trader net balances are in many cases against the trend—is certainly true, but likewise does not undermine the finding that on the whole floor traders trade with price trends, and more often than not exert a destabilizing influence on the market.

Brief treatment of the use of tick tests for floor traders is appropriate at this point. From time to time the Exchange has brought to the Commission's attention instances where floor trading appeared to have a stabilizing influence on the market or on a given stock, but only once has the Exchange submitted a report designed to rebut Commission findings that floor trading has an overall destabilizing influence on price movements. This report—the Cole, Hoisington, or Exchange Report—challenged the Commission's statistical methods, reinterpreted certain of the Commission's statistics, and presented certain examples of floor trading activity that appeared to stabilize the market. With respect to net balances studies the Exchange Report argued that floor trader net balances over weeks or months have little bearing on the effect floor traders have on price trends, in that such balances "* * * are very small in relation to the total volume of floor trading activity, and are insignificant in relation to the total volume of trading on the Exchange." With respect to daily floor trader net balances, the Exchange Report noted that aggregate floor trader balances during a 17-day period in September 1937 previously studied by the Exchange showed trading with the trend on a daily basis on 10 of the 17 days, or 59 percent of the time. The report went on to say, however, that stabilization should be measured by a transaction-to-transaction, or tick, system rather than by net balance studies. That is, all purchases on minus ticks and all sales on plus ticks should be considered "stabilizing," or against the "trend" indicated by the direction of the price change from one transaction to the next.

To this end, Cole, Hoisington studied floor trading in five selected stocks over the 17-day period by 15 floor traders who had "short sales of as much as 2,000 shares in any one or more of the five stocks" over the 17 days.

This study produced the following results:

	Shares	Percent
With price change	39,500	11.1
Against price change	98,000	27.6
Neither with nor against	217,900	61.3
Total	355,400	100.0

The Exchange Report therefore concluded that these figures indicated a "* * * preponderance of directly stabilizing transactions over directly nonstabilizing transactions." Of the 217,900 shares traded on zero-plus or zero-minus ticks, or "neither with nor against," the report found that "116,600 or 53.5 percent may be considered as having an indirect stabilizing effect." There is in these data, however, a strong built-in bias. Prior to the period covered by this study a Commission rule, which is still in effect, had been adopted which prohibited short sales on minus ticks. Selecting members with substantial short sales as the basis for the study, therefore, insured inclusion in the data of a large number of transactions that could not, a priori, fall into the "destabilizing" or "with price change" category.

In contrast, a study covering the weeks ended January 27 and June 16, 1961,[466] indicates that even as measured by the tick system, floor trading tends to be destabilizing in nature (table VI-72). On all 6 days on which the price index increased a greater percentage of floor trader purchases were destabilizing than stabilizing, and on 3 of the 4 days of price decline a greater percentage of their sales were destabilizing than stabilizing. Combined purchases and sales were less than 50 percent stabilizing on 6 of the 10 days.[467]

Of even greater significance are the theoretical shortcomings of this tick approach, treated in detail in the part on specialists, above. Briefly stated, the major fault of this approach is that it equates a "price change" with a "price trend." As a result of this semantic adjustment the term "trend" is given a meaning different than that given it in general usage, and floor traders may be heavy sellers in declining markets or heavy buyers in rising markets and yet be described under the tick test as stabilizing influences, simply by purchasing on the minus ticks appearing from time to time in a rising stock or by selling on the plus ticks occurring in a declining stock.[468] For example, a stock may open at 20 and rise to 24 by the close, never trading below 20, on, say, 200 round lots traded on zero-plus ticks, 150 round lots on zero-minus ticks, 90 round lots on plus ticks, and 60 round lots on minus ticks, for a total day's trading of 500 round lots or 50,000 shares. According to the Exchange's tick test, if floor traders purchased 100 shares on each minus tick and sold no shares whatever during the day, their trading would be deemed to be 100 percent directly stabilizing, despite the fact that they were heavy purchasers of a stock experiencing a sharp price rise.[469] For these reasons it is clear that net balance studies should provide the basic measure of the stabilizing or destabilizing nature of floor trading, and these studies consistently show that floor trading accentuates price movements.

On occasion the Exchange has argued that even if floor traders did accentuate price movements, this would not necessarily be undesirable. Thus it was stated in the Exchange Report:

> Nowhere in the Trading and Exchange Division's report is attention directed toward the interests of the public seller. *Even if the floor trader did customarily stimulate public buying interest, and did bring about unwarranted price advances, this should at least mean that some public sellers had been able to dispose of their stock either sooner, or at better prices, than would otherwise have been possible.* [Emphasis added.]

This argument adds nothing to the defense of floor trading, because it goes too far. It is desirable to have, in any auction market, sufficient buyers and sellers to maintain a liquid and continuous market. It is also desirable to have public buying and selling supplemented, to the extent necessary to provide liquidity and continuity, by that of a

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[466] Of the three 1-week periods studied, the week of greatest market rise (ended Jan. 27) and the week of greatest market decline (ended June 16) were selected for tick analysis.

[467] See testimony of E. H. Stern in subsec. 3.b(2), above. Also, compare the vastly higher stabilization rates of specialists in pt. D, above.

[468] It should be noted that in addition to ticks created by trading in which the specialist does not intervene as principal (a form of trading that best reflects the "mood" of investors), many ticks are created by the specialist trading on his spread—a form of movement that does not reflect the public's evaluation of price (or trend) so much as a time lapse between "matchable" investor buy and sell orders.

[469] In an analysis of actual price trends over the course of a day it was found that in most cases there were a large number of ticks against the trend. See pt. D.6.e(2).

specialist, who functions as a matter of obligation and under specific regulation. It seems sophistic to go beyond this, however, and argue that any purchases in a rising market—even in a market whose pace may have been accentuated by transactions of that purchaser—make a positive contribution by giving sellers the opportunity to sell at higher prices.[470] The argument that sellers benefit from rising markets (or that buyers benefit from declining markets) could be made as to many types of transactions now prohibited as deleterious: permitting such transactions might enable someone on the other side to buy or sell at a better price than he would otherwise obtain. If floor trading is destabilizing or otherwise deleterious, this kind of benefit to specific members of the public who may sell at higher prices or buy at lower prices is no more pertinent than it would be as a justification of pools or manipulations. The point is even broader: Whenever a market lacks continuity or stability for any reason, whenever a transaction is effected in error, or whenever a broker obtains less than an optimum result for his customer—in short, whenever the mechanisms of the market fail to operate at their normal best—a buyer or seller on the other side may benefit; yet this incidental benefit obviously is not considered by the Exchange as a reason for tolerating anything less than the best possible market mechanisms and standards.

5. FLOOR TRADERS AS QUASI-SPECIALISTS

There is a unique species of floor trading that does not seem to fit, in some respects, in the traditional patterns of accentuating price movements, following rather than providing activity or liquidity, and retreating from or accentuating rather than countering stress situations. This trading is concentrated in a few floor traders who voluntarily act from time to time in a quasi-specialist manner by taking or supplying large blocks of stock. In some cases one or another of these floor traders, who must be sufficiently capitalized to take or supply large blocks, will be approached by a floor broker with a sizable buy or sell order. The reasons for seeking out a floor trader in such situations were outlined in the testimony of an independent floor broker who handles large orders for several member firms. He noted that this practice was a secondary procedure rather than a regular procedure, which he turns to "* * * if I can't work it out otherwise." The prime factor in determining whether the order can be worked out otherwise is the willingness of the specialist in the stock to make a sizable bid.

A. * * * You are very much aware of the fact that the large [specialist] firms, the ones I have mentioned, are large, are the ones that have good financial situations and they can handle it.

A lot of the other specialists obviously haven't, aren't in the same position financially and they can't handle it. They make a regular market as they are supposed to; they make good ones, but when it comes to size, financially they are not able to.

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[470] Indeed this argument is inconsistent with and—if valid—would require the elimination of specialist market functions. In performing his function the specialist will often deprive a willing seller or buyer of a "bargain" transaction. Appropriately, the Exchange does not consider this a valid reason to prohibit specialist participation in the market. The Exchange, in short, considers a continuous market far more desirable than one that provides opportunities to individual buyers or sellers to snap up bargain transactions. See pt. D, above.

Q. When you have the specialist willing to make a sizable bid * * * does the necessity to call on the trader then pass out of the picture?

A. Yes.

Q. So in essence, the trader in these cases serves what one might call an auxiliary specialist role in special situations?

A. Yes.

This floor broker noted another condition that has to prevail before he would solicit floor trader assistance:

> First of all, the stock has got to be a stock that is an active stock. Quite obviously, when I ask traders to help me out, I want them to make some money out of it.

On other occasions the assistance of the floor trader will be solicited by the specialist in the stock involved. Most of the specialists testified that participation in cleaning up large blocks is one of the specialist's obligations, but that on occasion floor trader assistance is necessary. Ordinarily the floor trader will participate only in the more active stocks, purchasing large blocks at a discount and then feeding the stock back into the market over a period of time. Usually a block purchase is followed by a flurry of buying, during which the floor trader may dispose of part of the block. Thus, one of the most prominent floor traders testified:

> That really means after the block is purchased, approximately three-quarters of a point below the market, let's say, there is a flurry of activity, brokers run after the cleanup and try to buy.
>
> * * * * * * *
>
> When it [the block] comes on the tape, it could be interpreted as a cleanup, as the end of a large selling order, and individuals who might tend to favor that stock anyhow, will then feel, I want to buy it, it looks like the worst of the selling is over, or something like that. They will come in and buy.

One specialist testified that he tried to avoid calling on floor traders because of this trading pattern following such transactions:

Q. You said you usually don't ask the assistance of traders.

A. We usually don't need them.

Q. Is it because you feel if they can make a profit you can make a profit?

A. No, it is—here is what I usually do and why we don't usually take much stock. I feel usually that if there is an order around that the seller is going to sell it and sell it better than if I make the bid for it—he will sell it at a better price than we make the bid for it.

So I don't see any reason to call in traders for often it causes unwarranted activity in a stock and I would just as soon avoid that.

Unquestionably the participation of these few well-capitalized floor traders in block transactions relieves somewhat the financial burden of the specialist. But if, as appears to be the case, the major need for floor trader participation stems from specialists' capital problems, a more direct approach to the situation is called for, such as increasing specialist capital requirements. In any event, to the extent that the floor trader functions as a quasi-specialist in such cases, he should be required to perform subject to rules similar to those governing specialist trading.

6. REGULATION OF FLOOR TRADING

One of the last amendments made by the 73d Congress to H.R. 8720—the bill that was to become the Securities Exchange Act of 1934—was an amendment deleting a provision prohibiting floor trading. Prior to amendment the bill contained the following mandatory provision:

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

Shortly before floor debate on the bill, however, a committee amendment substituted a discretionary power to abolish or regulate floor trading:

The Commission shall prescribe such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors (1) *to regulate or prevent* floor trading by members * * * (etc.). [Emphasis added.]

The reasons for this amendment were stated by Congressman Lea on the floor:

When we came to the question of the broker and the dealer, a good deal of controversy was involved as to what control should be established; whether or not these positions should be separated; whether or not we would permit a man to act in the capacity of both broker and dealer, whether or not we should permit floor trading or permit specialists to be on the floor; and other problems.

In attempting to deal with these questions I am candid to admit that the committee proposed to confer a large regulatory power on the regulatory Commission.

There were two reasons for this: the first was that we recognized we are not experts and tried to act with a caution becoming our inexperience. Where in doubt as to what should be done, we thought it better to resolve the doubt in favor of maintaining the present business practices than to establish some fixed rule that might prove unfortunate. In the second place, where we gave the regulatory Commission the power, it would be a flexible power. If the Commission finds a mistake has been made, it can readily change its rules to more favorable ones and thus accomplish the purposes of Congress.[471]

The committee amendment became section 11(a) of the act, and in section 11(c) Congress directed the Commission "to make a study of the feasibility and advisability of the complete segregation of the functions of dealer and broker, and to report the results of its study and its recommendations to the Congress on or before January 3, 1936." This report ("Segregation Report") is discussed below. Although the Commission has promulgated no floor trading regulations under the power granted by section 11(a), it has on occasion encouraged the adoption of certain rules by the various exchanges.

a. The "excessive trading" rule

Prior to the completion of the Segregation Report, the Commission requested every national securities exchange to adopt 16 rules formulated by the Commission. These rules dealt with trading activities in joint accounts, specialist trading, and various other aspects of the exchange mechanism. One rule, the first, was applicable to floor trading generally, although it was not limited in application to floor trading. Known as the "excessive trading" rule it provided that "No member * * * shall effect on the exchange purchases or sales for any account in which such member * * * is directly or indirectly interested, which purchases or sales are excessive in view of the financial resources of such member * * * or in view of the market for such security." This rule, in essentially the same terms, is now rule 3 of the American Stock Exchange and rule 435(1) of the New York Stock Exchange.

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[471] 78 Congressional Record 7862 (1934).

Although the Segregation Report noted that the competitive advantage of members trading on the floor had been "in some measure diminished" by this rule,[472] the 1945 Report of the Division of Trading and Exchanges, made public by the Commission, said of this and of other rules subsequently adopted by the exchanges, that "* * * [a] review of the exchanges' enforcement of these rules over the past 10 years demonstrates that neither these nor any similar rules administered by the exchanges serve to restrain floor trading in the slightest measurable degree." [473]

The Segregation Report recommended that the following steps be taken with respect to floor trading:

> The complete suppression of floor trading does not, for the time being, appear to be demanded. But the immediate aim should be the restriction of floor trading as a whole in stocks. The suggested means for the accomplishment of this end are:
>
> (1) The requirement that commitments by all persons trading on the floor for their own accounts should be "fully margined" at all times. Such a requirement, by eliminating the "shoestring" trader and by discouraging excessive trading, would serve to reduce floor trading, particularly of the unduly speculative type.
>
> (2) Functional segregation of all members on the floor of the exchange, with the exception of the specialist in stocks in which he specializes. Under such a requirement floor traders could not act as brokers, and floor brokers and commission brokers could not, while on the floor, initiate orders for their own account or the account of their firms. From this requirement some recasting of the existing alignment among commission brokers, floor brokers, and floor traders is to be expected, with some shift in the direction of the floor trader. But, especially if some control over that movement should be exercised, a substantial reduction in the aggregate of floor trading would take place.
>
> This requirement, apart from its effect upon floor trading as a whole, possesses the virtue implicit in segregation; that is, insistence upon a singleness of allegiance on the part of the broker on the floor. As such, it has the added significance of tending to insure the better performance of the broker's fiduciary obligations to his client.[474]

The segregation recommendation of the report was not carried out: "Instead, the Commission adopted a policy of watchfulness, investigating market breaks and rises in order to determine, among other things, what role floor trading played in the movement." [475] The NYSE did adopt a rule, at the Commission's request, relating to trading on margin.

b. The "daylight margin" rule

The so-called "daylight margin" or "daylight trading" rule, adopted in 1937, required each member to have on deposit each night an amount equal to the margin required to carry the maximum position assumed during the day, even if such position was quickly abandoned. Studies conducted by the Commission in 1944 revealed that floor trading volume as a percentage of twice total volume on the NYSE dropped from 6.8 percent in 1936 to 4.1 percent, in 1942, and recovered to 5.3 percent in 1944. The 1945 report, based on these studies, therefore concluded that "* * * the 'daylight trading' rule's restrictive effects on floor trading volume were not particularly great." [476] The rule was rescinded by the exchange as of September 21, 1953.

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[472] Segregation Report at p. 16.
[473] 1945 report at p. 43.
[474] Segregation Report at p. 110.
[475] 1945 report at p. 4.
[476] Id. at p. 12, footnote 32.

c. The attempt to abolish floor trading

The major portion of the 1945 report by the Division of Trading and Exchanges was addressed to the issues of the floor trader and (1) his competitive advantage, (2) his conflict of interest if a broker, and (3) his effect on price movements. The findings of the report were vigorously stated on each issue:

(1) Floor traders "beyond a doubt" enjoy "formidable" trading advantages over the general public.[477]

(2) "Floor trading cannot fail to divert and distract brokers from their duties to the public. Nor does the floor trader help in the filling of public orders. By and large, floor traders compete with the public in their buying and selling. When public demand exceeds public supply at a given price, the floor trader is likely to step in to increase the disequalibrium; he is more likely to augment the demand and compete with the public for the available supply than to do the opposite." [478]

(3) "Floor trading engenders excessive trading and excessive fluctuations in price. The floor trader typically 'trades with the trend.' If there are times when he tends to reestablish equilibrium in prices, such trading is very likely the aftermath of a course of action which threw prices off balance in the first instance. Cases other than these may sometimes exist when floor trading acts as a stabilizing influence but, if so, the voluminous data which we have accumulated shows that they are certainly not common, let alone typical." [479]

The report then considered the following possible approaches to the problems: (1) segregation of broker-dealer functions and the registration of floor traders, (2) restraint of floor trading by either flexible or inflexible rules, and (3) prohibition of floor trading.

The first alternative was dismissed as merely postponing "the solution of the most pressing question of all * * * the effects of floor trading on market prices." [480] Control of floor trading by flexible rules was also rejected, on the ground that enforcement of existing rules had proved ineffective:

For all practical purposes * * * [this method] is already in effect and has been for many years. For a long time, the exchanges have had adequate power under existing rules to restrain undesirable floor trading. As we have already noted, rule 613 of the board of governors of the New York Stock Exchange prohibits transactions by a member which are excessive "in view of the financial resources of such member" or "in view of the market for such security." Section 4 of article XIV of the New York Stock Echange constitution provides for the suspension or expulsion of a member guilty of making any purchases or sales for the purpose of upsetting the equilibrium of the market and bringing about a condition of demoralization. Section 10 of the same article provides for the punishment of a member guilty of any act which may be detrimental to the welfare of the Exchange. Exchange officials always have been in a position to enforce these rules since they always have exercised a degree of surveillance over their respective floors and could not fail to have observed the incursions of floor traders. But a review of the exchanges' enforcement of these rules over the past 10 years demonstrates that neither these nor any similar rules administered by the exchanges serve to restrain floor trading in the slightest measurable degree.[481]

Control of floor trading by inflexible rules was also rejected on the ground that avoidance by floor traders would be easy:

* * * The Commission's one effort in this direction—the short-selling rule—has met with limited success at best, insofar as floor traders are concerned, for it has not adequately prevented heavy short selling from this source at critical junctures in the market. It did not prevent floor traders on the New York Stock

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[477] Id. at p. 42.
[478] Ibid.
[479] Ibid.
[480] Id. at pp. 42–43.
[481] Id. at p. 43.

Exchange, for example, from selling 15,100 shares short in the week ended February 15, 1941, as the Dow Jones Industrial Average dropped 6 points, nor from selling 2,600 shares short in U.S. Steel common stock, on December 8, 1941, as the stock fell 1⅝ points. The fact is that the floor trader's proximity to the marketplace affords him frequent enough opportunities so that he can legally avoid much of the impact of restraints of this kind, however restrictive they may appear to be.[482]

With these alternatives eliminated, prohibition of floor trading was recommended as the only effective remedy of floor-trading abuses, and a rule was proposed—designated X-11A1-1—to effect this abolition. The advantages of such prohibition were noted as (1) removing the competitive cost advantage of on-floor trading, (2) equalizing all traders' access to market developments, (3) elimination of the trader's privilege of representing himself in transactions, thus placing him on a par with off-floor traders, and (4) circumscription of the opportunity for concerted action (intentional or otherwise) among floor traders.[483]

Release of the 1945 report in January set off an intensive series of conferences and correspondence between the Commission, the two New York exchanges and others interested in the problem. It was at this time that the NYSE submitted the Cole-Hoisington report, referred to above, to the Commission. The conclusions and recommendations of that report were as follows:

It is therefore our conclusion that if floor trading is to be judged solely on the basis of the manner in which it has affected liquidity, continuity and orderliness in trading, then the record justifies a continuation of this practice. From an objective point of view, the evidence does not seem to us to be heavily one-sided in respect to price stability, although insofar as price continuity, and, particularly, liquidity are concerned, it seems obvious to us that floor trading makes a definite and unmistakable contribution.

A certain proportion of the traders' activities, as discussed above, tends to be directly nonstabilizing and therefore presumably initiates or accentuates price trends; the indirect effect on price stability of a large number of their transactions has yet to be satisfactorily measured, and, in certain specific instances presented in the Trading and Exchange Division's report of January 15, 1945, some of the effects of floor trader activity do not appear to have been in the public interest. It would therefore seem that every effort should be made to explore the possibilities of modifying floor trading practices as they now exist to the end that specific deleterious effects may be eliminated and, on an overall basis, the net favorable influence of floor trading may represent a larger proportion of all floor trading than currently seems to be the case.

As a preliminary to any discussions of the general directions in which such modifications in floor trading practices might be made, the question arises as to why floor traders as a class, or floor trading as a special type of activity, should be subject to specific regulations or restrictions to which the public generally, and all other trading, are not subject. The logical reason for restrictions or regulations applicable to floor traders is that these individuals possess certain prerogatives and enjoy certain advantages not held by the public at large. If a continuation of these prerogatives and advantages is to be justified, then it seems to us that such continuation must rest upon these premises:

1. The salutory effects of floor trading in terms of public interest are demonstrably greater than their cost; and
2. Floor trading activity could not be conducted at all if it did not enjoy these advantages.

The opinion has been previously expressed that the effects of floor trading as it is now conducted are on the whole salutory, but that the margin is rather moderate. It therefore seems proper to examine the nature and extent of the special advantages enjoyed by floor traders, and to attempt to assess their cost in terms

[482] Id. at p. 44.
[483] Ibid.

of public interest. The advantages enjoyed by floor traders in relation to the general public can be grouped under two headings:

1. Advantages of time and place;
2. Advantages in dollar costs.

Technically speaking, it would be impossible for floor trading to take place unless the floor trader were on the floor; therefore, it is impractical to try to restrict or modify the "place" advantage if floor trading is to continue. However, the floor trader could still remain on the floor, and yet forego certain time priorities which he now possesses, should any restrictions in this direction appear warranted. It would of course also be possible to impose certain modifications on his present cost advantages, such as are now imposed on members who trade off the floor, should it be determined that it was just and proper that such modifications of present operating costs be imposed.[484]

The report went on to suggest that rules regarding three specific trading procedures might be desirable to deal with "certain of the problems which exist." These problem areas, described as "matching," "precedence," and "stopping stock," eventually became the subject of Exchange rules, discussed below. By way of general recommendations, the report stated that every effort should be made to encourage floor trading that is stabilizing in nature, and similarly that every effort should be made to discourage floor trading of a destabilizing nature.

Conferences held between Commission representatives and officers of the NYSE, including a public conference, failed to produce agreement. On June 28, 1945, the board of governors of the NYSE approved new rules to govern floor trading, but held in abeyance, at the Commission's request, the formal adoption of these rules. In a letter to Ganson Purcell, Chairman of the Commission, Emil Schram, president of the Exchange, stated:

The Exchange will observe closely, as we feel sure the Securities and Exchange Commission will, the operation of the new rules to the end that their usefulness and effectiveness may be determined on the basis of a fair trial. A period of 6 months should be sufficient for such a test; I earnestly request on behalf of the New York Stock Exchange that, meanwhile, the Commission withhold action with respect to the proposals which its Trading and Exchange Division has made on the subject of floor trading.

This request, repeated again on August 2, was initially rejected by the Commission. On August 8, 1945, the Commission tentatively voted to abolish floor trading, but after continued deliberation determined to grant the Exchange's request. The reasons for this decision are set forth in the press release of August 28, 1945, which announced the Commission's decision as follows:

We have reviewed the information available to us from the sources just described, including the discussions subsequent to the conference of May 16, and are satisfied that floor trading as now conducted gives an undue advantage to floor traders over the public; that frequently it accelerates market movements and accentuates fluctuations in particular securities or groups of securities; and that more often than not it detracts from the stability of the market. We are convinced that it is essential to make effective as soon as practicable regulation that will minimize or eliminate those influences of floor trading which impair the stability of the market.

The New York Stock Exchange has urged us, in lieu of abolishing floor trading at this time, to afford it the opportunity to apply certain regulations which it believes will minimize the undesirable features of floor trading, yet preserve certain asserted benefits. The New York Curb Exchange has expressed its desire to put similar rules into effect.

The proposed rules would generally require floor traders who have acquired a position by purchasing stock on a price rise or selling on a decline to hold

[484] Exchange Report at pp. 41–42.

that position until the beginning of the second succeeding trading day; they would prohibit members on the floor from availing themselves of the privilege of "stopping" stock unless the stock is "stopped" against the order of another member; and they would terminate the existing privilege of members on the floor, while acquiring a position in a security, of claiming priority over a public order at the same price either by the toss of a coin or by reason of the greater size of his order.

We are not convinced that it is impossible to devise measures more effective than these to minimize the undesirable effects of floor trading and permit the realization of whatever contribution it might make to market stability.[485] Nevertheless, we believe that a prohibition of the kind proposed by our staff should not be imposed until the Exchanges, which now have recognized that floor trading gives rise to problems that require regulation more drastic than any heretofore attempted, are given a reasonable opportunity to demonstrate whether it is feasible for them to eliminate the abuses that have been associated with floor trading in the past. We propose to give them that opportunity.

* * * * * * *

If at any time it becomes evident to us that the Exchanges' rules, either in the form now proposed, or as they may be modified, are inadequate for the effective regulation of floor trading, we shall reconsider the recommendations of our staff, or any appropriate modification of those recommendations, and take such action as, in our opinion, will provide an adequate solution of the problems created by floor trading.[486]

Almost immediately upon the release of the Commission's decision, three new rules—apparently those earlier approved by the board of governors—were adopted by the Exchange setting forth restrictions on floor traders.

d. Rule 108: prohibiting floor trader parity or precedence with off-floor orders

The first rule, designed to moderate one element of the floor traders' on-floor advantages, dealt with the problems of "matching" and "precedence" that were discussed by the Exchange Report. These terms refer to techniques employed to determine which of two or more parties is entitled to the first transaction when such parties have placed bids (or offers) in a security at the same price. Such "deadlocks" are broken by the application of one or more of three principles, referred to as "priority," "precedence," and "parity."[487]

These principles allow the floor trader to exercise his on-floor advantages by being the first to bid, or by adjusting the size of his bid or offer to gain precedence over or parity with other parties at the post. The rule adopted by the Exchange, now rule 108, therefore provided that a member acquiring or increasing a position on the floor was not entitled to parity with a bid or offer originating off the floor. Subsequently the Exchange extended this prohibition to precedence, first

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[485] Commission minutes of Aug. 22, 1946, at which time the decision to permit a trial period for the Exchange rules was made, state the Commission's feelings on this point more strongly:

"The Commission, having given due consideration to various methods proposed for dealing with these problems, including the methods embodied in the rules proposed by the Exchange, expressed itself as doubting that the rules proposed by the Exchange would meet the more serious problems arising out of floor trading, especially the tendency of such trading to exaggerate market movements and aggravate fluctuations. The Commission considered, however, that each of the several alternative proposals, short of complete abolition of floor trading, which had been proposed and discussed with officials of the Exchange, involves some possible difficulties of administration and requires further study in order to determine whether any of them is capable of effective administration in a way that would minimize the undesirable effects of floor trading and at the same time retain whatever contribution it might make toward preserving a stable and orderly market and towards providing liquidity when it is needed instead of mere enhanced volume of trading which from time to time in the past has aggravated fluctuations."

[486] Securities Exchange Act of 1934, release No. 3727, Thursday, Aug. 28, 1945.

[487] The operation of these rules is explained in pt. B.1.a, above. Generally, persons first in time have "priority," while the largest bid (or offer) receives "precedence." "Parity" is broken by the flipping of a coin.

by interpretation and later by amendment. By further interpretation under the present rule, a floor trader bidding for "long" stock on a plus or zero-plus tick may not retain priority over off-floor orders nor may he have parity with or precedence over such orders. Also by interpretation, a floor trader bidding for "long" stock on a minus or zero-minus tick is entitled to priority, but not parity or precedence, over off-floor orders. Finally, floor trader offers designed to create or extend short positions may retain priority over off-floor orders, but may not claim precedence or parity.

This rule and its interpretations moderate the floor traders' trading advantages only slightly. It permits priority to floor trader offers to sell "short" stock. It places no restrictions on bids intended to cover short positions. It permits priority to floor traders making bids on minus or zero-minus ticks. Finally, and most important, it in no way prevents floor traders from outbidding or underoffering off-floor traders.[488]

e. Rule 109: prohibiting the "stopping" of stock on floor trades

The second rule, now rule 109, prohibits floor traders from accepting the privilege of "stopping" stock. In July of 1946 the Division of Trading and Exchanges said of this rule:

> It does not appear from any of our studies that the privilege of "stopping stock" has been of any material aid to floor traders. Accordingly, denying them the privilege appears to be of no particular consequence in solving the problems which floor trading creates.

f. Rule 110: the major floor trading rule

Since the adoption of these rules in August of 1945, rules 108 and 109 have remained relatively unchanged. Rule 110, however, by far the most important of the floor trading rules, has undergone frequent and often substantial change.

Originally adopted as rule 374, it provided that (1) if a member acquired or increased a long position by purchasing stock on the floor on a plus or zero-plus tick, he could not sell any of that issue until the second succeeding trading day unless he sold at a loss, and (2) if a member sold "long" stock on the floor on a minus or zero-minus tick, he could not replace the stock until the second succeeding trading day. Exceptions to the rule were provided for transactions to cover short sales and certain other transactions.

In February of 1947 the rule was amended and this "lock in" device was abandoned. In its stead the Exchange provided simply that floor traders could not purchase stock on a plus tick, again subject to certain exceptions including purchases to cover short positions. Under this rule the Exchange developed a policy that limited floor traders' purchases on zero-plus ticks to 300 shares or 30 percent of the amount offered, whichever was greater; when these limits were reached no further floor trader purchases on zero-plus ticks could be effected in that stock for a period of 15 minutes. This policy excepted purchases to cover short positions and purchases of stocks which floor traders

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[488] It should also be noted that the rule does not apply to limit orders placed by floor traders with specialists. Floor traders may therefore retain all rights to priority, precedence, etc., simply by paying floor brokerage to the specialist (i.e., by placing their order with the specialist). Although the floor trader forfeits a certain degree of his on-floor advantage by designating the specialist as his agent, he retains a significant advantage by virtue of the fact that he is still able to observe the trading as it takes place (rather than on the tape), and is able to place or cancel his order in a matter of seconds.

intended to hold for long-term investment. Through subsequent amendments of this rule, this control of "frozen stock"—whereby a stock is declared temporarily unavailable for certain types of floor trader purchases after a certain amount of floor trader purchases have been effected on plus ticks or zero-plus ticks—has become the major, almost exclusive, system of floor trader control utilized by the Exchange.

In July of 1947, the policy exemption granted to floor trader purchases of stock for investment purposes was rescinded. In October of 1947 the policy was further revised to allow floor traders to buy more than the limited amount of any stock if the prior approval of a floor governor was obtained, but any stock so purchased could not be sold, unless at a loss, for 2 business days. This revision, in effect, reinstated the "lock in" device, but only with respect to stock purchased with the prior approval of a floor governor.

Two changes were effected in the policy in April of 1948. The limitation on zero-plus tick purchases was raised from 300 shares or 30 percent of the offered amount to 300 shares or 50 percent, whichever was greater, and this limit was made applicable to purchases to cover short positions as well as purchases of "long" stock.

The rule was amended in December of 1948 so as to prohibit only plus tick purchases at or above the prior day's closing price of a stock. Purchases to cover short positions were not subject to the rule. Plus tick purchases below the prior day's close were limited, by exchange policy, to 300 shares or 50 percent of the offered amount, whichever was greater. Purchases of the limited amounts would then inaugurate a 15-minute freeze during which floor traders could not effect plus or zero-plus tick purchases. At this same time, all policy restrictions on zero-plus tick purchases below the prior close were abandoned.

Liberalization of the rule continued with an amendment adopted in August of 1949. The prohibition against plus tick purchases at or above the prior close was eliminated in favor of (1) a 300 share or 50-percent limitation on plus tick purchases above the prior close (which could be taken only if the offer quotation remained unchanged), and (2) a prohibition against plus tick purchases above the prior close if floor traders had twice purchased on plus ticks on their own bids within 15 minutes. The amended rule also allowed zero-plus tick purchases above the prior close of up to 500 shares or 75 percent of the offered amount, but this amount could not be taken if it would cause the offer quotation to change. Exempt from this rule were all purchases to cover short positions and purchases made, with the prior approval of a floor governor, with intent to hold the stock for at least 2 business days.

It is perhaps significant that the only two periods found by the Division of Trading and Exchanges in which floor traders tended to trade against rising price movements were the periods of July 1945 to February 1946, and August 1947 through July 1948.[489] The findings for the 1945–46 period are apparently accounted for by the "lock in" device then in effect. The latter period is marked by several rule and policy changes, but the major controls in effect through the period in-

[489] See app. VI–H.4.g. A breakdown of floor trader balances into daily figures for the August 1947–July 1948 period also indicated that floor traders were trading against rising price movements. See app. VI–H.4.h.

cluded an absolute prohibition against plus tick purchases, limitations on zero-plus tick purchases, and the "lock in" device on stock purchased with the prior approval of a floor governor. Since the 1949 amendment, which eliminated the absolute prohibition on plus tick purchases, and liberalized restrictions on zero-plus tick purchases, floor traders have tended to trade with rising price trends.[490]

In 1953, all of the above restrictions on floor trading were abandoned as the exchange rescinded rule 374, the predecessor of the present rule 110. Control of floor trading was then left largely to a rule adopted in 1949 which provided simply that members purchasing "long" stock—

(1) shall not congregate in a particular stock, and individually or as a group, dominate the market in that stock; (2) shall not effect such purchases except in a reasonable and orderly manner and they shall not be conspicuous in the general market or in the market in a particular stock.

This very general rule, discussed below, has remained in effect unchanged, and today constitutes the formal statement of rule 110. Willard K. Vanderbeck, vice president in charge of the Floor Department, testified that these general prohibitions must be interpreted and applied in a flexible or "commonsense" fashion. He defined "congregation" as the "assembling of a number of floor traders" at a post, "dominating the market" as a series of floor trader purchases or sales that effectively prevent others from trading until the floor traders are prepared to take the other side of the market, and "trading in a conspicuous manner" as effecting transactions in other than "an orderly way." The occasions on which Vanderbeck has deemed it advisable to direct a "cautionary word" to one or another floor trader with respect to these rather vague prohibitions have been, he testified, relatively rare.

Although these general prohibitions constitute the formal statement of the rule, the Exchange began in 1955 to revive the concept of "frozen stock" in "clarification" materials supplementing the general rule. It is almost entirely upon these materials, twice amended since 1955, that the Exchange bases its regulation of floor trading. It is clear, without for the moment considering the exact nature of these materials, that they have not prevented floor traders from accentuating price movement and that they have not channeled floor trader liquidity into those securities and trading periods where it is most needed. They have, in short, failed to meet the conditions set forth by the Commission in 1945 under which the Commission declared that it would permit the continuation of floor trading.

Study of the clarification itself reveals the reasons for this failure. The complexity of the material defies brief description,[491] but gen-

[490] The erosion of floor trading controls during the years 1948 and 1949 was apparently due in part to unrest among certain floor members, and to pressure exerted by these members on the governors of the exchange. In June of 1949 these members, headed by an informal "Committee of 17," successfully petitioned for changes in the exchange constitution which, among other things, increased floor member control over floor matters. (See ch. XII.B.) Although none of their demands dealt directly with floor trading rules, a high exchange official ascribed the unrest to the fact that floor members were not making enough money, noted that they blamed this on "too many restrictions" on trading, and stated that these members wanted to remove all restrictions on floor trading.

[491] See app. VI–I for full text of clarification.

erally speaking the clarification provides that a 15-minute "freeze" is initiated if floor traders effect "long" purchases of offered stock on a plus or zero-plus tick above the prior close—

(1) at two different prices within 15 minutes, or

(2) of 500 shares or 50 percent of an offer, whichever is greater (up to a maximum of 7,500 shares), at one price, or

(3) of 500 or more shares of an offer, and the remainder of the offer is purchased by other than floor traders.

The "freeze" that follows such purchases does not prohibit all floor trading in the stock involved, but rather prohibits, subject to certain exemptions, additional purchases on plus or zero-plus ticks. In addition to the above limitations, if a floor trader purchases stock on his own bid on a plus tick, a 15-minute freeze is initiated during which no floor trader may purchase on his own bid on a plus tick or a zero-plus tick at a different price.

Numerous shortcomings of this clarification may be noted. First, the clarification, like the rule itself, places no restrictions whatever on floor trader sales.[492] The significance of this omission is best illustrated by the floor trading in Sperry Rand Corp. described in section 3.a, above. Asked why the Exchange does not restrict floor-trader sales, Vanderbeck testified as follows:

> Well, the whole aspect of floor trading, as worked out with the SEC back in the year 1945, was concentrated on the buy side, because of the fear that the SEC had that floor traders would mark stocks up and dump them on the unsuspecting public and walk away with a bundle of money.
>
> That is why, ever since then, the direction of thought has been toward the buy side. Also, I think that behind the fact that we have not ever thought in terms of their selling, are two things: first, with respect to the sale of long stock; that it certainly should be the democratic right of any citizen or investor, whether he be a floor trader or not, to be able to dispose of stock at a price when he wants to do it. Otherwise, you may be infringing, I think, unduly, upon the rights and privileges of a man who wants to participate in the market.
>
> Secondly, with respect to short selling: he has to keep within the bounds of your short-selling rule, and sell short only at prices which are higher than the last given price.

However, the Commission minutes and press release quoted in section 6.c, above, refer quite clearly to "market movements" or "fluctuations," without regard to their direction. Moreover, the rule originally adopted by the exchange applied the "lock in" device to both purchases on plus or zero-plus ticks and "long" sales on minus or zero-minus ticks.

Vanderbeck's reference to the "democratic right * * * to be able to dispose of stock" is hardly in accord with earlier thinking of the exchange, or indeed with the general concept of regulation of the conduct of members. Thus it seems most anomalous that the specialist, whose admission to the floor is earned by obligations assumed, is restricted in his selling while the floor trader is not.

In any event, the restrictions set forth in the clarification of rule 110 are limited to the purchase side of the market, but even here the restrictions apply in only a limited number of situations. No restrictions whatever, for instance, apply on purchases made at prices below the prior day's closing price, on the theory that any such purchases tend to have a stabilizing effect on the price. Under this view floor

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[492] The Commission's short-selling rule prevents all persons, including floor traders, from selling short on minus or zero-minus ticks.

traders may sell unlimited amounts of a stock experiencing a decline, and then purchase unlimited amounts of the stock as the price recovers. In selling on the decline and buying on the recovery, floor traders may thereby trade with the price trend and accentuate the price movement or fluctuation.

Even as to purchases above the prior close the restrictions are limited in nature. No restrictions, for instance, apply to purchases effected to cover short sales. Also, no restrictions apply to purchases made above the previous close on a minus or zero-minus tick, on the theory that purchases on minus or zero-minus ticks are stabilizing, regardless of the general trend of the stock price. As noted in the discussion of the "tick" measure of stabilization in section 4.c, this permits floor traders to be heavy purchasers on balance in a stock that experiences a price rise, simply by purchasing on the minus or zero-minus ticks that appear from time to time over the day. Even purchase on plus or zero-plus ticks above the prior close are permitted within the 500-share (or 50 percent of the offered amount) limitation.

Although these prohibitions to some extent limit floor trader opportunities to drive a price up, it is equally obvious from net balance studies conducted by the Commission that they have not prevented floor traders from trading with rising price movements. Because they are based on the tick system, they fail to meet directly the question of trend rising, and ignore altogether the problem of directing floor trader liquidity into its most useful channels.

In addition to these fundamental defects in the structure of the rule, the Exchange's administration and enforcement of the rule falls noticeably short of what may be justifiably expected. Effective enforcement of the rule depends in the first instance upon prompt and accurate reporting of floor trades by each member effecting such trades, but several instances of late or inaccurate reporting were found by the Special Study in a spot check.[493] Moreover, even with prompt and accurate reports, it is often impossible to reconstruct the market in sufficient detail to establish clear violations of the floor trading rules. It is virtually impossible, for instance, to prove that a floor trader took more than 50 percent of an offer when no written record of offers in the crowd exists. Finally, although the Exchange expends many man-hours daily reviewing reports received, and thereby detects violations of the rule with some frequency, only one member has been formally disciplined for violation of the rule since January 1, 1957. These matters, treated in more detail in part B of chapter XII, point up the difficult and costly administrative problems created by opening the floor to members for their personal trading purposes.

7. THE AMERICAN STOCK EXCHANGE

Regulation of floor trading on the American Stock Exchange has followed a pattern almost identical to that on the New York Stock Exchange.[494] Until 1959 the rules of the two exchanges were very similar. In June of 1959, however, the Amex adopted a rule that prohibited members from initiating bids on the floor at a price higher than the last sale, limited plus tick purchases to 300 shares or 30 percent of

[493] See ch. XII.B.
[494] For details on the nature and extent of floor trading on Amex, see app. VI–H.

the amount offered (whichever is greater), and limited zero-plus tick purchases to 500 shares or 50 percent of the amount offered (whichever is greater). Such purchases initiate a 15-minute "freeze." In April of 1960 this rule was amended in several respects, the major change being that all restrictions on purchases below the prior close were lifted.[495]

The effect of this rule is difficult to assess. Floor trading data covering the periods in question are unreliable, due to deficiencies in the Amex reporting system.[496] For what it is worth, recent studies based on this data, noted in appendix VI-A.3.h, reveal a sharp drop in floor trading as a percentage of total exchange trading in the 45 stocks in which floor traders were most active over selected 2-week periods. The most recent study, however, was during a period of very high total volume in these stocks which prompted the chairman of the board to issue a notice to floor traders to reduce their purchases until further notice. Total floor trading in recent years, as indicated in appendix H.1, has declined as a percentage of total exchange purchases and sales, but the number of shares traded by floor traders each year has remained relatively constant.

In any event, as noted in the "Staff Report on Organization, Management, and Regulation of Conduct of Members of the American Stock Exchange," floor trading on the Amex still posed serious problems as of January 1962.

8. REGIONAL EXCHANGES

Floor trading on the regional exchanges must be evaluated in a different light than floor trading on the New York exchanges. More than 80 percent of the dollar volume on regional exchanges is in dually traded securities, which are customarily executed against the NYSE or Amex tape. Regional members who floor trade in such securities, therefore, do so without the time or place advantage of NYSE or Amex floor traders and, in addition, cannot influence price movements in the primary market.

On some of the smallest exchanges, however, significant member trading appears to occur in solely listed securities, a finding only recently established by the Division of Trading and Exchanges. Further study of this type of trading is required, however, before meaningful conclusions or recommendations can be formulated.

9. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Of all classes of exchange members on the floor, the floor trader stands alone in having no fiduciary status, no duty to execute transactions, and no market responsibilities or obligations in relation to the operation of the market as a public institution. He is, in short, the only type of member granted access to the floor without being required or expected to participate in the handling of securities transactions. The floor trader's presence on the floor is simply a matter

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[495] Although the specific "tick" restrictions of the Amex rule 110 apply (as on the NYSE) only to purchases, the general provisions prohibiting congregating, dominating, etc., as written apply (unlike the general NYSE provisions) to both purchases and sales.

[496] SEC, "Staff Report on Organization, Management, and Regulation of Conduct of Members of the American Stock Exchange," pp. 42–43 (January 1962.)

of his desire to trade for his own account. That any individual who purchases a seat thereby becomes entitled to do his personal trading on the floor of an exchange without having any special function or undertaking any obligation in relation to the operations of the market raises, in itself, a fundamental question of public policy as to the extent to which a public market may be permitted to maintain this vestigial "private club" aspect, even apart from very serious questions as to the net impact of floor trading on the orderly functioning of the market.

The privilege of access to the floor provides trading advantages of a substantial nature; the commission cost of trading on the floor is appreciably lower than for off-floor trading, trading activity may be observed minutes before it appears on the tape, and bids or offers may be entered or withdrawn in a matter of seconds. In addition, presence on the floor carries with it the benefit of what has been termed a "feel of the market"—a heightened sense of market tenor and trend. In part this "feel of the market" is attributable to the constant exchange of observations among floor members, either with respect to general market conditions or, more specifically, to such factors as the volume and type of orders or cancellations coming to the floor. More subtle factors also add significantly to the floor member's awareness; familiarity with the trading techniques of specialists or floor brokers, for instance, in many case combined with knowledge that a large block of stock is being accumulated or distributed, is a factor that facilitates the trading activities of the floor trader.

Section 11 of the Exchange Act vests the Commission with broad powers to regulate or prevent principal transactions by exchange members on the floor of an exchange. It is clear that one of the major legislative concerns underlying this broad grant of power was that benefits derived by the public from member trading on exchange floors were not in balance with the advantages derived by the preferred groups.[497] Viewed in this light the broad scope of the section is thoroughly consistent with one of the dominant themes running through the series of statutes administered by the Commission—denial of special advantage in the public interest and for the protection of investors. The equality of access to full and accurate corporate information sought to be guaranteed by these statutes is complemented by the specific provisions of the Exchange Act which seek to provide open and honest markets in which investment decisions may be acted upon. In its administration of the statutes the Commission has shown that the guiding concepts are dynamic and not static. If anything, there has been an increasing emphasis of fairness and equality. A recent case, for example, has made it clear for the first time that a broker in possession of important nonpublic corporate information is under severe limitations as to the use of his knowledge in the marketplace.[498] In a disciplinary proceeding within the last few months the NYSE found it contrary to acceptable business practice for a broker

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[497] Early drafts of sec. 11 would have turned exchanges into pure auction markets, banning all except brokers from access to the floor. See "Hearings on Stock Exchange Regulation Before the House Committee on Interstate and Foreign Commerce," 73d Cong., 2d sess., pp. 116–117 (1934).

[498] *In the Matter of Cady, Roberts & Company*, Securities Exchange Act release No. 6668 (Nov. 8, 1961). This case held a broker-dealer in violation of secs. 17(a) of the Securities Act and 10(b) of the Securities Exchange Act, for selling stock for his own and customer discretionary accounts, upon learning—one-half to three-quarters of an hour before the public—that the issuer had cut its dividend. (See ch. III.F.)

to trade on similar information. Although the content and quality of floor information and the "leadtime" of a trader on an exchange floor may be different from the information and advantages noted in these cases, the principle remains the same. Only some strong demonstrable, countervailing public benefit can justify the special advantages enjoyed by the floor trader. Absent such a balancing consideration, floor trading is an anomaly—a special advantage in a public market which can be enjoyed by purchasing access to the floor of an exchange.

The anomaly becomes more disturbing in light of the fact that floor traders tend to have a destabilizing influence on prices. On at least 15 separate occasions since 1934, studies conducted by the Commission and the Division of Trading and Exchanges, confirmed by studies made by the Special Study, have shown that floor traders are generally buyers in rising markets and sellers in declining markets, with respect to both the market as a whole and to individual stocks. Their trading, as a result, is inimical to the orderly functioning of the market, tending to accentuate rather than to stabilize price movements.

Apart from its effect on price stability, floor trading has been defended on the grounds that added market liquidity and continuity are its beneficial byproducts. There is no doubt that floor trading, as does any kind of trading, adds liquidity to the market. The same may be said, however, of transactions effected in error, pool operations, wash sales, or other transactions generally acknowledged to be undesirable elements of a sound market. That is to say, added liquidity standing alone cannot justify trading that in other respects is deleterious. In addition, floor trading is heavily concentrated in the active stocks where added liquidity is needed least. Finally, to the extent that floor traders improve liquidity; they may on occasion fulfill a specialist's function but they remain totally free of the specialist's responsibilities.

Much the same considerations deprive the continuity defense of floor trading of much of its weight. Because floor traders concentrate their trading in the active stocks, the continuity they add is limited for the most part to the stocks that suffer least from lack of continuity. Such continuity, moreover, is obtained at the expense of permitting a type of floor activity that has an adverse impact on price stability. Again, in adding continuity they perform a specialist function without incurring specialist obligations. In at least one respect, the continuity defense of floor trading is definitely less persuasive than the liquidity defense; whereas floor trading may never be said to detract from liquidity, there are occasions on which floor trader participation in the market has a negative impact on price continuity. Due to the tendency of floor traders to trade with price trends, their participation in auction proceedings often adds to the imbalance of buyers and sellers and thereby encourages more rapid and sizable price changes.

Floor trader contributions to market liquidity and continuity, in short, are not of sufficient magnitude or importance to warrant retention of this vestigial "private club" aspect of the exchanges. If the exchanges feel problems of market liquidity or continuity exist, solutions should be sought which provide greater assurance of these

qualities in those stocks and during those periods when they are most needed, rather than fortuitously or when and where least needed. Improving specialist capital requirements, for instance, or assigning floor traders responsibilities as "auxiliary specialists," would constitute more direct approaches to these problems, and the latter approach would enjoy the further merit of tempering special market advantages with definite market obligations.

Attempts to retain or expand the benefits of floor trading and at the same time curtail its undesirable characteristics have been nominally successful at best. In 1945 the Commission proposed the abolition of floor trading, but withheld action in light of repeated assurances that the exchanges would develop effective self-regulation of this activity. Despite the great variety and complexity of exchange rules experimented with to date, however, floor traders still retain their significant private trading advantages in a public market, continue to concentrate their activities in the more active stocks, and continue to accentuate price movements.

Self-regulation in this particular area has not only been generally ineffective, but in a most important respect it has been misdirected. The exchanges' regulation of other categories of members on the floor is generally to assure adherence to obligations designed to benefit the market. In the case of the floor trader, on the other hand, the exchanges have established elaborate rules and complicated enforcement mechanisms, the sole purpose of which is to restrict activities that are primarily of private benefit. The public interest cannot ignore this administrative burden required to police private investing practices on the floor.

The Special Study concludes and recommends:

1. Floor trading in its present form is a vestige of the former "private club" character of stock exchanges and should not be permitted to continue on the NYSE or Amex. The Special Study therefore recommends that, except as permitted under any program adopted pursuant to the following paragraph, (a) floor trading on the part of members and member firms of the NYSE and Amex whose income from floor trading in each of the years 1961 and 1962 amounted to less than 25 percent of their total gross income from all activities in the securities business (including floor trading) should be prohibited by a Commission rule under section 11(a) on and after January 2, 1964; and (b) floor trading on the part of members and member firms whose income from floor trading in either of the years 1961 or 1962 exceeded 25 percent of their total gross income from all activities in the securities business (including floor trading) should be prohibited by such rule on and after January 2, 1965. There should be excepted from these prohibitions, however, (i) transactions by specialists or odd lot dealers in stocks in which they are registered, if reasonably necessary in terms of the functions served by such members; and (ii) transactions effected to offset transactions made in error.

2. It has been noted, in part D, above, that the financial capacity of some specialists or of the specialist system generally is in need of strengthening, and it is possible that some present floor traders could perform a highly useful function as "auxiliary specialists."

The NYSE and Amex should undertake studies, in conjunction with the Commission, as to the feasibility and desirability of a program under which present floor traders or other members of such exchanges might register with the exchanges as "auxiliary specialists," with permission to trade on the floor in any security on condition that (a) the auxiliary specialist meets special capital requirements equivalent to those applicable to a specialist registered in (say) 10 average-priced stocks; (b) all transactions of such auxiliary specialist on the floor are either undertaken at the unsolicited request of a specialist and, in accordance with rules similar to those governing specialists, or are effected for the purpose of reversing in whole or in part a transaction so undertaken. If such studies indicate the feasibility and desirability of such a program, it should be put into effect promptly with appropriate procedures for surveillance by the respective exchanges.

3. Since floor trading on regional exchanges in dually listed stocks does not appear to influence price movements or involve special advantages, a different approach or approaches to floor trading on regional exchanges may be warranted and should be the subject of separate consideration by the Commission. Among other things, consideration should be given to whether floor trading in solely listed stocks on regional exchanges is or is not comparable to floor trading on the NYSE and Amex.

G. MEMBERS' OFF-FLOOR TRADING

1. INTRODUCTION AND METHOD OF STUDY

Approximately 5 percent of all shares purchased and sold in the round-lot market of the NYSE is attributable to members' trading for their own accounts in transactions which originate away from or "off" the floor. During the congressional hearings preceding enactment of the Securities Exchange Act of 1934 this type of member trading received considerable attention, due in large measure to member participation in pool operations.[499] Under section 11 of the act, the Commission is empowered "to prevent such excessive trading on the exchange but off the floor by members * * * as the Commission may deem detrimental to the maintenance of a fair and orderly market," but it has never exercised this authority. Rule 435 of the NYSE, adopted at the Commission's request in 1935 and since expanded by the exchange, sets forth certain general prohibitions on member trading, the first of which provides that no member shall effect transactions on the exchange which "* * * are excessive in view of his * * * financial resources or in view of the market for such security." This rule has not played a significant role in the exchange's disciplinary actions, however, and generally speaking member trading from off the floor has excited little Commission or NYSE interest since 1935. Although members must file weekly forms with the exchange setting forth the aggregate number of shares traded from off the floor for their own accounts each day (total pur-

[499] See Senate Committee on Banking and Currency, "Stock Exchange Practices," S. Rept. 1455, 73d Cong., 2d sess., pp. 30–45 (1934). See also ch. VI.C for a brief description of the legislative history regarding member trading.

chases, total sales, total short sales), no identification of the stocks, number of transactions, or time of transactions is required. Less is known, as a result, about the nature of member trading from off the floor than is known about the trading of specialists or floor traders.

In order to study the trading of members from off the floor, the Special Study requested all NYSE members to set forth on questionnaire forms all such round-lot trading by stock and by day for the 3 weeks ended January 27, March 24, and June 16, 1961.[500] These data were then analyzed on a "stock day" basis,[501] facilitated by the computer process described in appendix VI-A.

2. VOLUME OF MEMBER TRADING FROM OFF THE FLOOR

Member trading from off the floor of the NYSE between the years 1937 and 1961 accounted for 2.9 to 6.1 percent of total round-lot purchases and sales each year. Prior to 1955 this trading exceeded 4.5 percent only once (6.1 percent in 1949), but it has since ranged from 4.8 to 5.3 percent (table VI-73). This trading declined from approximately 40 million shares in 1937 to less than 8 million in 1942, but has since shown a relatively constant increase to over 102 million shares in 1961.

Over the three 1-week periods studied, NYSE members off floor accounted for 5 percent of total round-lot purchases and sales on the NYSE, a slightly higher rate of participation than their percent participation for the entire year of 1961. They traded 6,803,800 shares over the 3 weeks in 6,728 stock days, or an average of 1,011 shares per stock day in which they participated (table VI-a). In about half of the stock days in which they participated their purchases and sales equaled 9.75 percent or more of the total stock-day volume, or approximately 4.87 percent or more of total stock day purchases and sales (table VI-2).[502]

Unlike specialists and associate brokers, whose trading is limited primarily to their marketmaking functions, and unlike floor traders, whose trading consists largely of short-term investment or speculation, members seem to trade from off the floor for a variety of purposes, ranging from personal investment to arbitrage, and including the offsetting of positions by dual members who are specialists on the regional exchanges. No data are available, however, indicating the extent to which member trading from off the floor is attributable to each of these various trading purposes.

Although virtually every exchange member participates in this type of trading (if only, in many cases, for personal investment) the bulk of such trading tends to be highly concentrated in relatively few member accounts. Over the 3 weeks studied, the 30 member accounts trading most actively from off the floor each week accounted for 51.9 percent of all shares traded by members from off the floor (tables VI-74 to VI-76). A total of 49 accounts were among the 30 most active, with 16 accounts appearing among the most active in all 3 weeks, and 9 accounts appearing in 2 of the 3 weeks.

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[500] These data were reported on form EX-2, a copy of which appears in app. VI-J. Form EX-3, also in app. VI-J, obtained data for each transaction by members on Mar. 23, 1961, but the Special Study has not been able fully to analyze these data in time for inclusion in the report.

[501] The "stock-day" concept is explained in note 63, p. 51, in pt. C. above, and in app. VI-A.

[502] For an explanation of these two different measures of trading, see note 1, table VI-b. of pt. C.

3. CONCENTRATION OF MEMBER TRADING FROM OFF THE FLOOR

Members traded from off the floor in less than half of the total stock days over the 3 weeks. As measured by the number of stock days in which they participated, members off floor exhibited a slight preference for higher priced stocks; approximately 55 percent of the stock days in which they participated were above the median price of all stock days over the 3 weeks (chart VI-1). Within the stock days in which they did trade, however, members off floor revealed a slight tendency to account for a greater percent of total stock-day volume in low-priced stocks relative to high-priced stocks (app. VI-A, chart 13 and table 13). Overall, therefore, the conclusion appears to be warranted that the trading of members off floor does not concentrate to a significant extent in either high-priced or low-priced stocks.

Members revealed a more pronounced tendency to trade from off the floor in those stock days with wider daily price ranges; approximately 61 percent of the stock days in which members traded from off the floor were those with daily price ranges wider than the median price range over the 3 weeks (chart VI-2). Again, however, within the stock days in which they did trade, members off floor tended to account for a greater percent of total stock day volume in stock days of narrow price range relative to stock days of wide price range (app. VI-A, chart 14 and table 14).

Most pronounced is the tendency for members to trade from off the floor in stocks experiencing high volume on any given day. Approximately 77 percent of the stock days on which members traded from off the floor were stock days of higher share volume than the median stock day (approximately 1,800 shares) for the 3 weeks (chart VI-3).[503] Again, however, within the stock days on which they did trade members off the floor tended to account for a greater percent of total volume on the stock days of lower volume (app. VI-A, chart 15 and table 15). That these members nonetheless tend to trade a disproportionate number of shares in the more active stocks is indicated by the concentration of their trading in the 25 most active stocks in each of the 3 weeks studied. Whereas the 25 most active stocks accounted for 19.6, 22.1, and 19.7 percent (tables VI-58 to VI-60) of total NYSE volume in these weeks respectively, members trading from off the floor did 27.9, 36.1, and 29.7 percent of their trading in these stocks (tables VI-77 to VI-79), and accounted for 7.3, 8.7, and 7.8 percent of the total purchases and sales in these stocks.[504]

In several cases members trading from off the floor accounted for substantial proportions of the weekly purchases or sales in individual stocks among the 25 most active. For the week ended January 27, 1961, for instance, they accounted for 12.5 percent of all shares purchased in Loew's Theatres, Inc., 17.7 percent of all shares purchased in American Telephone & Telegraph Co., 29.9 percent of all shares sold in Alleghany Corp., 47.6 percent of all shares sold in Royal Dutch Petroleum Co., and 59.9 percent of all purchases in Chance-Vought Corp. Member trading in American Telephone & Telegraph Co.

[503] See also chart VI-4. This chart reflects stock day activity by number of transactions rather than by share volume, but produces results almost identical to chart VI-3.

[504] This concentration is corroborated by the fact that members trading from off the floor had high participation rates in a significant number of very active stock days over the 3 weeks (app. VI-A, chart 15 and table 15).

was heavy in each of the other weeks studied, accounting for 49.2 and 23.5 percent of all sales in the March and June weeks, respectively. It appears that many of the days or weeks of concentrated trading by members from off the floor are attributable to arbitrage operations.[505] Not all cases are explainable in this fashion, however. On Monday, January 23, for instance, Chance-Vought Corp. opened late at 43⅛, up 3¼ from the prior close. Members trading from off the floor purchased 23,600 of the 29,200 shares traded over the day. In this case, it seems that members were utilizing their commission-rate advantages to benefit from an offer by Ling-Temco Electronics to purchase all offered shares of Chance-Vought at $43.50 a share.[506]

4. RELATIONSHIP OF MEMBER OFF-FLOOR TRADING TO PRICE MOVEMENTS

These cases of concentrated member buying or selling raise a question as to the effect of such trading on stock prices. To the extent that arbitrage is involved, this trading keeps NYSE prices in line with other domestic or foreign markets, or with rights, warrants, convertible securities, et cetera. Some trading may also reflect member responses to specialist requests for bids or offers on large blocks of stock. In any event, a question remains as to the effect of such trading on price movements.

The few studies that have been made in this area have done little more than reveal a unique feature of trading by NYSE members from off the floor—that they usually sell more shares than they buy on the exchange. Over the years 1937 through 1961, members trading from off the floor sold over 90 million shares more than they purchased, for an average yearly sale balance of more than 3.5 million shares (table VI-80). In the period November 2, 1959, to November 1, 1961, members trading from off the floor had net sale balances on 330 days, and purchase balances on only 174. On the 6,728 stock days in which members traded from off the floor during the 3 weeks studied, they posted even balances in 512, purchase balances in 2,928, and sale balances in 3,288, and had a net sale balance for the 3 weeks of 458,000 shares. Because of this tendency to post rather consistent sale balances, it is difficult to show a correlation between member off-floor purchase and sale balances and price movements, as has been done with floor traders.[507] There is some evidence, however, that suggests that the sale balances of members trading from off the floor may occur relatively more frequently on days of price decline than on days of price rise.[508]

In a majority of the stock days in which members traded from off the floor during the 3 weeks studied their net balances were relatively small. In 7.6 percent of the stock days they posted even balances, and their balances were between minus 100 shares and plus 100 shares (including zero balances) in 40 percent of the stock days. In only 16 percent of the stock days in which they traded did they post net pur-

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[505] The Royal Dutch Petroleum Co. instance noted in the text is probably traceable to foreign arbitrage, and the Alleghany Corp. situation was due to arbitrage between the common and preferred stock. The March trading in American Telephone & Telegraph Co. apparently involved trading in rights. The nature of arbitrage transactions is explained in pt. H.1.c(3).

[506] Wall Street Journal, Jan. 24, 1961, p. 23. Nonmembers, due to higher commission rates, could not purchase the stock at 43⅛ or 43¼ (the range for the day) and sell it at a profit to Ling-Temco Electronics.

[507] See pt. F, above.

[508] See Securities and Exchange Commission, "Report on the Feasibility and Advisability of the Complete Segregation of the Function of Dealer and Broker," p. 48 (1936).

chase or sale balances in excess of 700 shares. In approximately 5 percent of their stock days they posted net purchase or sale balances in excess of 2,000 shares, and these balances ranged up to 64,000 shares.[509]

In broad terms it is possible to explain the rather consistent sale balances of members' trading from off the floor by reference to shares obtained off the exchange via stock splits, stock dividends, new issues, arbitrage, et cetera. It is impossible, however, to pinpoint the primary source of the "excess" shares, or to weigh the relative importance of the various possible sources, due to a virtual absence of data.[510]

Until data are available indicating the extent of member trading from off the floor for various purposes (investment, speculation, arbitrage, offsets of positions by regional specialists, et cetera), the source of the unusual sale balances characterizing such trading, and the degree of its concentration in particular stocks, no conclusions may be reached as to the significance of this type of trading. Some thought should be given, therefore, to the propriety of expanding the present reporting requirements for members off floor.

5. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Trading by NYSE members on the exchange but from off the floor accounts for approximately 5 percent of total exchange purchases and sales, but on occasion accounts for more than 50 percent of all purchases or sales in a given stock over a given day or week. Generally such trading is characterized by a tendency to favor stocks and stock days of high volume; and by a rather consistent pattern showing significantly more sales than purchases. The sources of the shares sold on the exchange in excess of those purchased are generally considered to be stock splits or dividends or arbitrage purchases in other markets, but data have not been obtained to confirm these assumptions. Similarly, the extent to which member off-floor trading represents investment, speculation, arbitrage activity or other functions has never been ascertained. Until such data are available, no conclusions as to the significance of such trading may be reached.

The Special Study concludes and recommends:

1. The purpose, nature, and significance of trading by members from off the floor remain concealed in the aggregate data reported by such members to the NYSE each week. Because this trading on occasion accounts for a large percent of total trading in individual stocks, and may therefore have a substantial impact on the trading in such stocks, the propriety of expanding the present reporting requirements of members trading from off the floor should be considered by the NYSE and the Commission.

H. SHORT SELLING

1. INTRODUCTION

A short sale is the sale of stock which the seller does not own or which he owns but does not deliver. In order to make delivery, he

[509] This sale balance was registered in Rhodesian Selection Trust, Ltd., on Mar. 22, 1961, and was probably due to foreign arbitrage activity.

[510] The NYSE did send a form to a sample of its members in the summer of 1962 in an effort to ascertain the sources of these sales, but felt that the results were not reliable. The Exchange has indicated that the study will be continued.

borrows the stock, which at some later time he returns to the lender, ordinarily obtaining it by purchase in the open market.

There is only partial accuracy to the popular conception of the short seller as a free-wheeling speculator who anticipates a market decline so that he will be able to buy, or "cover," at a lower price, realizing as his profit the difference between the sale price and the subsequent purchase price. Speculation is but one of the motivations which may lead to short selling. Among the nonspeculative kinds of short selling are the so-called technical short sales—e.g., by arbitragers, specialists and odd-lot dealers—the hedging short sale, the short sale for tax purposes and the short sale "against the box"; all of these are explained below, and some are analyzed in detail subsequently.

In 1934, the Senate Banking and Currency Committee found that "few subjects relating to exchange practices have been characterized by greater differences of opinion than that of short selling," [511] and the matter was one of the central issues in controversy during the congressional scrutiny of exchanges and their practices which led to enactment of the Securities Exchange Act of 1934. Argument about the utility and impact of short selling tends to be renewed after each major downward plunge of security prices. In part, the objections to short selling seem grounded in a vague attitude that it is simply gambling, of no economic value. More particularly, it has been attacked with the claim that its banishment would remove a market force which serves only to accentuate the violence of periodic price swings. The crux of the argument in defense of short selling is that it helps to maintain an orderly market and to stabilize price fluctuations. The classic theory has held that short selling occurs when the market advances, thereby acting as a brake to the rise, and conversely, that the resulting covering transactions, which represent the only compulsory buying power in the market, take place as prices decline and thus act as a cushion breaking the force of the decline.

Under section 10(a) of the Exchange Act, Congress granted the Commission full power to regulate short selling.[512] The purpose of this part of chapter VI is to examine the rules regulating the practice and to evaluate some of the effects that short selling has on the market. Short selling also takes place in the over-the-counter markets,[513] but the subject is considered in the present chapter because the available data concerns short selling on the major exchanges.

a. Method and scope of study

Short selling has been the subject of various prior analyses under different market conditions and regulatory requirements. The Special Study has made use of this informtion as well as of data filed with the Commission by the New York Stock Exchange on a continuing basis, and of members' reports on file with that exchange.

To supplement these data, the Special Study requested additional statistics on short selling for limited periods. Detailed information was obtained covering individual transactions by members and by a

[511] S. Rept. 1455, "Stock Exchange Practices," Senate Committee on Banking and Currency, 73d Cong., 2d sess., p. 50 (1934.)

[512] An outright ban on short selling by "insiders" of issues of listed securities was enacted, with limited exceptions. See exchange Act, sec. 16(c).

[513] See app. VII-A for some data on short selling in the over-the-counter market. Public customers' over-the-counter short sales of NYSE-listed securities appears to be negligible; see ch. VIII.D.

substantial sample of nonmembers for the market break period of May 28, 29, and 31, 1962, in eight stocks actively traded on the New York Stock Exchange; summary data on a daily basis were obtained for 14 selected days prior to, and 2 selected days subsequent to, the market break period.[514]

Since short sales exempted from the Commission's short selling rules, such as arbitrage transactions, are included as "long" sales in all trading reports, no record of exempt short sales is available in any form other than individual accounts kept by brokers and dealers. In an attempt to evaluate the use of the exemptions, offices of nine firms were visited and their records examined, and arbitrage accounts of three firms were requested and examined for the period of the market break.

The study includes analyses of the sources of short selling by categories of NYSE members and nonmembers, of the types of securities in which short selling has been most prominent, and of the relationships between changes in short positions and subsequent price trends. The study also provides an evaluation of the extent and significance of short selling in the eight selected stocks. Additionally, there are limited discussions of short sales exempted under Commission rules. No information was obtained on short covering transactions and only indirect reference to this aspect of short selling is made in the present report.

b. The mechanics of short selling

The usual speculative short sale on an exchange involves the following steps:

1. A customer who expects that a stock will decline from its present price, but does not own any shares of it, instructs his broker to sell the stock short on the exchange.
2. The sale is made as a regular sale, subject to SEC and exchange rules discussed in section 1.d, below.
3. The short seller's broker borrows shares and makes delivery to the buyer. The stock may be borrowed from the broker's customers' margin accounts[515] or the broker's own accounts, or from other brokers.[516] In the last case, cash equal to the current value of the securities must be deposited with the lending broker; this deposit may be increased or reduced as the brokers "mark to the market" in line with significant movements in the stock's price. Whatever the source of the stock, such loans ordinarly involve neither cash compensation to the lender nor interest to the borrower.
4. Except for the normal costs of execution, there is no fee attached to executing a short sale. The short seller must deposit in his margin account with his broker an amount satisfying the required margin. Of course if the price of the stock should rise to the point at which the exchange's margin maintenance requirement applies, the short seller will have to deposit more cash or securities or close out his short position. If he is willing to make such further deposit (or if none is needed) and willing to cover any dividends or other distributions on

[514] For a more detailed discussion of these data, see ch. XIII.
[515] The borrowing and lending activities of odd-lot dealer firms, for example, are discussed in pt. E, above.
[516] See ch. III.D.

the stock, the short position normally can be maintained indefinitely, but, it is believed, is usually covered relatively soon.

5. At some later date, when the price of the stock has fallen or when the short seller has for some reason decided to take a loss, he buys in the market to cover his short sale.

The short selling mechanism would break down but for the availability of stock for borrowing in order to make delivery. At one time brokers interested in making such arrangements congregated in a so-called "loan crowd" at a designated place on the floor of the Exchange. Among the principal lenders were large corporations, investment funds, and even banks who were represented by their own brokers. Sometimes the loans were made at premiums providing the lenders with extra income. Today a premium is extremely rare; it may be charged if a "short squeeze" develops in the stock, as it might in a stock with a large short interest and a limited floating supply of shares.

c. Types of and reasons for short selling

(1) *Speculative short selling*

As already noted, to speculate on the short side is to sell stock, in the expectation that the stock's price will fall and make possible a profitable covering purchase.

In order to get at the short interest resulting from speculative sales, a study was conducted in June 1947 by the New York Stock Exchange at the request of the Commission. For this purpose a breakdown was requested of the short interest outstanding for members and nonmembers, showing the totals in each class of short position, such as "against the box," arbitrage, and hedges. When these categories were counted, the speculative short interest was found to be about two-thirds of the total. Current data are not available but the one-time survey serves to indicate that since some of the short interest represents technical short sales such as arbitrage transactions or "sales against the box," not all of the short interest represents compulsory buying power.

(2) *Technical short sales—facilitating operations in the market*

(a) *The specialist.*—The specialist's function on the stock exchange is to maintain price continuity and to minimize the effects of temporary disparity between supply and demand. More simply, his duty is to maintain an orderly market.[517] At times, he does this by using the short sale to supply stock.

(b) *Odd-lot dealers.*—The odd-lot dealer sells to his customer, or buys from him, amounts of stock which are less than the unit of trading on the exchanges.[518] However, he must deal in regular units, i.e., round lots, when buying and selling on the exchange. The odd-lot dealer, therefore, may sell round lots short either to anticipate or to offset odd-lot orders of his customers.

When the Commission adopted its first short selling rules in 1938,[519] it exempted short sales in odd lots as well as certain short sales by the odd-lot dealers because of the "undue burden and inconvenience which a short-selling restriction would place on the odd-lot machinery of the securities exchanges." [520] However, several exchanges, notably the

[517] See pt. D of this chapter.
[518] See pt. E of this chapter.
[519] See subsec. d(2), below.
[520] Securities Exchange Act release No. 1548 (Jan. 24, 1938).

New York Stock Exchange, the American Stock Exchange, and the Midwest Stock Exchange, have adopted regulations making the Commission's short selling rules applicable to sales of odd lots, except those of odd-lot dealers.

(c) *Arbitrage.*—Arbitrage, in essence, is a series of transactions whereby a trader takes advantage of a price difference between equivalent securities. The difference in price may arise because the identical security is being traded in two different markets, or because exchangeable securities are being sold. Thus, a stock might be selling at a lower price on the New York Stock Exchange than on the Pacific Coast Stock Exchange or in London; the arbitrager would buy in New York, and at the same time sell short in one of the other markets. Arbitrage involving different forms of securities may occur, for example, when a security which is convertible into the issuer's common stock is available for less than the current value of the shares into which it is convertible, or when an exchange of securities is being effected pursuant to a corporate reorganization or merger. In these cases, the arbitrager sells the shares short, buys the convertible or exchangeable securities, and later turns those into common stock to make delivery. One firm spoke of arbitrage as follows:

> The secret of successful arbitrage [is] turnover. Because of fractional differences per 100 share unit between the purchase and sale and the expenses of operation which include commission, taxes, and other incidental expenses, there must be a very large volume turnover to make a sizable profit and there is always the risk of a loss.

(3) *Hedging*

The hedging short sale is used by a security holder who fears a price decline but wants to continue to hold his securities. For example, it may be that the securities are inactive and he believes he cannot sell at a good price. Rather than disposing of his own securities, he will sell short approximately the same dollar value of the stock of a "market leader" or of another company in the same industry. If the market goes down, he covers the short sale at the lower price and has succeeded in balancing the loss taken on the securities he held throughout. If the market rises, he takes the loss on his short sale, but may be compensated for it by a rise in the stock he wanted to hold.

(4) *Taxation*

Most of the advantages of the short sale for tax purposes were eliminated by revisions in the tax code in the early 1950's. Nevertheless, the short sale can still be used to preserve a gain without realizing the income until the following year. Although this type of short selling may tend to increase near the end of the year, the available statistics are not of a nature either to confirm or to deny the supposition.

Trading such as this, in which the seller owns the particular stock sold short, is called selling "against the box"; some argue that it is not short selling at all. Selling against the box also may be resorted to, for example, when the seller cannot conveniently get the securities from his safe deposit box in time for delivery, or for reasons of secrecy.

* * *

Also, though technical, short positions may arise particularly in the case of an underwriter of stock or bond issues. The underwriter

may desire to stablize the price of the security during the offering or he may want to protect against a possible flooding of the market after the offering. This is most often done by over-alloting the issue at the time of the offering. The resultant short position provides the underwriter buying power to stabilize the price of the security during the offering, to offset any cancellations by selling dealers and to absorb, through covering purchases in the open market, any unusual selling of the securities after the offering is completed.

d. A brief review of the regulation of short selling

(1) *The exchange rule; 1935*

The Commission did not at first promulgate a short selling rule of its own, but in 1935 requested the exchanges to regulate the practice. The rule adopted that year by 16 exchanges required that a member should not effect a sale which would demoralize the market. This merely codified requirements which had been in force on at least the New York Exchange since 1931. A portion of the financial community had long considered that a sale at a price lower than that of the last sale exerted a demoralizing effect, particularly when the lower price represented a short sale. Accordingly, the 1935 exchange rule prohibited the short sale of a security at a price below the last sale price. The Commission voiced a hope that the rule would "preserve those features of short selling which are in the public interest." [521]

(2) *The Commission rules; 1938*

The autumn of 1937 brought a sharp drop in the market, and the Commission immediately began a study of the market decline and a reassessment of the exchanges' short selling rule. This study led to the promulgation of a set of Commission short selling rules, which went into effect in February 1938.

The Commission's three rules were designed to correct some of the limitations of the 1935 provision. The first rule defined a short sale, something which the exchange rule had failed to do. The definition, now Exchange Act rule 3b-3, describes a short sale as—

> * * * [A]ny sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.

But the heart of the new provisions was embodied in paragraph (a) of the second rule, the important part of which is:

> No person shall * * * effect a short sale of any security at or below the price at which the last sale thereof, regular way, was effected on such exchange.

This meant that all short sales were prohibited unless made above the last sale price, usually by 1/8 point or more. In this aspect, the rule met three objectives which the Commission felt a short selling rule should accomplish:

> (1) Allow relatively unrestricted short sales in an advancing market;
> (2) Prevent short selling at successively lower prices—thus, eliminate the use of the short sale by the "bear raider" to drive the market down;
> (3) Prevent short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by longer sellers.

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[521] S.E.C., 1st Annual Rept., p. 16 (1935).

Paragraph (b) of the second rule contained provisions which required all sales to be marked either "long" or "short" [522] while paragraph (c) described the conditions for marking the sale "long." Paragraph (d) provided exceptions, including any sale of an odd lot and certain offsetting transactions by the odd-lot dealer. The third rule related to the conditions under which a broker could borrow securities for a "long" account.

(3) *The adoption of the present rule; 1939*

In the months after adoption of the Commission's rules, the total short interest on the New York Stock Exchange declined more than 50 percent, and Exchange officials suggested, and had extensive discussions with the Commision about, modification of the rules. In March 1939 the Commission promulgated what is now the main portion of rule 10a–1(a). Whereas the 1938 rule had prohibited all short selling at the last long sale price, the new rule permitted it at such price if that was higher than the last different price.

The rule's operation is illustrated by the following example. (The asterisks denote short sales which would not have been permitted under the 1938 rule.)

Sequence of sales	Sale price	Short sale permitted	Reason	Sequence of sales	Sale price	Short sale permitted	Reason
1	40			6	39¾	No	Minus tick.
2	39⅞	No	Minus tick.[1]	7	39⅝	No	Minus tick.
3	39⅞	No	Zero-minus tick.	8	39¾	Yes	Plus tick.
4	40	Yes	Plus tick.	9	39⅞	Yes	Plus tick.
5	40	Yes*	Zero-plus tick.	10	39⅞	Yes*	Zero-plus tick.

[1] A sale on a "minus tick" is made at a lower price than that of the preceding transaction; on a "zero-minus tick," at the same price as the previous sale, the last change in price having been downward. Sales on "plus ticks" and "zero-plus ticks" are simply the respective opposites.

On several other occasions the New York Stock Exchange has urged the Commission to modify the existing rules, usually suggesting that short sales should be permitted without restriction at any price above the security's closing price on the preceding day. The Commission, however, has indicated that it did not believe such modification to be in the public interest. In 1955 the Commission reiterated this position to the Senate Banking and Currency Committee, which was investigating factors affecting the stock market.[523] At various times during this period and in later years, the Commission has continued to support the need for a strong short selling rule.

e. The data regularly available on short selling

The only data regularly compiled and published concerning short sales are daily aggregate figures for all stocks on the New York and American Stock Exchanges and monthly figures on the short positions in certain stocks on the NYSE and in all securities on the Amex. Analysis of such data permits only broad conclusions about short selling practices. The series of reports are here described, and their limited usefulness is indicated.

[522] Such a requirement had been in effect for some years at least on the New York Stock Exchange, but its purpose and use were solely statistical.
[523] Hearings before the Senate Committee on Banking and Currency, 84th Cong., 1st sess., p. 949 (1955).

(1) *Records filed on a continuing basis with the Commission*

Three types of reports containing short selling data are filed on a continuing basis with the Commission. One is a weekly report of daily round-lot transactions on the New York and American Stock Exchanges, in which daily aggregate short selling in all stocks is reported as well as aggregate short selling effected by members for their own account, classified into the three categories of specialists, floor traders, and members off the floor.

Secondly, the Commission receives weekly reports of aggregate daily short sales by odd-lot customers. For the NYSE, these data are reported by the odd-lot dealer firms, and for the American Stock Exchange, by the Exchange itself. The data are similar to round-lot short sales in that only aggregate short selling in all stocks is reported.

A third category of reports, containing information on short positions, are released by the NYSE each month to the press and are filed with the Commission. These reports provide an aggregate midmonth short interest figure for all stocks, the number of issues in which short interest was reported, and the actual short interest for identified individual issues in which there is a short position of 5,000 shares or more, or in which there was a change in short position of 2,000 shares or more from the previous month.[524] They also report as a separate figure the total short interest of the odd-lot dealer firms. The value of these reports is reduced because they cover only the short positions as of monthly points, rather than reporting as of more frequent intervals or, also, giving total short sales volume in at least the most active "short" issues. Their value is further reduced because they fail to classify the short interest into categories of traders as do the round-lot short sales reports, or to classify the short interest by such types of short selling as sales "against the box" or sales for speculation.

While these three types of reports constitute the primary sources of information regularly available to the Commission, two additional reports concerning short sales are regularly filed: daily reports on the floor traders' transactions and month-end stock positions reported by the two largest odd-lot dealer firms on the New York Stock Exchange, Carlisle & Jacquelin and DeCoppet & Doremus. The daily reports of floor traders' transactions represent the most complete record available for any single group, as such members are required to report each transaction effected on the floor of the Exchange, giving the time, tick, price, and number of shares. These reports are quite comprehensive but apart from their limitation to one class of traders their use for a study of short selling is limited because floor traders are not required to report on this form trades initiated off the floor of the NYSE or those effected on other exchanges. The reports of odd-lot dealers' month-end positions in each stock cover periods differing from the total short interest report by approximately 2 weeks, and are limited, like the short interest reports, in what they reveal.

Thus, the drawback common to most of the short selling information on file with the Commission is that it does not provide, with respect to either round lots or odd lots, the total volume of short selling occurring in single issues over continuous periods of time.

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[524] The Amex also makes midmonth short interest reports covering all securities traded on that exchange.

(2) *Records on file with the exchanges*

Reports of short-selling data available at the New York and American Exchanges though not regularly filed with the Commission are those of the individual members and firms, which are used to compile the summaries of trading data regularly submitted to the Commission.

On file with the exchanges are the individual reports of all clearing members' daily total sales and short sales, and all members' daily total transactions for their own account. These are filed at the end of the week following that in which the transactions occurred. Summaries of these reports provide the data for the weekly round-lot reports to the Commission on aggregate reported short sales for each trading day.

Also on file with the exchanges are tabulations of members' mid-month short positions in each stock. These tabulations, as compared with the short-interest report submitted to the Commission, have two useful features: they contain the total short interest in each stock whereas the published short interest reports do not, and they permit a stock-by-stock analysis of the large positions or monthly changes in any reporting member's short interest.

The data available in exchange records afford a means of further classification of short sellers, but these records still do not provide the most basic material necessary for an appraisal of short selling—a record of total short sales effected in any particular issue either classified by type of seller or, ideally, in terms of each short sale transaction.

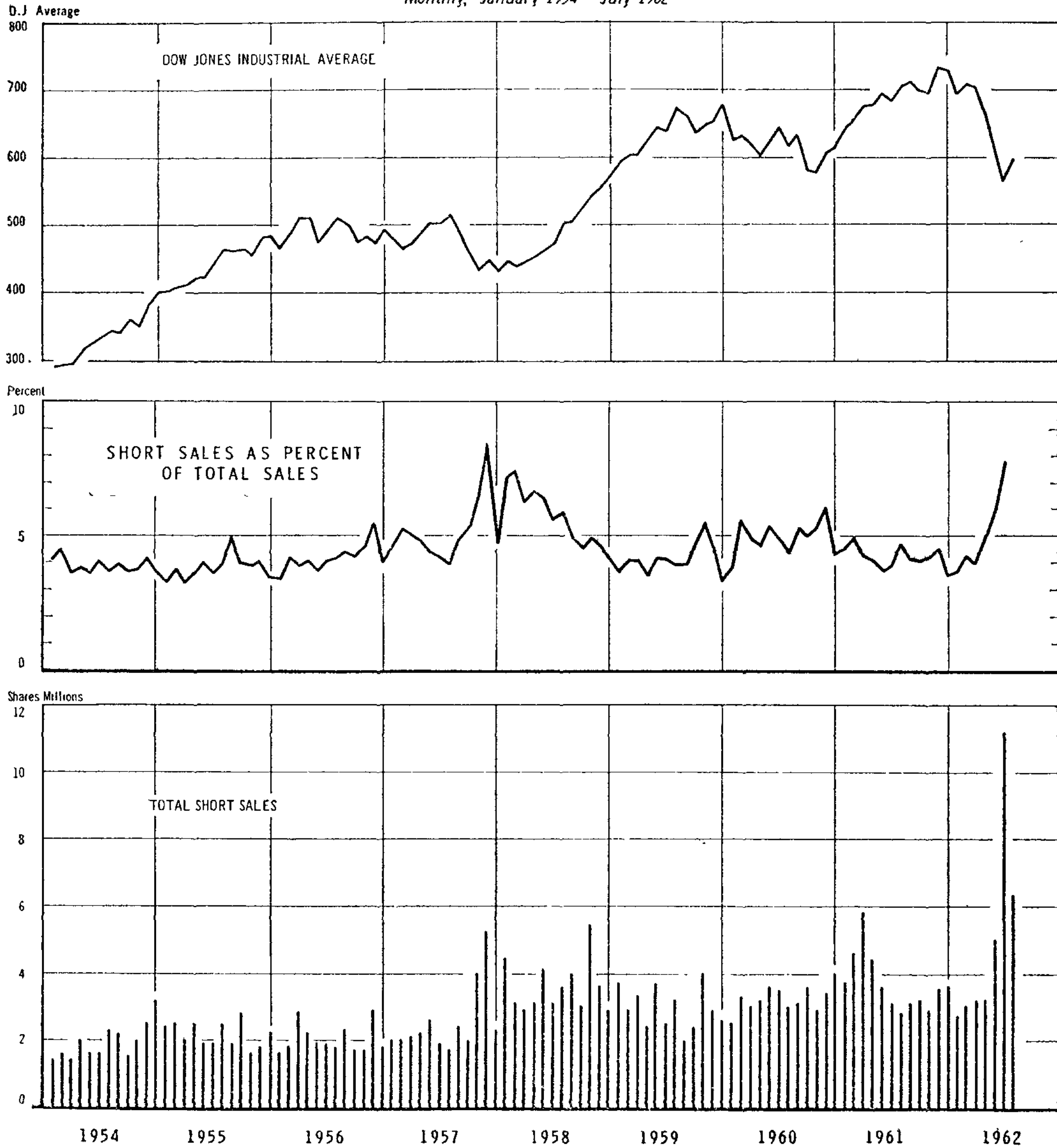
2. GENERAL FEATURES OF SHORT SELLING

Assuming that the technical uses of short selling are responsive to operating needs of the market and that short selling in its various forms may contribute liquidity to an exchange market under ordinary conditions, the important question is the extent to which the current rules operate as originally intended to restrict short selling in sharply declining markets. For this purpose, the Special Study examined short selling in a group of selected stocks during a period culminating in the market break at the end of May 1962. As a background, an examination was made of the relative volume of short sales by the various classes of participants in the securities markets and the movements of stock prices.[525] The results, presented in chart form, provide some information about the timing of short selling by the different types of sellers during the major swings of the market.

a. Total volume

Chart VI–d illustrates the pattern of short selling on a monthly basis from January 1954 through July 1962. The chart shows that short sales in the aggregate vary considerably in volume, ranging for the period shown from less than 2 million shares per month to more than 11 million shares during the break in May 1962. In relation to total trading, short selling during this 8½-year period varied from 3 percent to over 8 percent.

[525] All references to market levels in this part of the report are to Dow Jones Industrial Average (DJI).



NOTE: Also see Table VI-81

It is further evident from the chart that the ratio of short sales to total sales generally varies inversely to the trend of stock prices. As the market advanced from a level of 290 (DJI) in January 1954, to above 500 in early 1956, short selling as a percentage of total sales generally remained well below the 5-percent level and declined to below 4 percent near the peak of the market. Only during the price decline in the latter part of 1956, did the ratio rise above 5 percent. As prices rose in July 1957, to match the earlier peak, the ratio again dropped to the 4-percent level. Then on the more severe decline of prices during the following 6 months the percentage of short selling increased to more than 8.5 percent of total sales, reaching this high point near the bottom of the price decline.

The same general pattern is seen during the following rise and subsequent fall in stock prices. Prices advanced from the 440 level in January 1958, to nearly 700 at the end of 1959, while the short sales ratio dropped from 8.5 percent to about 3.5 percent. During the decline in prices in 1960, the ratio once again rose to above 6 percent, this high coinciding very nearly with the low point of the market in October of that year.

The pattern was repeated in the third general bulge in prices during 1961 and on the subsequent decline through June 1962. While prices rose from 580 to nearly 740, the ratio of short selling dropped from 6 percent to about 3 percent, the latter once more virtually coinciding with the peak in prices. Thereafter, the ratio rose as the 1962 decline set in, increasing again to one of the highest points in the 8½-year period—nearly 8 percent of total sales.

b. Members' and nonmembers' short sales

Though reports by the exchange do not differentiate among the various types of short selling, the weekly reports do provide a breakdown of short selling in the round-lot market by principal classes of members; i.e., specialists, floor traders and members off the floor. Since the total sales figures for each class of members are also known, it is possible to state the proportion of each class's activity which is short selling, and by subtracting members' short sales from total short sales, the volume of nonmembers' short selling in round lots is indicated. It is thus possible to note the differences, if any, in the patterns of short selling by the several classes. It is also possible to note the extent to which the different clases account for portions of total short sales. The following analysis is directed first to a comparison of short sales by all exchange members with those by nonmembers, and then to a comparison of short sales by the several classes of members.

Chart VI–e shows total volume of short sales by members and by nonmembers, together with the trend of the market. During the 8-year period, 1954–61, when the market averages showed an overall advance from 290 to 740 (DJI), members more than doubled their volume of short selling, increasing it from an average of 1,390,000 shares a month during 1954, to 3,060,000 a month during 1961. Nonmembers, on the other hand, averaged well under a million shares per month during most of the 8-year rise, exceeding their average almost entirely during periods of falling prices, especially during the decline in the last 6 months of 1957 and early 1958, and also during the first 7 months of 1962. The latter period, one of the sharpest drops in prices

for many years, witnessed a greatly increased amount of short selling by members and nonmembers alike.

This short selling is examined in more detail below; but turning again to its general features it will be noted from chart VI–e that, on an aggregated basis, the volume of short selling by members far exceeds that of nonmembers. This is also indicated in chart VI–f which pictures, in percentage terms, how the total of short selling is divided between the two groups. It is immediately apparent that the monthly volume of members accounts for more than half of all short selling, generally varying from 60 to 80 percent of the total and sometimes reaching as high as 90 percent.

Members appear to increase their proportion of all short selling as an advance in stock prices progresses, and it follows that nonmembers are then accounting for less. The reverse is true during declines. Even though in absolute terms short selling by both members and nonmembers increases during sharp price declines, the greater increase is by nonmembers. Actually, though the monthly totals do not reveal it, nonmembers' sales exceed those of the member class on some days during declines. This was true near the end of the decline in 1957 and again at the bottom of the more drastic decline of 1962.

Charts VI–g and VI–h have been plotted on a daily basis from April through July 1962, to show in more detail the volume of short sales and the proportions of total short selling by the two groups as compared with the trend of the market during this brief period of rapid market change. During the decline, as indicated, nonmembers increased their proportion of short selling and accounted for more than 50 percent during the near-panic decline in the final days of May. Later in June as the market dropped to a lower point, the nonmembers accounted for as much as 60 percent of total short sales. In the slight sell-off in mid-July, they once more contributed the greater part of short selling. Thus, while the bulk of short selling is generally effected by members, on some days of unusually sharp price declines short selling by nonmembers has predominated.

c. Members' short sales

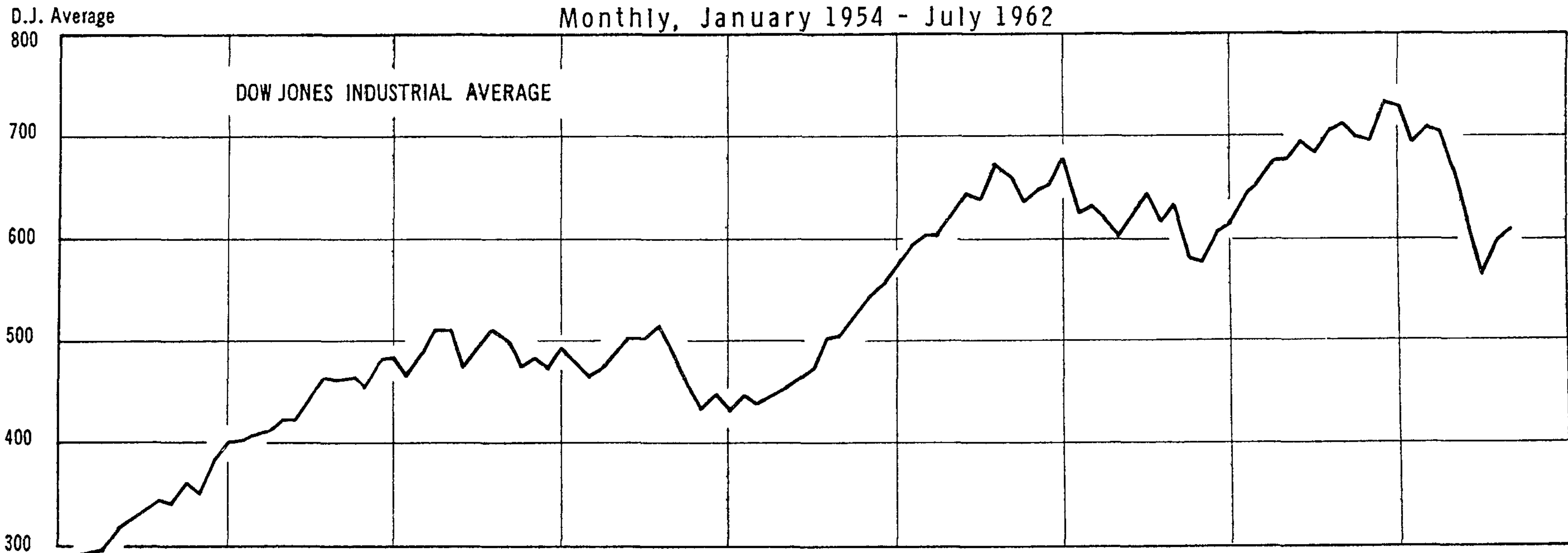
That the greater part of short selling on the New York Stock Exchange is done by members has been known from earlier studies by the Commission; and it was partly for this reason that the Commission in 1936 asked that the exchange, in its weekly report of trading, report short sales separately for the three principal classes of members. The series of weekly reports since then have shown that the great bulk of such selling has been by specialists, followed in order of magnitude by members off the floor (firms and office partners), and by members trading for their own account while on the floor (floor traders).

Chart VI–i shows the short selling by the three classes of members as percentages of total short sales, on a monthly basis from January 1954 through July 1962. The ratios in the case of specialists vary from 40 to nearly 70 percent of all short sales, for members off the floor from 10 to 25 percent, and for floor traders from 2 to 10 percent. (Obviously, the three classes time their short selling at least somewhat differently in relation to the market.)

Chart VI-e

SHORT SALES IN SHARES ON N.Y.S.E. by Members and Non-Members

Monthly, January 1954 - July 1962



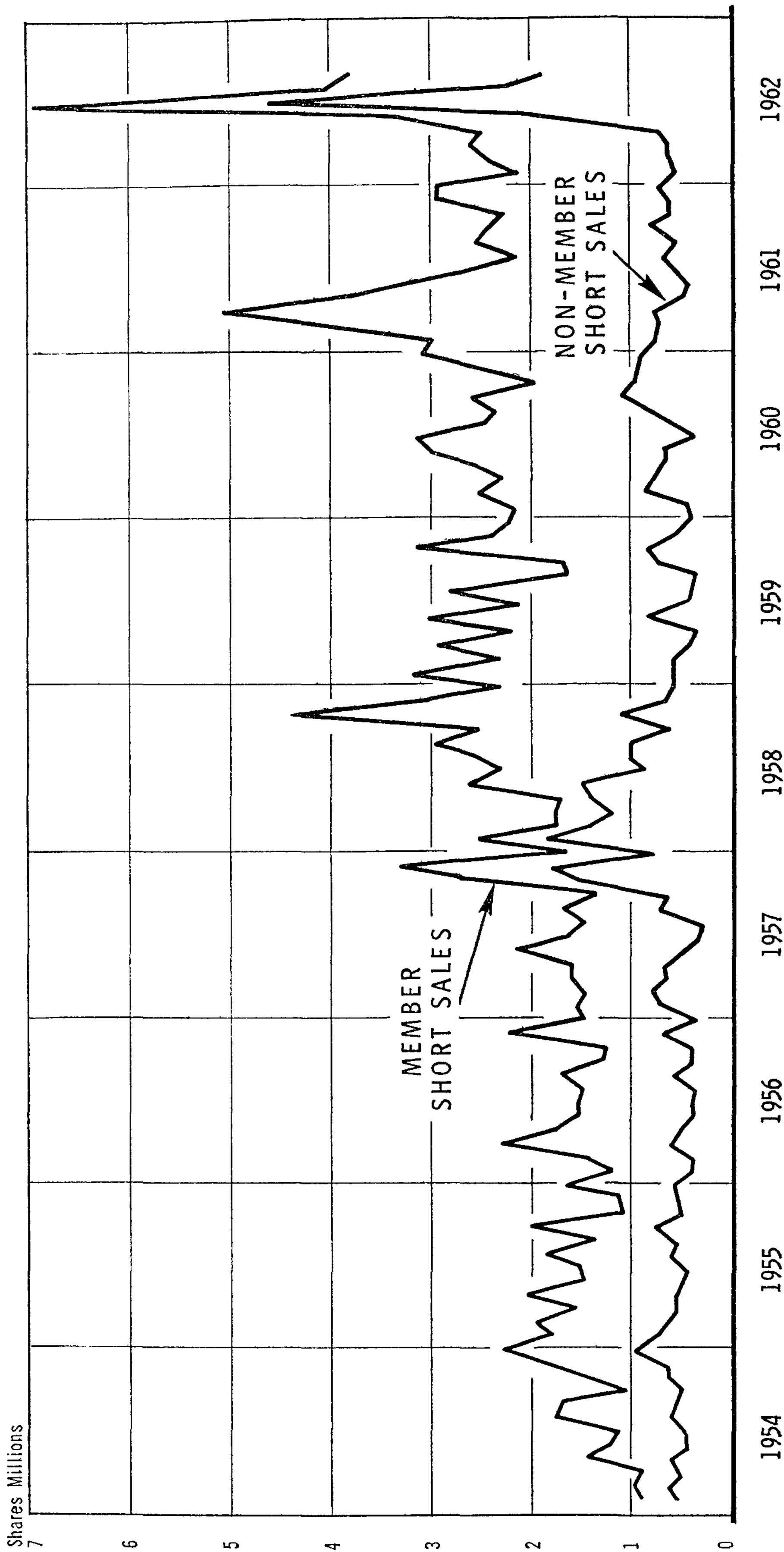
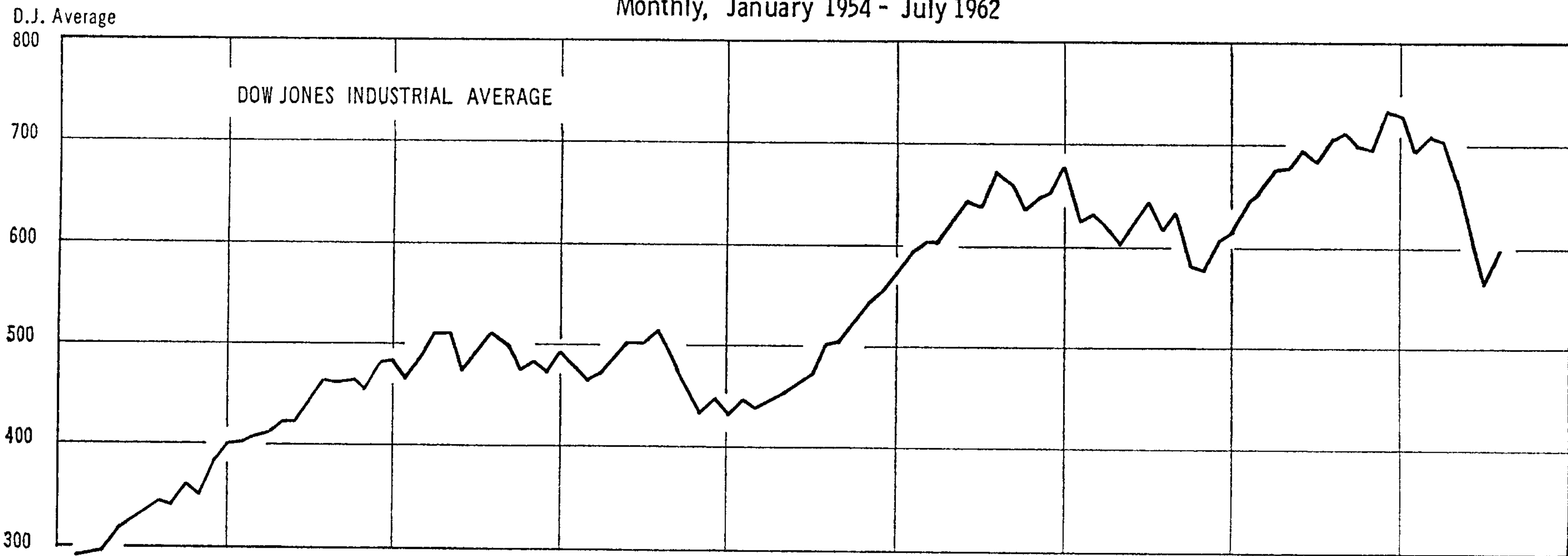
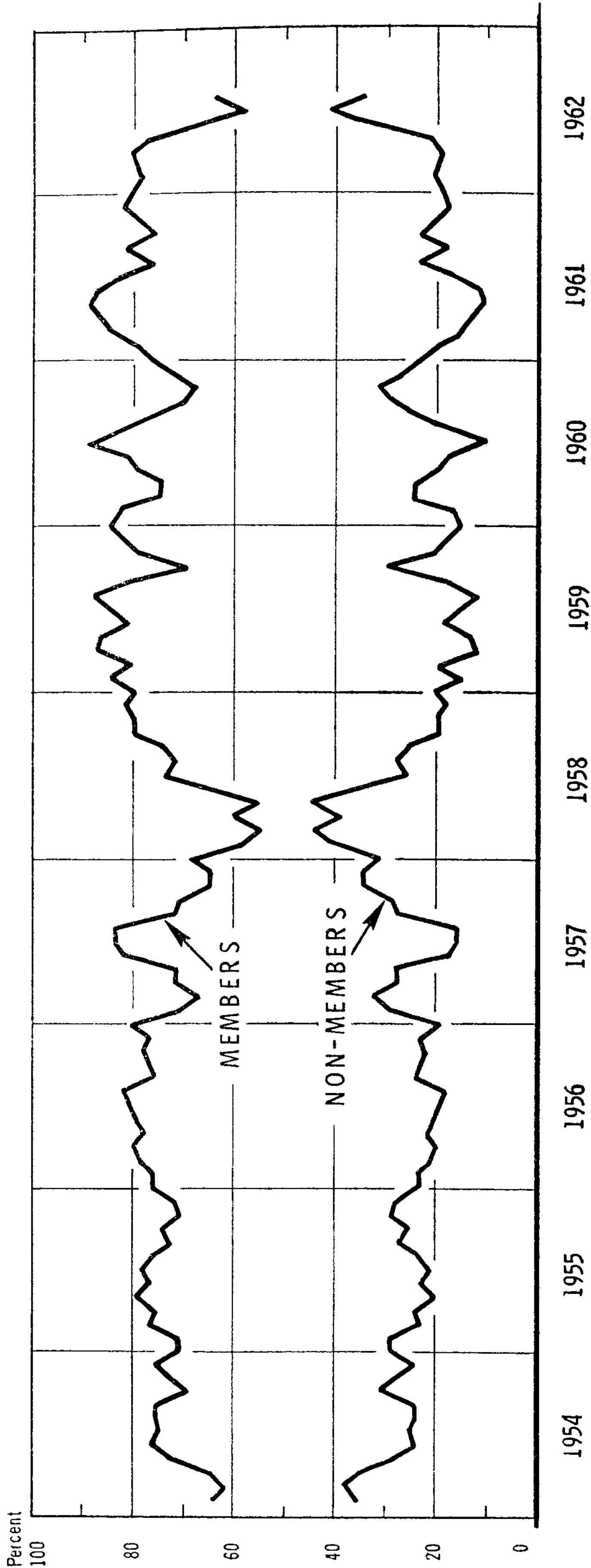

Shares Millions
7
6
5
4
3
2
1
0
1954
1955
1956
1957
1958
1959
1960
1961
1962
MEMBER SHORT SALES
NON-MEMBER SHORT SALES
DS-4420

Chart VI-f

PERCENT OF SHORT SELLING by Members and Non-Members on N.Y.S.E.

Monthly, January 1954 - July 1962





NOTE: Also see Table VI-81

Chart VI-g

SHORT SALES
By Members and Non-Members on N.Y.S.E.
Daily, April - July 1962

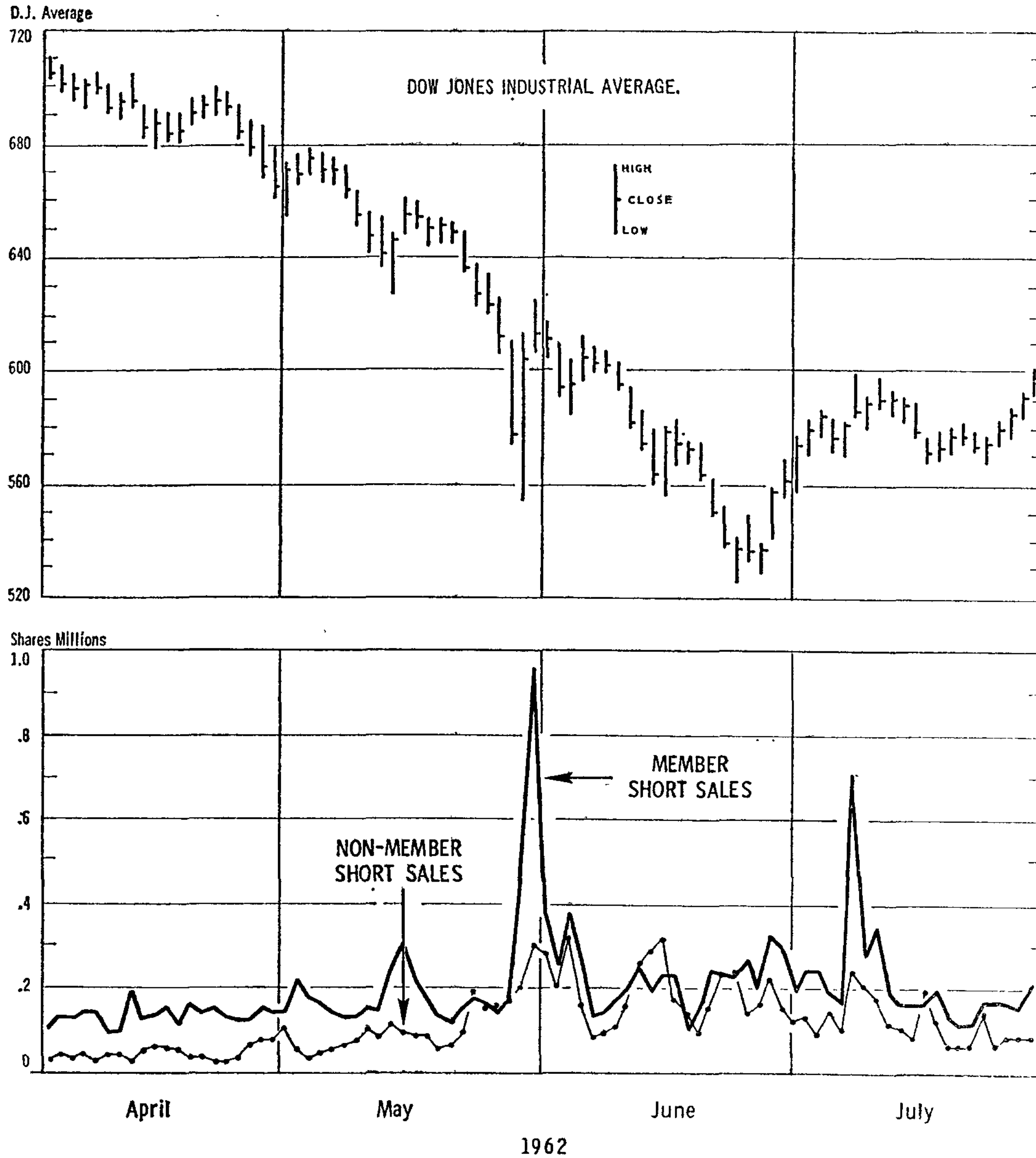


Chart VI-h

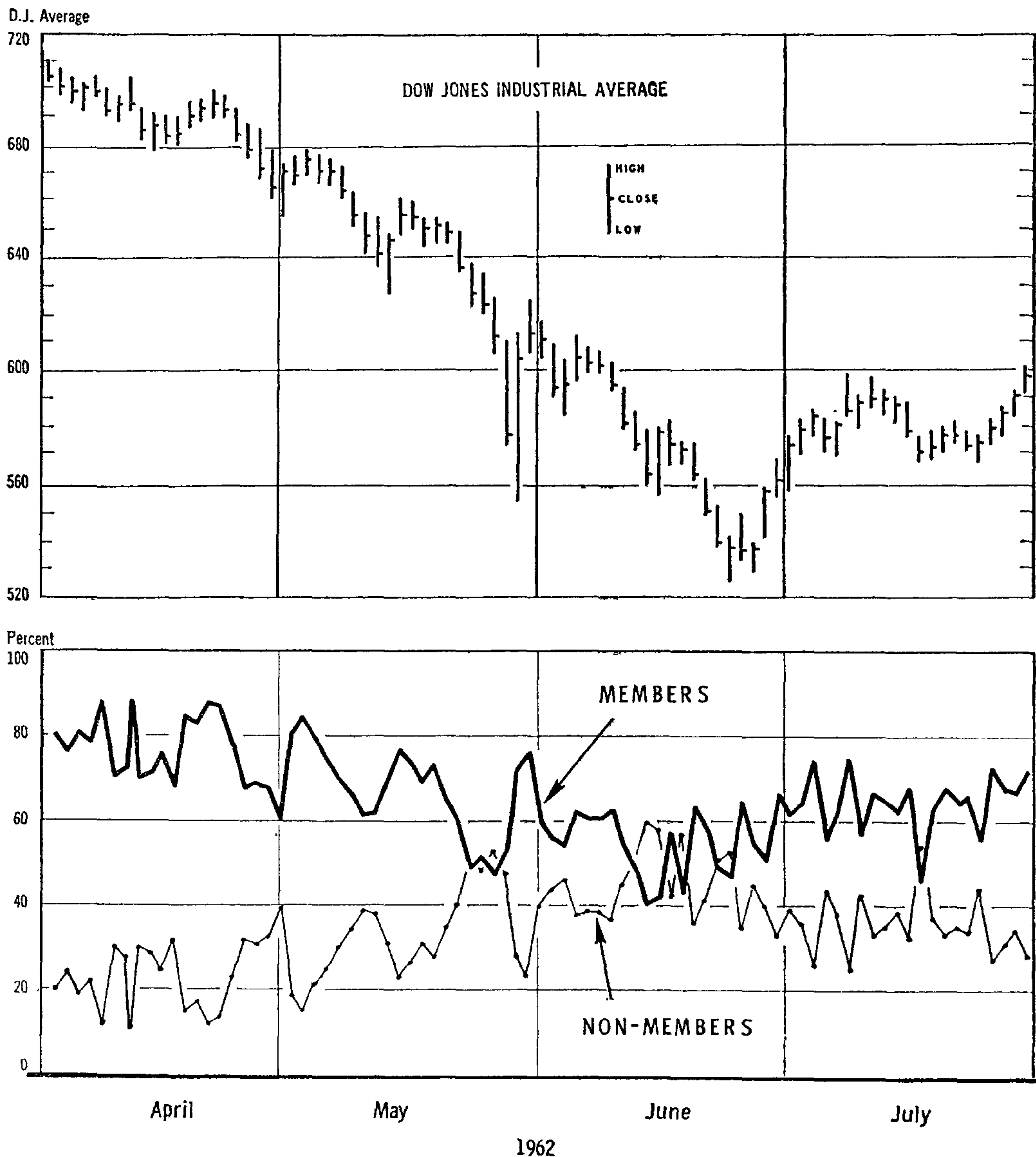
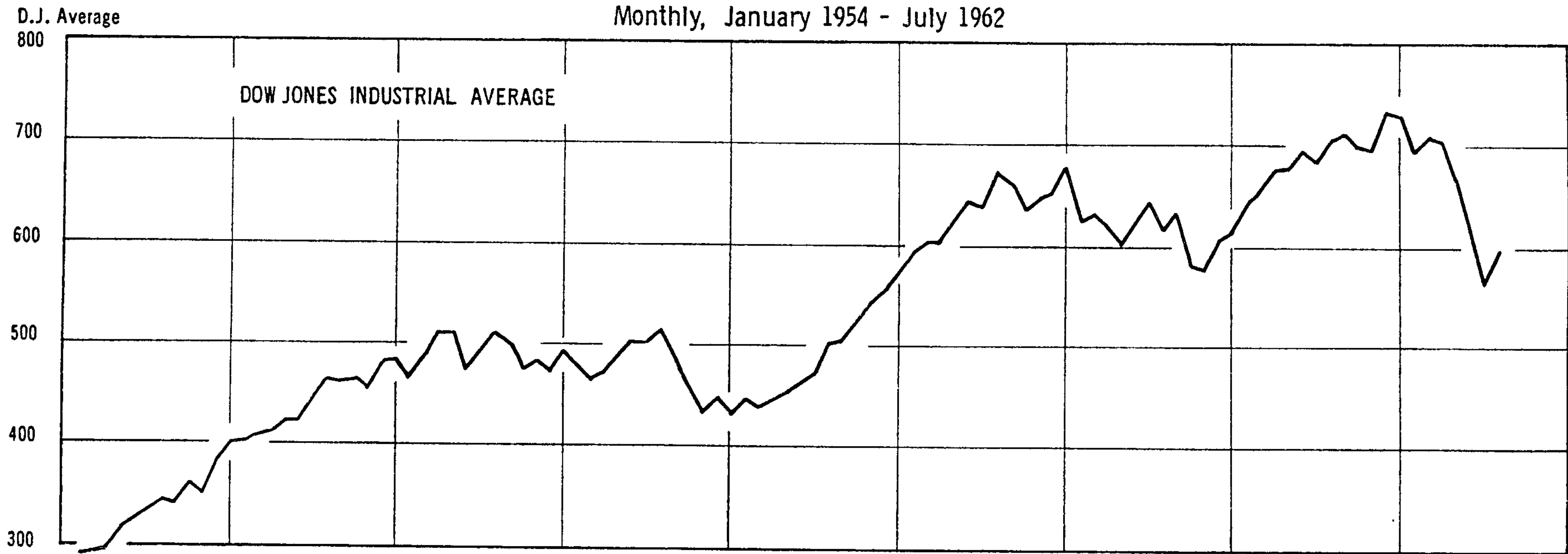
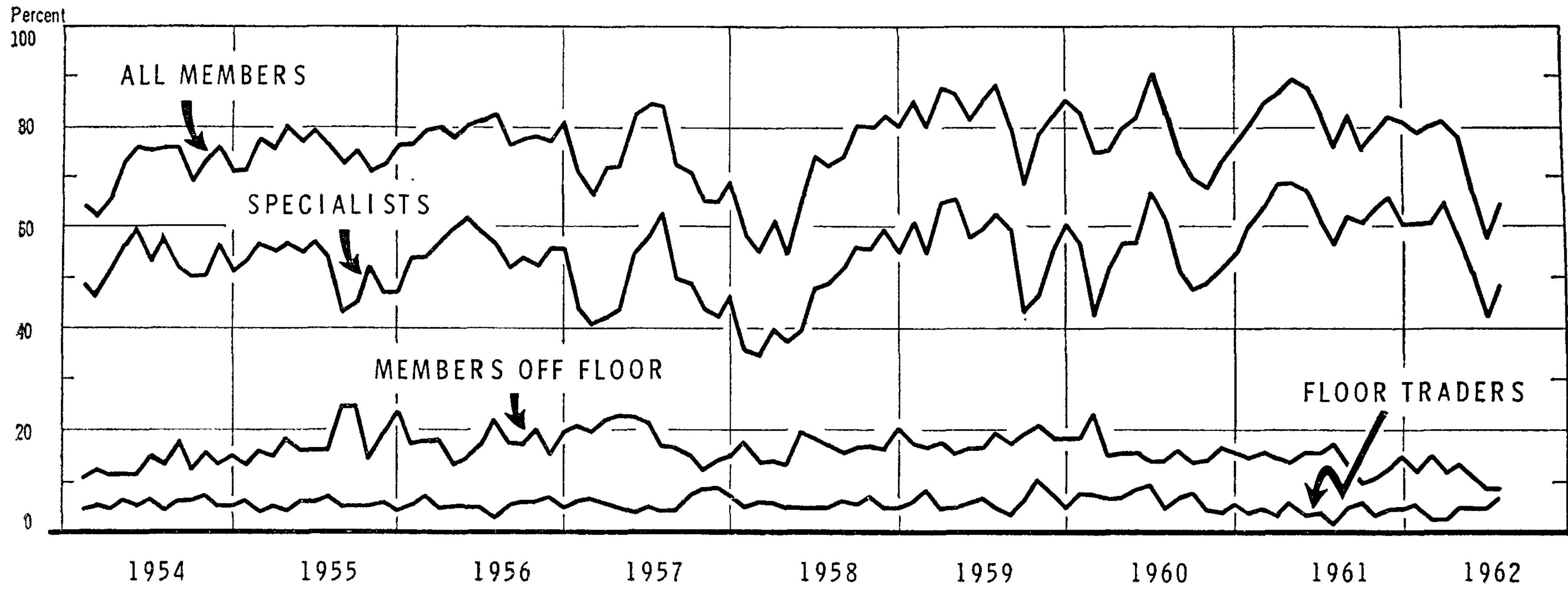


Chart VI-i

MEMBERS' SHORT SALES ON N.Y.S.E. as Percent of Total Short Sales





NOTE: Also see Table VI-81

DS-4412

(1) *Specialists*

Specialists contend that during a major upturn in prices they are called on to supply stock in increasing amounts to maintain price continuity and orderly markets; also, that during the later stages of an upturn they may, in fact, have to resort to short sales to supply the increased demand on the part of the public. It is true that near the tops of bull markets, specialists often account for 60 percent or more of all short sales. Also, chart VI–j, which shows the share volume of short sales by specialists on a daily basis from April through June 1962 indicates that specialists effected close to 900,000 shares, or about 73 percent of total short sales (practically all of members' short sales) on May 31, a day of sharply rallying prices, and close to 600,000 shares, a large portion of members' short sales, on July 10, another bouyant day. However, it appears from the testimony of a number of specialists about their attitudes during this period that their heavy short selling was at least partially the result of their bearishness.[526] Indeed, in relation to their own total activity from 1954 to 1962, specialists' short sales tend to shrink on advances and to bulk larger on market declines, showing marked rises during periods of acute price weakness (chart VI–k).

(2) *Members off the floor*

Members off the floor, as a group, account for between 10 and 25 percent of total short selling. Because the group represents such a variety of accounts, including firm accounts and partners' personal trading accounts, the group's short selling probably includes every type from the purely technical arbitrage to out-and-out speculation. There are no data, unfortunately, to indicate the amounts of each.

In terms of the percentage of their activity which is short selling, members off the floor appear no different from other short sellers. They do most of their short selling on declines, reaching their peaks (almost 25 percent of their total sales) at market lows, and, like most others, tend to decrease their selling as the market advances and to do least at (about 8 percent of their total sales) market peaks (chart VI–k).

(3) *Floor traders*

Floor traders represent the smallest member group in number of traders as well as in volume of short sales. Their short selling, which accounts for about 2 to 10 percent of total short sales and ranges predominantly between 5 and 15 percent of their own total sales, is very largely short term with covering generally taking place on the same day, often in a matter of minutes. For this reason, short selling by floor traders requires little borrowing of stock, and their short sales are seldom reflected in the short interest statistics. These aggregate figures, however, obscure the fact that individual floor traders on occasion have taken large short positions in particular stocks. Chart VI–k, on which floor traders' short sales are shown as a percentage of their total sales, indicates that they are like others' short sales but more volatile.

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[526] See pt. D.6.e(4) of this chapter.

Chart VI-J

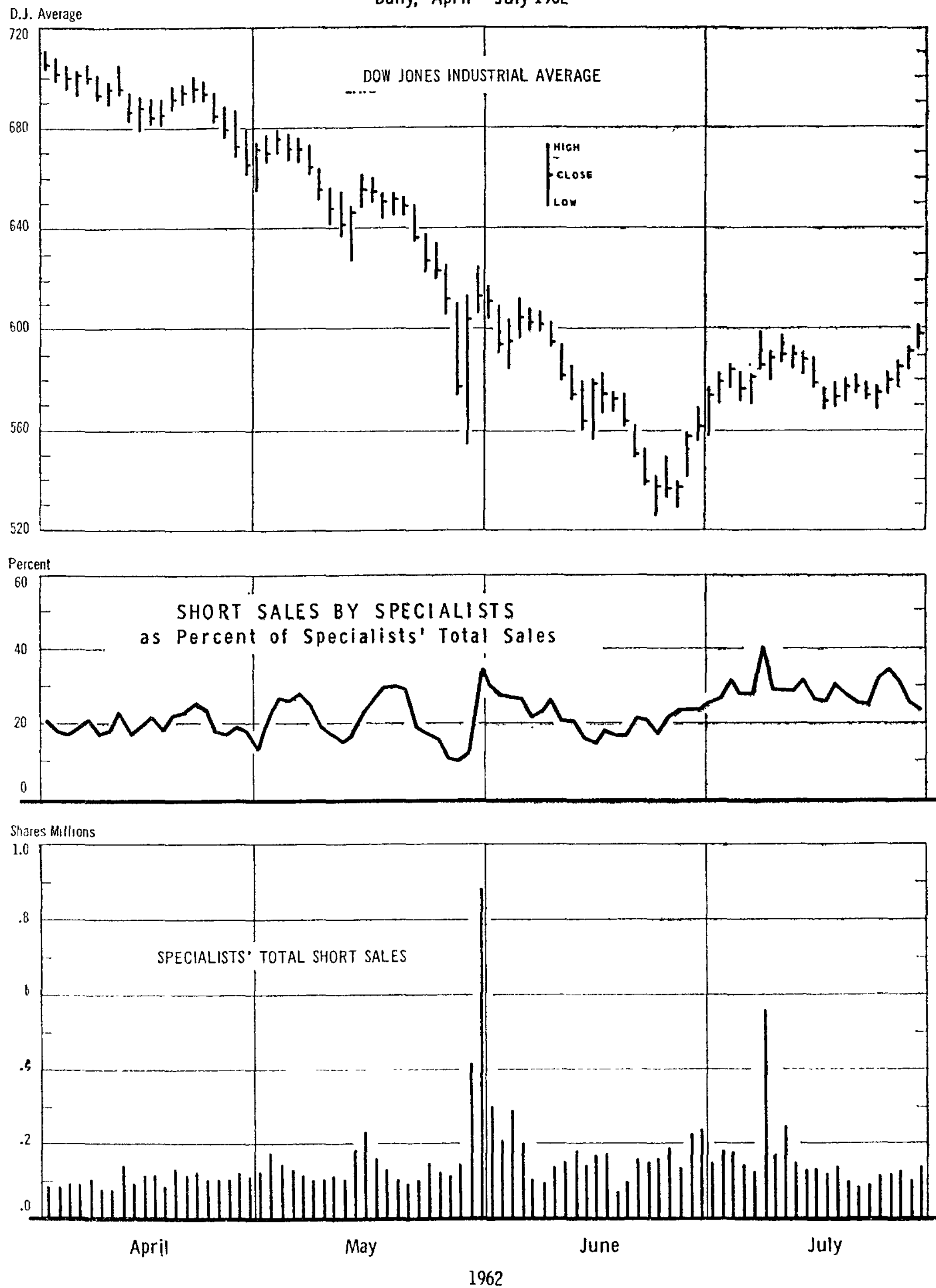
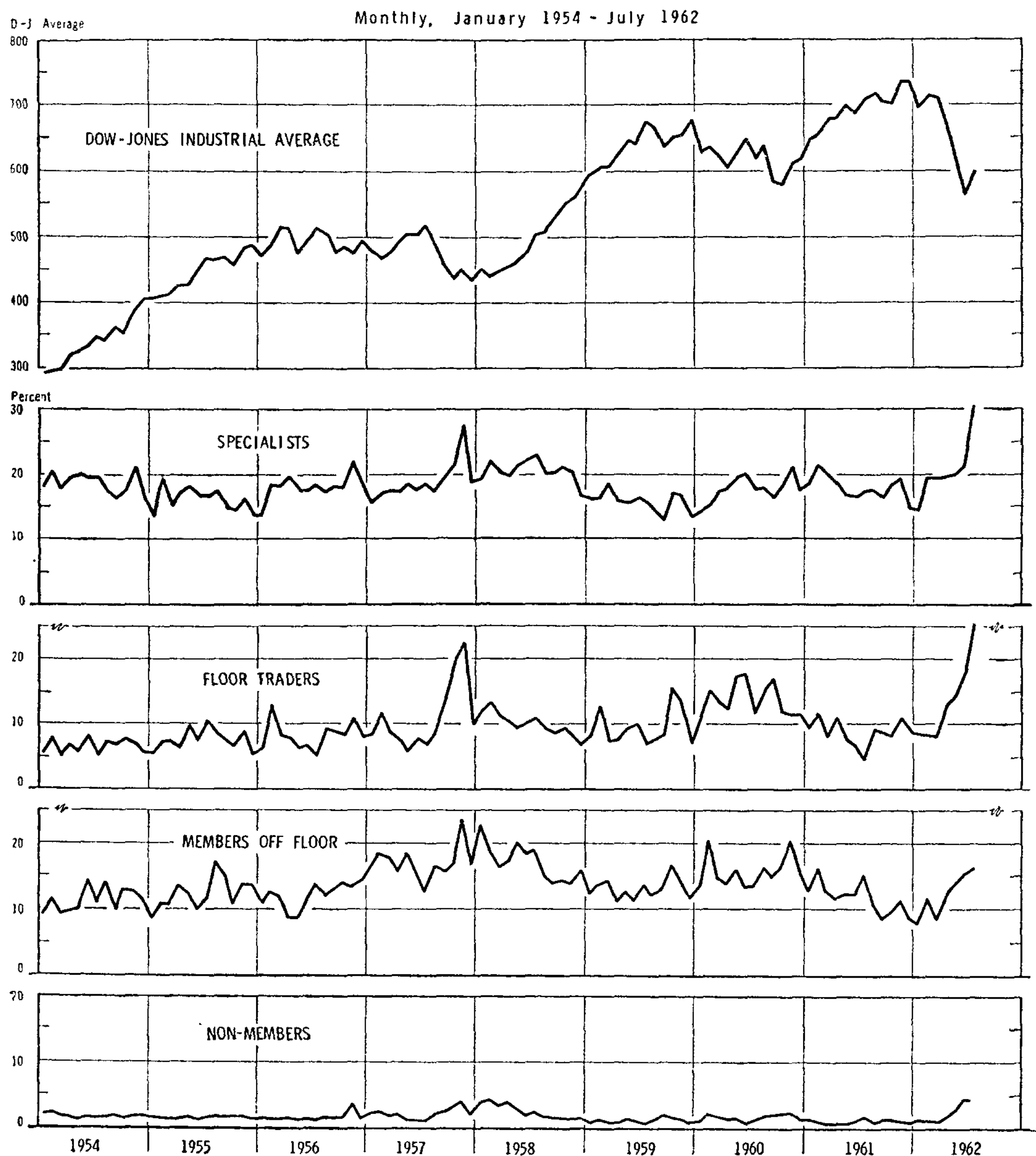


Chart VI-k

NYSE MEMBERS' AND NON-MEMBERS SHORT SALES AS A PERCENT OF THEIR OWN TOTAL SALES

Monthly, January 1954 - July 1962



NOTE: Also see Table VI-81

(4) *Odd-lot dealers*

A fourth category of members, the odd-lot dealers, have never reported their short sale volume figures, if any, since July 1944, claiming that any short sales they may have made were under the exemption provided by SEC rules.[527] However, the reports of their long or short positions in individual stocks, and the New York Stock Exchange's mid-month report on the short interest in exchange stocks,[528] reflect short positions of the odd-lot dealer firms in a number of stocks.

Short positions may be acquired by odd-lot dealers in two ways other than by a regular short sale: first, by an exempt short sale of a round lot; and second, by failing to offset their odd-lot sales to customers by purchasing stock in the round-lot market. Formerly, it was the practice of the firms to make their offsetting round-lot transactions as profitable as possible by permitting positions in individual stocks to accumulate until, in the judgment of the firm's partners, it was an opportune time to close out the position. In recent years, however, the policy of the two largest firms has apparently been to keep positions at a minimum level. The individual positions appear to be nominal in the sense that the position in a given stock may be short a few shares one month and long the next month, apparently without regard to the trend of the market. For the majority of the stocks in the monthly inventory, relatively small positions are reported, usually amounting to less than a round lot. Reports on month-end positions are limited by their nature, however, and the odd-lot firms do frequently retain, for numbers of days, positions in individual stocks which exceed 1,000 shares.[529] Major instances usually are to be noted in situations involving a "when-issued" stock, where a short position may have accumulated simply because the new stock had not yet become available for delivery.[530]

The total short interest figures for odd-lot dealers, as previously mentioned, are reported separately in the New York Stock Exchange's mid-month report and are shown in chart VI-1. For comparative purposes, the chart shows the total short interest for all accounts, other than odd-lot dealers, and the trend of the market. The chart also appears to reflect the above-mentioned change by the odd-lot dealers to a policy of smaller positions. Prior to 1957, aggregate positions often ran over 100,000 shares and exceeded 200,000 shares in the latter part of 1955, while changes averaged 40,000 per month. Since then, the aggregate positions have averaged well below 100,000 shares. Month-to-month changes also are much smaller, usually less than 20,000 shares.

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[527] Prior to that date, odd-lot dealers frequently reported short sales.
[528] See sec. 1.e(1).
[529] See pt. E.3.e of this chapter.
[530] Often when such cases involve an identical issue, an equivalent long position in the issued stock is allowed to accumulate, apparently as an offset.

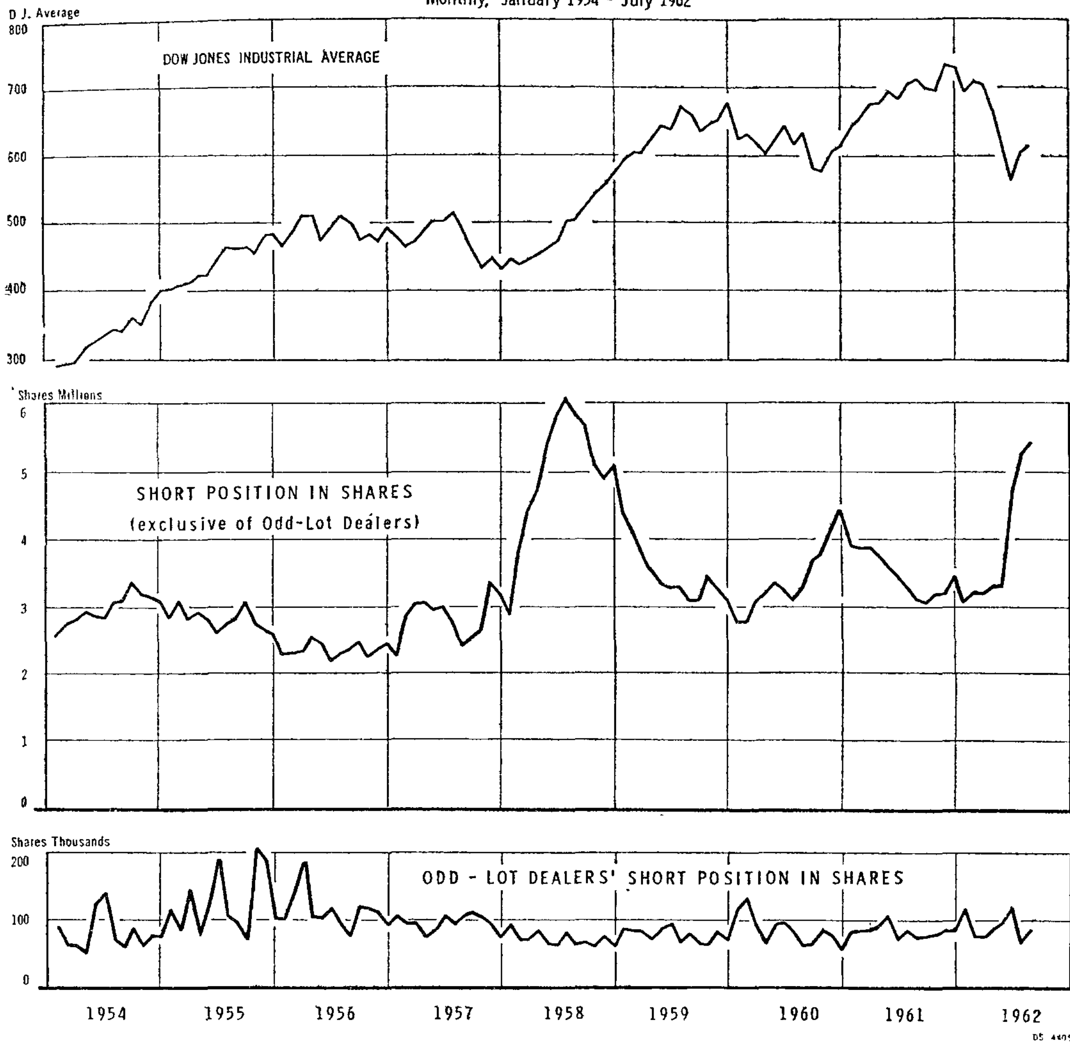
Chart VI-1
SHORT POSITION IN SHARES ON N.Y.S.E.
Monthly, January 1954 - July 1962
D J. Average
800
700
600
500
400
300
DOW JONES INDUSTRIAL AVERAGE
Shares Millions
6
5
4
3
2
1
0
SHORT POSITION IN SHARES
(exclusive of Odd-Lot Dealers)
Shares Thousands
200
100
0
ODD - LOT DEALERS' SHORT POSITION IN SHARES
1954
1955
1956
1957
1958
1959
1960
1961
1962

d. Nonmembers' short sales

(1) *The round-lot customer*

As noted previously, round-lot short selling by nonmembers customarily accounts for less than half of all short sales, but this proportion tends to increase during a sharp decline. Considering the nature of short selling itself, it is probable that nonmembers' short selling consists mostly of speculation for the decline. As indicated in the NYSE's June 1947 study of short positions [531] technical short selling, including short positions "against the box" and hedging, was only about one-quarter of total nonmember short selling.

Ordinarily, nonmembers' short selling in the aggregate is small compared with total sales by nonmembers, especially toward the end of bull markets when the ratio tends to fall below 1 percent. The ratio has risen to around 2 to 3 percent in market drops. Indeed, during the critical decline in May 1962, the ratio rose to more than 4 percent and almost to 7 percent during the further decline in June 1962.

(2) *The odd-lot customer*

Chart VI–m pictures the odd-lot short selling in total shares for each month since January 1958. The chart indicates that most of the short selling by odd-lot customers occurs during declines in the market and that peaks in such selling coincide rather closely with the lowest point of the decline. For example, the peaks in October 1959 and October 1960 both occurred at the low points of declines. Moreover, the chart throws into bold relief the relatively large amount of short selling that odd-lot customers effected during the sharp decline in May 1962. As the market dropped from 671 (DJI) on May 4 to 561 on June 29, the volume of short sales in odd lots progressed in weekly totals as follows: 40,000 shares; 46,000; 60,000; 92,000; 92,000; 112,000; 112,000; 153,000; 113,000; and 120,000. It is necessary to go back to 1938 to find comparable volume. The May–June 1962, volume figures were 4 to 8 times larger than comparable figures for the November–December 1961 period, when the market was near its peak.

The odd-lot short seller has at least one advantage over the round-lot short seller, which takes on added significance in a declining market. While both must sell on up-ticks,[532] the short seller in the round-lot market must take his turn in finding a buyer, whereas the odd-lot short sale must be taken by the dealer, no matter how many shares there may be in the aggregate at a particular price level, whenever the order(s) can be executed on the next appropriate round-lot sale. It is not surprising, therefore, that during drastic declines, as in May 1962, odd-lot short sales tend to increase in relation to short selling in general, as well as in relation to total odd-lot sales.

A comparison between odd-lot short sales and total round-lot short sales may not be too meaningful, since, as has been seen, 40 to 70 percent of all short selling is effected by specialists. Chart VI–n, there-

[531] See sec. 1.c(1), above.
[532] The restriction as to price on odd lots is by Exchange rule; the odd lot is exempt under SEC rules.

Chart VI-m

SHORT SALES BY ODD-LOT CUSTOMERS ON N.Y.S.E.

Weekly, January 1958 - July 1962