should be, for the specialist is expected to provide such continuity in good times and bad, whereas the floor trader, who has no responsibilities whatever, may simply withdraw from—or indeed aggravate—stress situations to the detriment of other investors.

c. Market stability

Despite the consistent findings that floor traders as a group tend to trade with price trends, or in a destabilizing fashion, the Exchange has maintained that floor traders exert a stabilizing influence on the market. This argument usually takes one or more of three forms: (1) floor traders stabilize declining markets when they cover short sales, (2) in many cases floor traders trade against the trend in the market as a whole or in individual stocks, as measured by net purchase or sale balances, and (3) as measured by "tick" tests, a majority of floor trader transactions are against the trend.

The argument that purchases to cover short sales tend to stabilize declining markets overlooks the fact that such purchases are only a portion of total purchases, and are fully accounted for in net balance studies, which show that in declining markets floor traders generally tend to sell more than they buy.[465] The second point—that floor

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[463] See pt. D.5, above.

[464] The relative number of times floor traders impair rather than improve price continuity has not been studied, due to the fact that it is impossible to reconstruct the market situations in which floor traders participated in the auction. No record is kept, for instance, of bids and offers made at particular times at the post, and it is therefore virtually impossible to ascertain whether a floor trader's presence affected the auction proceeding and resultant price of a transaction.

[465] Short selling is treated in pt. H, below.