CHAPTER VII

OVER-THE-COUNTER MARKETS

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CHAPTER VII

OVER-THE-COUNTER MARKETS

A. INTRODUCTION

1. SCOPE OF CHAPTER

Transactions in securities not taking place on an exchange are referred to as over-the-counter transactions. The over-the-counter markets, unlike the exchanges, have no centralized place for trading. There are no listing requirements for issues traded and all registered broker-dealers are entitled to participate. The broker-dealers vary in size, experience, and function; the securities differ in price, quality, and activity.

The diversity and lack of organization of the over-the-counter markets have continually perplexed those seeking to study or regulate them. The framers of the Exchange Act stated that both the exchange and the over-the-counter markets were "affected with a national public interest." [1] The statute, as originally enacted, while subjecting the exchange markets to detailed regulation, granted the Commission broad powers to deal with broker-dealers and securities in the over-the-counter markets, without laying down guidelines concerning practices to be regulated or abuses to be curtailed.[2] Working first with this broad grant of power and, a few years later, with an amended statute, the Commission provided for registration of broker-dealers engaging in over-the-counter transactions, the prohibition of various fraudulent practices, and the adoption of standards for recordkeeping and financial responsibility.[3] With the passage of the Maloney Act in 1938, the principle of self-regulation was applied to the over-the-counter markets, and the NASD was formed to supervise the business conduct of over-the-counter broker-dealers.[4]

During the following years, both the Commission and the NASD made significant advances in regulating the over-the-counter markets and raising the business standards of its participants. The Commission and the NASD established broker-dealer inspection programs, adopted further rules prohibiting fraudulent and unethical practices, and developed higher standards through administrative and disciplinary proceedings and litigation.[5] Nevertheless, regulation of the

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[1] Exchange Act, sec. 2.

[2] Sec. 15 of the Exchange Act, as originally enacted, authorized the Commission by rules and regulations to register over-the-counter broker-dealers and "securities for which they make or create markets." See ch. IX pp. 5–6 (pt. 3) for a further discussion of this provision and present sec. 15(d).

[3] See secs. 15(a), 15(b), and 15(c) of the Exchange Act, and rules 15c1–1 to 9, rules 15c2–1 to 5, rule 15c3–1 and rules 17a–3 to 5. The 10th Annual Report (1945) of the Commission contains a summary of the history of regulation of the over-the-counter markets during the early years of the Commission.

[4] See the discussion of the background of the NASD in ch. XII. It is interesting to note that the original draft of the Maloney Act gave the Commission power to alter or supplement NASD rules relating to, among other things, "the collection, recording, and dissemination of information relating to the over-the-counter markets." The provision was later deleted from the bill.

[5] For a discussion of some of these regulatory actions, see pts. C and D, below.

over-the-counter markets continues to be considerably less pervasive and less exacting than in the case of the major exchanges.

The comparative lag in regulation may have been due partly to lack of information. Whereas there is a continuous flow of information about market and trading activities in the exchange markets, comparable information concerning the over-the-counter markets is not available. At any given time, unless a special investigation is undertaken, neither the number of broker-dealers participating in the over-the-counter markets, the number and type of issues traded in these markets, the aggregate volume of trading in such issues, nor the size, price or timing of individual transactions is known.

There is also a lack of information about the issuers of securities traded in the over-the-counter markets. Since most over-the-counter issuers are not subject to the reporting provisions of the Exchange Act, the Commission and the NASD, as well as the investing public, often have no source of continuing information concerning their operation.[6]

At the time of the hearings on the legislation authorizing the Commission to make the Special Study, the absence of data concerning the over-the-counter markets was described by the Chairman of the Commission as a "fundamental problem," and one of the primary tasks of the study was stated to be the gathering of "important information concerning the actual operation of the over-the-counter market and the adequacy of the rules governing trading in that market."[7] The difficulty of assembling this information concerning over-the-counter trading and the vastness of the area to be covered compelled the Special Study to limit the scope of its inquiry to the over-the-counter markets for corporate equity securities.[8]

Part B of this chapter provides a survey of the over-the-counter markets, including the broker-dealer firms that participate in over-the-counter trading and the securities that are traded. This statistical overview includes a considerable amount of data that have not previously been assembled and tabulated, and which are set forth in greater detail in appendix VII–A. Part B also includes a brief description of the mechanics of over-the-counter trading.

The functions and structures of the interdealer (or wholesale) and the public (or retail) markets, the interaction between them, the manner in which trading is effected in each, and their quotation systems and other methods for communicating trading interest are more fully described in parts C and D, respectively.

The over-the-counter markets are unlikely to escape the impact of current technological developments affecting the collection, processing, and dissemination of information. Part E discusses the need for accurate and current information concerning transactions and activities in the over-the-counter markets and explores the potential effects of

[6] See ch. IX.B.

[7] Hearings on H.R. Res. 438 (1961) before a subcommittee of the House Committee on Interstate and Foreign Commerce, 87th Cong., 1st sess., p. 6 (1961).

[8] The market for Federal, State, and municipal issues historically has not occupied the attention of the Commission primarily because of specific statutory exemptions from the Federal securities laws Such issues are exempt from the registration provisions of the Securities Act but not from its antifraud provisions. The Exchange Act exempts these issues from all of its provisions except the antifraud provisions of secs. 10(b) and 15(c)(1). The over-the-counter market for Federal Government obligations was the subject of recent studies by other Government agencies. See "Treasury-Federal Reserve Study of the Government Securities Market" (1959); "A Study of the Dealer Market for Federal Government Securities," Congressional Joint Economic Committee, 86th Cong., 2d sess. (1960).

automation upon quotation systems and the compilation of data concerning over-the-counter transactions. Finally, part F sets forth conclusions and recommendations and relates certain of the recommendations in this chapter to other recommedations of this report.

In considering the discussion in this chapter of over-the-counter trading practices it must be borne in mind that much of the data has never been available before and that some of the areas covered have never been studied in the context of a total integrated view of the over-the-counter markets. Moreover, the very diffuseness and heterogeneity of the over-the-counter markets described below necessarily complicate the task of arriving at generalizations about these markets and devising remedial measures to deal with the varieties of securities, broker-dealers, and practices. The study has, however, attempted to draw generalizations where they appeared justified by the evidence and to make distinctions where this appeared necessary in devising solutions. As already emphasized in chapter I of this report, the specific conclusions and recommendations of the study have not been presented to any private person or group for comment.

It is believed that the data and discussion in this chapter will improve professional and public understanding of the over-the-counter markets and that the recommendations will provide increased protection for investors. The emphasis on problem areas in this chapter should not, however, obscure the vitality and strength of the over-the-counter markets in many securities and the importance of these markets to the economy.

2. METHODS OF STUDY

Much of the data for this study of the over-the-counter markets was compiled by the use of questionnaires. In March 1962, questionnaire OTC–3 was sent to all broker-dealers registered with the Commission on February 28, 1962.[9] This questionnaire was designed to elicit information on the volume of trading in equity securities in the over-the-counter markets in 1949, 1955, and 1961;[10] major activities of firms in the over-the-counter markets; and industry practices with respect to quotations and making markets. The firms were also asked to give the number and dollar volume of shares traded over the counter on January 18, 1962, which was believed to be a typical trading day.[11] Aggregate transactions were broken down into those: on a principal and agency basis; with other dealers, individuals, and others, pri-

[9] See app. VII–B. Questionnaire OTC–3 was not sent to broker-dealers who were in business in 1961 but whose registrations were canceled, revoked, or withdrawn prior to March 1962. If these firms had successors, their over-the-counter volume for 1961 and for prior years was reported by the successor firm. Where there were no successors, the data are missing. However, it seems likely that, with very few exceptions, the only broker-dealers who did not have successors were small firms. Also excluded from the survey were broker-dealer firms not required to register with the Commission. The only such broker-dealers who participated in over-the-counter trading of equity securities are firms conducting a solely intrastate business. See sec. 15(a) of the Exchange Act.

[10] Sales occurring in the course of syndicated offerings and sales of open-end investment company shares were excluded. Generally, the over-the-counter markets covered by questionnaire OTC–3 parallel the exchange markets, i.e., markets in which purchases and sales of outstanding securities occur.

[11] Jan. 18, 1962, was typical of market activity during the first 4 months of 1962. Volume on the New York Stock Exchange was 3,460,000 shares, somewhat below the average daily volume in 1961. The Dow-Jones Industrial Average on Jan. 18, 1962, drifted downward from a close of 697.41 on the previous day to a low of 693.48 at 1:00 p.m. It then recovered and closed at 696.03, off 1.38 points or 0.20 percent for the day. The National Quotation Bureau Over-the-Counter Industrial Average of 35 issues, on the basis of prices at noon, declined from 138.73 on Jan. 17, to 138.08 on Jan. 18, a decrease of 0.47 percent. On Jan. 19, the National Quotation Bureau average rose slightly to 138.61.

marily institutions; and in over-the-counter and exchange stocks. In addition, each firm was asked to report the details of every over-the-counter purchase and sale of 200 stocks on January 18, 1962. For some of the less actively traded of these stocks, transactions for 16 additional days were also requested.

The 200 stocks used in questionnaire OTC-3 were selected in the following manner: for the more active stocks (schedule I of questionnaire OTC-3), every 200th dealer inserting a listing in the National Daily Quotation Service (the "sheets") on January 18, 1962, was marked and the stock quoted was selected. It was assumed (and later proved to be true) that the number of dealers listed in the sheets in any particular stock tends to vary directly with the volume of trading in that stock. By counting the dealer listings rather than the stock listings it was more likely that a greater proportion of active stocks would be chosen. In addition, from the stocks thus selected, all those which had fewer than four dealer listings and all issues which sold for less than $1 were eliminated. A total of 110 stocks remained. Five additional issues were selected from the National Quotation Bureau's average of 35 industrial stocks.[12] This average, similar to the Dow Jones average, contains a diversified selection of the largest, most broadly held companies whose securities are traded exclusively in the over-the-counter markets.

For the less actively traded stocks a second list (schedule II of questionnaire OTC-3) was compiled containing issues with fewer than four dealers appearing in the sheets. About half of the stocks appearing in the sheets have fewer than 4 dealer listings, and a representative group was obtained by selecting every 50th such stock, resulting in a list of 85 stocks.[13] Dealers were asked to report their transactions from January 18 through February 9, 1962, to obtain an adequate picture of trading in these issues.

The 200 stocks selected in the above manner are identified in appendix VII-B. The selection included 3 stocks listed on the New York Stock Exchange, about a dozen preferred stocks, and issues of several foreign companies. The amount of dealer interest, as indicated by insertions in the sheets, ranged from 1 to more than 20 listings. Among the issuers were banks, insurance companies, utilities and railroads, as well as a large number of industrial companies.[14]

Of the 5,785 broker-dealers who were sent questionnaire OTC-3, 5,605 replied. These included all broker-dealers with any sizable over-the-counter business. More than half of those who failed to respond apparently had gone out of business, leaving no forwarding address; and 40 others were foreign firms conducting a minimum amount of business in the United States. Of the 5,605 replies received, 241 were from new firms not yet operative and 400 were from older firms which were inactive at the time of their reply and had been inactive through-

[12] Three other stocks in the National Quotation Bureau average were among those included in the selection of the 110 issues.

[13] The three sections of the National Daily Quotation Service were checked to ascertain that a selected stock did not have more than three dealer listings in another section. Four stocks with more than three dealer listings were inadvertently chosen.

[14] As a group, the 200 stocks were more active and higher priced on the average than all stocks traded over the counter on Jan. 18, 1962. Of the 200 stocks, 135 were traded on Jan. 18, 1962, of which 103 were schedule I stocks. Purchases and sales in these 135 stocks accounted for 5 percent of the number of shares and 7 percent of the dollar amount of all purchases and sales in the over-the-counter markets on that day. Of the 85 stocks in schedule II, 62 were traded during the 17-day period from Jan. 18 through Feb. 9.

out 1961. The results of a tabulation of the replies of the remaining 4,964 active broker-dealers provide the basis for the statistical materials presented in this chapter.

In a number of instances in this chapter, statistical analyses are based upon varying smaller samples derived from the full 200-stock sample. It was necessary to use these smaller samples because the number of stocks showing characteristics or types of transactions relevant to the discussion in different parts of the chapter did not cover the full sample. With few exceptions, relied upon primarily for illustrative purposes, the smaller samples included all the stocks with the characteristics or types of transactions under discussion. In a number of other instances in this chapter, trading on January 18, 1962, in particular securities derived from the 200-stock sample is described. It is recognized that although January 18, 1962, was probably a typical day in the over-the-counter markets as a whole, it was not necessarily a typical day for each individual security.

In July 1962, in order to study the over-the-counter markets in the market break of May, questionnaire OTC–5 [15] was sent to approximately 180 broker-dealers who had transactions or made markets in 40 of the 200 stocks covered by questionnaire OTC–3. The questionnaire sought trading data and related information for certain additional dates, prior to and during the market break. These broker-dealer firms were asked to state their inventory position on specified days during the period from January 19 through June 1, 1962, and to supply copies of market letters, research bulletins, reports, analyses, and investment advisory recommendations which they distributed concerning the 40 stocks. In addition, this followup questionnaire requested, for certain stocks among the 40,[16] trading data for the period January 19 through January 26, 1962.

Information on issuers was obtained through the use of questionnaire OTC–4, which was sent in April 1962 to approximately 1,800 companies selected at random, whose stocks were traded solely over the counter,[17] and in addition, almost all of the 200 issuers represented in questionnaire OTC–3. Information was requested about the companies' size, shareholders, shares outstanding, and stock transfers and other matters. The method of selecting the sample and a further analysis of the replies to questionnaire OTC–4 appear in chapter IX.

In addition to material derived from the questionnaires described above, this chapter also makes use of data accumulated through other inquiries made by the study. For example, questionnaires OTC–1 and OTC–2 and the private hearings concerning new issues described in part B of chapter IV provided information on over-the-counter trading of new issues and the role of the managing underwriter in the after-market.[18] Questionnaire IN–4 threw light on the methods by which institutions acquire and dispose of large blocks of securities in the over-the-counter markets.[19]

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[15] See app. VII–C.

[16] The January data were requested for those stocks which were originally in schedule I of questionnaire OTC–3. The January data for the schedule II stocks had already been furnished in replies to that questionnaire.

[17] See app. IX–A.

[18] See apps. B and D of ch. IV, pp. 688–712, 718–729 (pt. 1).

[19] See app. VIII–A.

This study of the over-the-counter markets is based also upon interviews and private hearings with officials of the NASD, officers of the National Quotation Bureau, broker-dealers active in the over-the-counter markets and persons affiliated with various electronics companies manufacturing devices for these markets. Finally, the Special Study has made use of materials supplied by the NASD and the National Quotation Bureau and information in the files of the Commission, including correspondence, reports of investigation, records of administrative proceedings, and memorandums of interviews.

B. The Over-the-Counter Markets—An Overview

The over-the-counter markets are markets both for the distribution of securities and for the trading of outstanding securities. Through the over-the-counter markets, corporations obtain funds vital to their own growth and the growth of the economy, and large blocks of securities are efficiently transferred from large shareholders to smaller investors; this distribution function of over-the-counter markets is considered in chapter IV. Over-the-counter markets also serve as the sole or primary trading markets for thousands of outstanding securities—the function which is the subject matter of the present chapter.

The purpose of this part B is to provide a brief overview of the over-the-counter markets as trading markets, emphasizing two of their most important characteristics—their diffuseness and heterogeneity. Appendix VII–A is a compilation and analysis of statistical data concerning the over-the-counter markets and their components, based on the responses to the study's questionnaires. Only the highlights of the appendix are summarized in the text.

1. Volume of Trading in the Over-the-Counter Markets

The volume of over-the-counter trading has grown dramatically in the past few years.[20] Over-the-counter sales of outstanding stocks, excluding sales of mutual fund shares and syndicated distributions, by dealers and by the public amounted to an estimated $4.9 billion in 1949 while during 1961 such sales amounted to 2.5 billion shares valued at $38.9 billion. In 1961 2 billion shares valued at $63.8 billion were sold on all securities exchanges. The following table shows the growth in the volume of over-the-counter and exchange sales since 1929:

[20] The most comprehensive and complete data assembled by the Special Study are for the year 1961 and certain prior years. It is known that volume diminished significantly in 1962 but comprehensive data are not available.

TABLE VII-a.—*Estimated over-the-counter and exchange sales of outstanding corporate stocks for selected years (1929–61)*

[Dollars in billions]

	Over-the-counter sales	Sales on all exchanges	Over-the-counter sales as percent of exchange sales
1929	$22.0	$135.0	16
1935	2.1	15.4	14
1937	5.6	21.0	27
1939	3.4	11.4	30
1946	10.5	18.7	56
1948	6.7	12.9	52
1949	4.9	10.7	46
1955	14.2	37.9	37
1961	38.9	63.8	61

Source: 1929–48 data from Friend, Hoffman & Winn, "The Over-the-Counter Securities Markets," p. 109 (1958); 1949–61 data derived from questionnaire OTC-3.

While the absolute and relative growth of over-the-counter markets is clear, it is necessary to express the caveat that sales figures for exchanges and over-the-counter markets are not strictly comparable since a single transaction between a public buyer and seller is likely to involve more "sales" (because of greater dealer participation) in the latter case than in the former.

For some individual firms the pattern of growth in over-the-counter sales has been even more impressive. Several broker-dealers, including some of the larger ones, increased their volume of over-the-counter sales by more than 20 times between 1949 and 1961. For example, one broker-dealer reported sales of $17 million in 1949 and $510 million in 1961; another, $12 million in 1949 and $327 million in 1961; a third firm, $8 million in 1949 and $220 million in 1961.

Growth in the volume of trading in large measure reflects an increase in the number of issues traded—in turn partly attributable to the large number of companies making first public offerings of their securities, particularly during the years 1959–61—and such growth has been accompanied by a significant increase in the number of participating broker-dealers and their salesmen. Growth in all these respects has outpaced the ability of the regulatory agencies to obtain information about over-the-counter markets and their components and made it difficult to devise solutions for new problems created by such growth.[21]

2. DIVERSITY OF ISSUES TRADED IN THE OVER-THE-COUNTER MARKETS

Securities traded over the counter are quite diverse in kind, price, quality, and activity, reflecting the free entry of securities into the over-the-counter markets.[22] These securities include most Federal, State and municipal securities; almost all bank and insurance company stocks; industrial and utility issues ranging from those of large, established enterprises to new and unseasoned ones; and, in a rather

[21] For a discussion of the growth of the securities industry generally, see ch. I.B.
[22] See app. VII-A, table a.

special sense, all mutual fund shares. In addition, there is an active over-the-counter market in exchange-listed securities.[23]

During a sample 10-month period in 1961–62, it was found that broker-dealers advertised markets in approximately 14,000 domestic over-the-counter stocks and for a shorter period in 3,340 United States, other Government and corporate bond issues. At the end of 1961, 3,041 stock issues and 1,284 bond issues were admitted to trading on all exchanges—a number considerably smaller than the number of over-the-counter issues in which there was apparent trading interest. However, many issues available for trading in the over-the-counter markets are traded infrequently.[24]

Issues traded over the counter vary considerably in dealer interest. At a given time some issues have as many as 20 to 30 broker-dealers quoting active markets while many others have only 1 or 2 broker-dealers indicating a trading interest. The trading interest of broker-dealers in a security may be transitory. Broker-dealers may commence or discontinue trading for any reason whatsoever, and issues that attract trading interest at one period of time attract none at another.

3. DIVERSITY OF BROKER-DEALER PARTICIPANTS

Just as there is an unlimited right of entry of securities into the over-the-counter markets, there is also virtually free access of persons into the over-the-counter securities business.[25] In February 1962, there were about 5,000 active broker-dealers registered with the Commission. Of these, 3,303 participated in over-the-counter transactions in equity issues in 1961. By comparison, approximately 1,200 member firms participated in trading on the Nation's securities exchanges.

Broker-dealer participants in the over-the-counter markets exhibited vast differences in size, experience, and type of activity. Firms range in size from the large retail firm with a network of branch offices to the sole proprietor principally engaged in distributing mutual fund shares or merchandising a single underwritten issue. The reported over-the-counter sales of stocks by any one broker-dealer during 1961 ranged from less than $50,000 to over $2 billion.

There is a high concentration of over-the-counter business within a few large firms. Fifty-six broker-dealers, or less than 2 percent of the total number, accounted for half the dollar volume of over-the-counter sales reported by broker-dealers for their own accounts or the accounts of others in 1961. The concentration of over-the-counter sales in 1961 is shown graphically in chart VII-a. NYSE member firms were responsible for 47 percent of the number of shares sold and 55 percent of the dollar volume of over-the-counter sales during 1961. Of 67 broker-dealers with over-the-counter sales of $100 million or more in 1961, 43 were NYSE members.

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[23] See the discussion of the over-the-counter markets for listed securities in ch. VIII.D.

[24] Of the 200 stocks sampled in questionnaire OTC–3, 65 were not traded on Jan. 18, 1962. See app. VII–A, table 3, for a comparison of the volume of trading of the 135 stocks which were traded on that day. See also pt. C.2.a, below.

[25] See ch. II.

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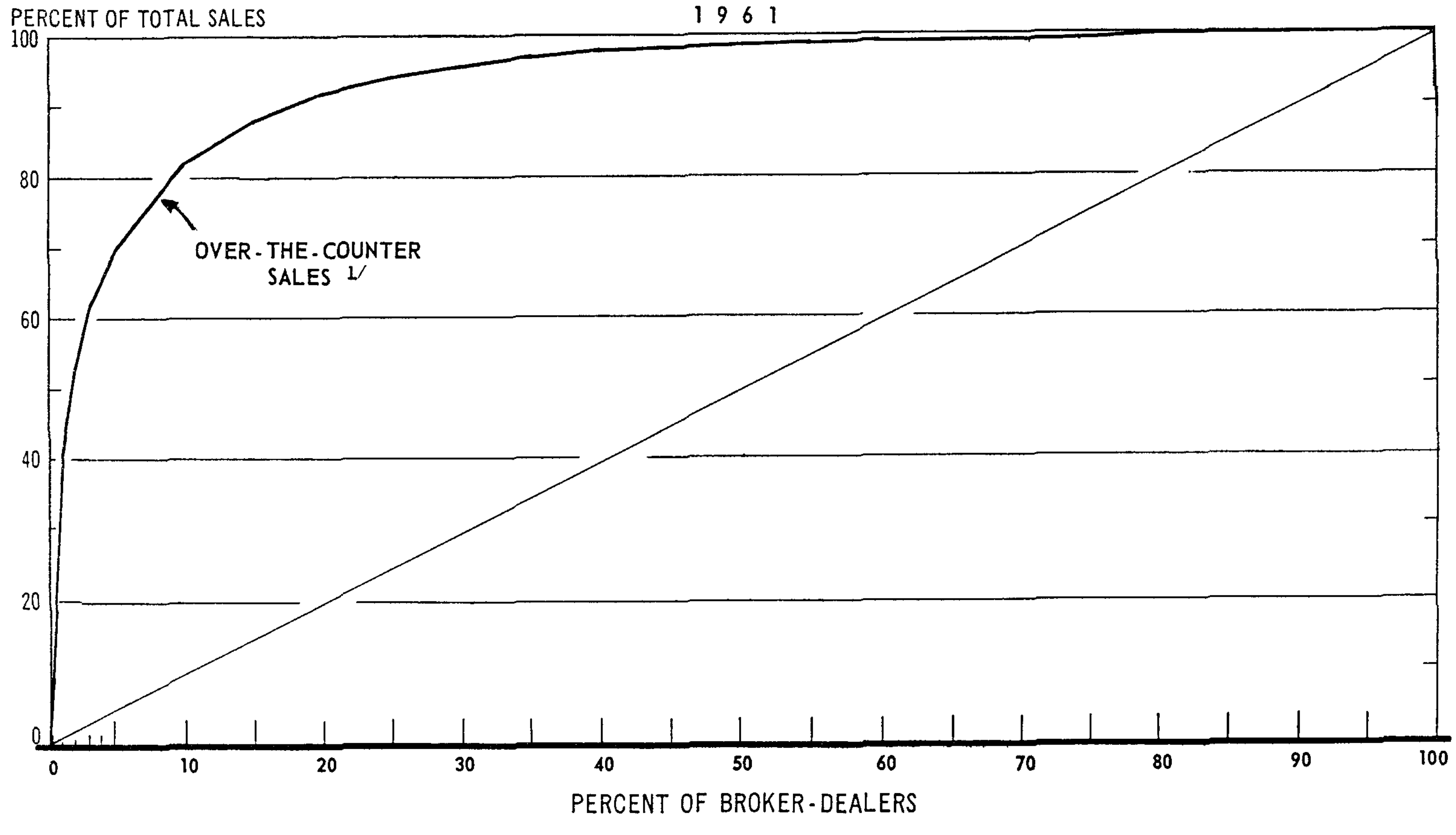
Chart VII-a

CONCENTRATION OF OVER-THE-COUNTER SALES BY REGISTERED BROKER-DEALERS

1961



1/ *Value of reported sales over the counter by 3,186 broker-dealers registered with the SEC.*

Firms engaging in over-the-counter business show wide differences in professional experience and capital commitment. Some older firms have years of experience in over-the-counter trading while many of the newer firms are managed by persons totally unacquainted with the intricacies of the over-the-counter markets. In chapter II, the study analyzed the prior experience of the principals—proprietors, partners, officers, and large stockholders—of new broker-dealer firms registering with the Commission during a period in 1961. Almost 28 percent of the firms whose applications were examined included no experienced persons among their principals and more than half of the firms had no principals with 2 years' experience or more.[26]

As described below, professional activity in the over-the-counter markets breaks down into two general categories—wholesale and retail. The wholesale dealer "makes markets" by standing ready to buy or sell securities for his own account from or to professionals who act for themselves or for the public. The retail firm, on the other hand, is engaged in selling securities to public customers and buying or finding buyers when its customers wish to sell. Some of the most important firms—called "integrated firms"—combine wholesale and retail activities in varying degrees.

In early 1962, there were about 1,100 broker-dealer firms who "made markets" in over-the-counter securities.[27] These firms ranged from sole proprietorships making markets in only 1 or 2 stocks to a few large firms making markets in 200 or more (table VII–1). Almost 40 percent of the dealer firms made markets in five or fewer stocks. Some firms making markets were primarily wholesale dealers who sold principally to other broker-dealers and institutional investors, while others were integrated firms who made markets in order to service their customers. By way of contrast there were 110 specialist units on the NYSE, each registered in an average of 12 common stocks.[28]

Wholesale over-the-counter activity is concentrated in a relatively small number of firms, mostly located in New York City. On January 18, 1962, 25 market makers, 17 of which are located in New York, accounted for $33.5 million, or approximately 50 percent of the total volume of trading by all wholesalers with other dealers (table VII–2). Eight of these largest wholesale dealers have just a nominal retail business, and only 11 are members of the NYSE, 2 of which are among the top 10. Interdealer trading is the primary activity of 14 of the 25 largest wholesale firms, NYSE commission business is the primary activity of 8 firms, over-the-counter retail business is the primary activity of 2 firms, and underwriting is the primary activity of the remaining firm.

A much larger number of firms participated in retail activity in the over-the-counter markets. On January 18, the public effected over-the-counter transactions with or through 1,839 registered broker-dealers out of the total of 2,051 firms having over-the-counter trans-

[26] See the discussion of qualifications for entry of persons into the securities business in ch. II and the discussion of the prior experience of managing underwriters of new issues in ch. IV.B.

[27] In late 1962, the National Quotation Bureau indicated to the study that about 1,300 dealers had the right to enter wholesale quotations indicating their interest in buying or selling particular securities. However, some firms inserting quotations may not be making a market in a security. For example, a listing may be an entry for a correspondent firm in another city or it may represent a bid or offer by the dealer to fill a customer's order. See pt. C.3, below.

[28] See ch. VI.D.4.

actions in corporate stocks on that day. Approximately half of the public transactions were made with or through 4 percent of these firms. Eight broker-dealers, accounting for 21 percent of the value of all public trading over the counter in corporate stocks, had over $1 million in over-the-counter transactions with the public on the sample day. Five of the firms were primarily NYSE commission houses and three were primarily wholesale over-the-counter houses having a large institutional business, one of which specialized in exchange stocks.

4. DIVERSITY OF ISSUERS

The issuers of corporate stocks traded over the counter vary considerably in asset size, number of shareholders, and shares outstanding. There are substantial numbers of over-the-counter companies that cannot be distinguished from companies with securities listed on exchanges.[29] Many others, however, are small companies, often speculative ventures in the promotional stage which have recently obtained public financing.[30]

In a study of a sample of 1,618 companies whose securities were traded exclusively over the counter at the end of 1961,[31] it was found that 31 percent had assets of $10 million or over, 47 percent had $5 million or over, and 77 percent had $1 million or over. (The NYSE requires a minimum of $10 million of net tangible assets while the Amex requires at least $1 million.) Only 13 percent had less than $500,000 in assets.

Approximately half of the companies in the sample had 500 or more shareholders, and 16 percent had 2,000 or more. (Under the listing requirements of the NYSE, an issuer must have at least 1,500 shareholders after making adjustments for small holdings; the Amex requires 750 shareholders.) Seventeen percent of the issuers had fewer than 100 stockholders. Generally, banks had fewer shareholders and insurance companies more shareholders than the average.

Approximately one-half of the issuers in the sample had less than 200,000 shares of their principal issue outstanding. (The NYSE requires a minimum of 500,000 shares outstanding to qualify for listing while the Amex requires 200,000 shares.) Approximately 20 percent had stocks outstanding with a total market value of $10 million or over and 60 percent had stock worth $1 million or over. (Under the listing requirements of the NYSE an issuer must have outstanding common stock of a minimum market value of $10 million. The Amex requires a minimum market value of $2 million.) At the other end of the scale, the stock of 15 percent of the companies was valued at under $250,000 and that of 25 percent was under $500,000. Banks were not significantly different from the group as a whole; but 39 percent of the insurance companies had outstanding stock with a market value of $10 million or over, and only 3 percent had stock worth less than $500,000.

Slightly over 50 percent of the securities in the sample were priced at less than $20 per share. The median price of the issues was $19 compared to a median price of $35 per share at the end of 1961 for stocks traded on the NYSE.[32]

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[29] See the discussion of the distribution of stocks among markets in ch. VIII.B.
[30] See ch. IV.B.4.
[31] These issuers consisted of 1,164 industrial, utility, and other companies, 358 banks and 96 insurance companies. See app. VII–A.4.
[32] See ch. VI.A.

5. MARKET MECHANISMS

The diffuseness of the over-the-counter markets—their lack of formal organization and a centralized marketplace—combined with their heterogeneity—the variety of securities traded and participating broker-dealers—have resulted in flexible and varied market mechanisms. In general, over-the-counter trading tends to be governed by informal codes of conduct and practices evolving out of the workings of the markets themselves—in contrast with the major exchange markets where trading is carried on in a marketplace during fixed trading hours by members subject to detailed trading rules.[33]

In many over-the-counter transactions, it is likely that the customer has been solicited by a salesman of a broker-dealer to stimulate his interest in the security. The absence of a tape to report and publicize transactions in over-the-counter securities and the fact that such securities are generally less widely known and distributed than exchange securities tends to increase the likelihood that the firm will employ a selling effort. The varied merchandising aspects of the securities business which are of particular importance in over-the-counter transactions have been discussed in chapter III of this report.

In executing over-the-counter transactions a firm may act either as principal or as agent for a public customer. If the firm owns the securities that the customer wishes to buy, it may sell them from its own account at a "net" price. The confirmation which the customer receives does not disclose the cost of the security to the firm or the prevailing interdealer market for the security.[34]

If the broker-dealer firm does not own the security at the time of a customer's inquiry, it may buy the security from another broker-dealer (a wholesale dealer), place the security in its own account, and immediately resell it to the customer on a principal basis. Again, the difference between the firm's cost (the price paid to the wholesale dealer) and the net price to the customer, known as the "markup,"[35] is not disclosed to the customer.

Alternatively, the transaction may be consummated on an agency basis. In this event, the customer's firm buys the security from the wholesale dealer on behalf of its customer, without placing the security in its own account. It charges a commission which is disclosed to the customer in his confirmation.[36] If the customer's broker-dealer uses the services of another firm to communicate with the wholesale dealer or to "shop around," this second firm may also charge a fee for this service in which case it is said to be "interpositioned." Although this fee may be passed on to the customer, it is not disclosed.[37]

Wholesale dealers, or market makers, generally advertise their willingness to buy or sell through the facilities (known as the "sheets") offered by the National Daily Quotation Service, a private service which publishes on a daily basis, for the use of professionals, the names of broker-dealers making markets in specified securities and their quoted prices.[38] The price at which a wholesale dealer announces it

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[33] See the general comparison of the exchange and over-the-counter markets in ch. V.B.2 and the discussion of the mechanics of exchange trading in ch. VI.B.
[34] See pt. D.2 below.
[35] For a discussion of "markups," see pt. D.4, below.
[36] Where the customer sells a security, the above procedures, both in principal and agency transactions, are reversed.
[37] See the discussion of "interpositioning" in pt. D.2, below.
[38] See the discussion of characteristics of wholesale markets in pt. C.2, and of the wholesale quotation system in pt. C.3, below.

is willing to buy is known as the "bid" or "bid price"; the price at which it is willing to sell is known as the "offer" or "asked price." The difference in price between the bid and offer, know as the "spread," is the ordinary source of profit for the wholesale dealer.

Prices quoted by wholesale dealers to other broker-dealers are known as "inside" or wholesale prices; those quoted to the public are "outside" or retail prices. An inside quotation of 20–20½ means that the dealer making the market is willing to buy from another dealer at 20 and to sell to another dealer at 20½, to the extent of 100 shares (or whatever is the security's acknowledged trading unit). A quoting wholesale dealer who receives an inquiry from another firm may ordinarily expect to do business at his own quoted prices, while the broker-dealer making the inquiry must be prepared to pay the market maker's price or negotiate on the basis of it.[39]

If there are a number of competing wholesale dealers making markets in a security, the customer's broker-dealer may "shop around" to determine which wholesale dealer is quoting the best price. The extent to which a firm will shop around and negotiate for a customer may depend upon a number of factors, including the number of firms with which it has wire connections, the sophistication of the customer, the size of the order, and the diligence and probity of the broker.[40]

Most metropolitan newspapers publish retail quotations for some of the more actively traded over-the-counter securities.[41] These quotations do not represent actual prices as in the case of newspaper reports of exchange transactions; they are derived from interdealer quotations to which is added a predetermined, undisclosed markup on the "asked" side. Quotations among dealers are not publicly disseminated although some sophisticated investors, such as institutions, may have access to wholesale quotations and may deal with broker-dealers on the same terms as other broker-dealers.

Consummated transactions are not publicly reported in the over-the-counter markets. The customer's broker-dealer maintains a record of its own transactions, but there are no facilities for reporting them to any central location for dissemination to the public. There is no ready means by which a customer can check the price and quality of his execution. Although he may observe published retail quotations, these do not purport to represent actual prices and are available for only a limited number of over-the-counter securities. The customer must therefore rely upon his broker-dealer, and as a practical matter, he is ultimately dependent upon him for a good execution.

C. Wholesale Markets

This part describes the organization and structure of wholesale over-the-counter markets, the factors entering into the determination to trade or to discontinue trading of a security, the conduct of wholesale trading, and the systems for disseminating wholesale quotations.

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[39] It is frequently said that transactions in over-the-counter markets are "negotiated." Nevertheless, many transactions between dealers are executed more or less automatically at the wholesale dealer's quotations. In large transactions or transactions in inactive securities, however, there may be negotiations. See pt. C.2, below.

[40] See the discussion of execution of orders in pt. D.2, below.

[41] For a discussion of retail quotation systems, see pt. D.4, below.

1. ORGANIZATION OF THE WHOLESALE MARKETS

a. *The wholesale dealer*

(1) *The role of the wholesale dealer*

Because there is no central location where public orders can be collected, matched and executed, the wholesale dealer is the key firm in the over-the-counter markets. He "makes the market" by advertising his willingness to buy or sell securities for his own account with the expectation of buying at his bid and selling at his offer. There is a wholesale market in a particular security if a broker-dealer stands ready to buy from and sell to other broker-dealers at his quoted prices in amounts at least equivalent to the security's recognized trading unit. Whereas in most exchange stocks only one specialist makes a market,[42] there may be a score of competing wholesale dealers—but there need not be any—bidding for and offering an over-the-counter security.

The wholesale dealer performs two important and related functions. He provides a conduit through which orders flow from broker-dealers whose customers are selling to broker-dealers whose customers are buying. In this sense, the wholesale dealer acts as an intermediary between public customers and participates in virtually every transaction originating or terminating with a public buyer or seller, making possible the operation of the market.

A second function of the wholesale dealer, closely related to the foregoing, is adding marketability for particular securities by assuming the risk of taking long or short positions. Viewed from this standpoint, professional participation is particularly important for some securities as compared to others, and particularly important for all securities during periods of price stress or inactivity. The degree of liquidity that the wholesale dealer adds to the market depends upon the number of shares bought or sold on balance, the size of his spreads, and the effect of his transactions upon succeeding quotations and transactions. His participation will be limited by his financial resources and his expectations of retail activity, his own or others', that will eventually permit sale of accumulated inventories or the covering of short positions.

A firm practically all of whose activity is that of a wholesale dealer, also known as a "pure" wholesale firm, tends to conduct its market making activities differently from a firm that uses its trading department in connection with its retail business, the "integrated" firm. The pure wholesale firm seeks to make a profit on its "spread," and generally requires activity in a stock before it will trade in it. It normally accumulates or disposes of inventory positions by adjusting its quotations to attract buying or selling interest, i.e., lowering its bid and offer to dispose of a long position or to acquire a short position.

The integrated firm, on the other hand, may accumulate or dispose of securities as a result of the activities of its own retail or syndicate department. For example, if the retail department of an integrated firm decides to recommend a security, the trading department may be used to accumulate a position to satisfy expected customer demand. The integrated firm thus has a "safety valve" which may affect the

[42] See ch. VI.D.3.a.

firm's trading activity. It is not limited to using its interdealer quotations and transactions to adjust positions but it may conduct its wholesale trading with the expectation of disposing of positions "away from" the wholesale market through retail channels.[43]

The difference between the two kinds of wholesale dealers is not a sharp one in all cases and may be a matter of degree. For example, a pure wholesale dealer may have some retail customers, and an integrated firm may also have a trading department which trades some stocks without regard to the firm's retail activities. The distinction should be kept in mind, however, in the following discussion of the wholesale over-the-counter markets.

(2) *The trader*

Wholesale trading in the over-the-counter markets, whether by a pure wholesale firm or an integrated firm, is performed by persons known as traders. The trader ordinarily sits at a desk from which he has one or more telephones or wires to other firms and sometimes to banks and other institutions. Some market makers have as many as 200 private telephone lines and wires to other firms. In firms with more than one trader, each trader is assigned a number of stocks in which he makes markets. He maintains a "book" or some other means for informing himself of the size of his positions in each security which he trades. In firms with only one trader or in which traders are permitted to trade only the stocks assigned to them, the trader may keep notations showing his current quoted bid and asked prices. In other firms, a quotation board is also maintained at the front of the trading room for this purpose, and changes in quotations are shouted to a clerk, who posts them on the board. Firms that maintain trading boards generally permit any trader or assistant trader to execute transactions at prices listed on the quotation board. The authority of such a trader, however, is usually limited to transactions of 100 or 200 shares. After executing a transaction he must advise the trader to whom the stock is assigned of the execution so that the latter may adjust his position and make any necessary change in quotations. Transactions involving larger amounts require the assent of the trader to whom the stock is assigned.

After executing an order, the trader notes the change in his inventory position and fills out a slip reflecting the transaction. The bookkeeping (or clearance) departments of both the buying and selling firms send a memorandum of the transaction, called a confirmation, to the firm on the opposite side. Upon receipt of the confirmation, each bookkeeping department compares it with its own records of the transaction and attempts to resolve any differences.[44] If one party to a transaction fails to deliver securities or to make payment, the other party may "wash out" the transaction in the open market and bill the failing party for any loss. In practice, however, this is rarely done and it is not uncommon for broker-dealers to tolerate fails for many

[43] See C.2.c, below. It should be borne in mind, of course, that no wholesale firm—"pure" or integrated—makes markets in more than a small fraction of all over-the-counter securities, so that with respect to all other securities in which an integrated firm has retail transactions its integrated character is irrelevant and it is simply in the category of "retail" firms.

[44] Settlement of a "regular way" transaction, i.e., the actual exchange of cash and stock certificates, must be effected within 4 business days after execution of the trade. See NASD Uniform Practice Code, sec. 4.

months. There are no central clearance facilities for the over-the-counter transactions, although the NASD has recently initiated the establishment of a National OTC Clearing Corporation to operate in the New York City area.[45]

The only formal requirement or qualification for a trader is that he be registered with the NASD as a "registered representative." Since the trader's activities affect the profits or losses of the firm and involve risk of the firm's capital, most trading firms are careful in choosing traders. Some firms have training programs. Most large firms employ assistant traders who are in effect apprentices. The number of stocks assigned to a trader, the size of orders which he has authority to execute, and the size of his allowable position generally depend upon his skill and past performance. The more experienced and successful traders in the larger wholesale dealer firms may trade as many as 80 securities but, as a general rule, firms which maintain relatively large inventory positions do not assign so many stocks to 1 trader.

Traders may be compensated by salary or commission. Under most commission arrangements, traders receive from 15 to 50 percent of the profit from their trading activity. For purposes of computing a trader's profits, inventories usually are marked to the market about once a month, and inventory losses incurred in one month must be made up before the actual profits of succeeding months are computed. Where the trader has a long position in a security, the firm may evaluate his inventory on a "lower of cost or market" basis; if he has a short position, the "higher of sale price or market" is the basis. This method of evaluation has the effect of not crediting the trader with profits until he actually realizes them and, to some extent, encourages a trader with profits to end the month with a relatively small position. Commissions may be computed on the basis of gross profit, net profit, or something between the two, i.e., trading profits may be calculated either before or after deduction of some or all expenses allocable to the trading department. In some small firms the trader is required to pay the salary of his assistant.

A number of trading firms simultaneously employ straight salary, straight commission, and combined salary and commission compensation, depending upon the experience and proficiency of the trader.[46] Less experienced traders are usually paid straight salaries, others receive a combination of a salary and a small commission, and the most experienced traders are often paid a straight commission. Some traders earned more than $100,000 in commissions in 1961, a year of unusually great activity in the over-the-counter markets. One firm stated that its senior traders had not suffered a loss from their trading activities in any month in the preceding 5 years.

Many broker-dealers are convinced of the necessity for compensating traders on the basis of profits. Their view is that a trader who has a personal stake in his activities will perform his duties more diligently and, in a declining market, more conservatively. Some broker-dealers, however, oppose payment of traders of firms having retail departments

[45] The problem of fails and the clearance of over-the-counter transactions are discussed in pt. E. of ch. III.

[46] Where salary and commission methods of compensation are combined, the commissions will usually be less than those payable to a straight commission trader. Some firms treat the salary as a draw against commissions.

by a percentage of profits on the ground that the traders may attempt to gain an extra one-fourth or one-eighth profit at the expense of the firm's retail customers. Moreover, they feel that the trader, whose job frequently involves the execution of retail orders in securities in which he is not making a market, will devote insufficient time to the nonproductive aspects of his work, such as checking markets and obtaining quotations. Representatives of other firms have stated that commission or profit-sharing compensation of traders is undesirable even where the trader deals solely with other brokerage firms, because the trader is said to be less inclined to provide buying or stabilizing support when it is most needed.

(3) *Supervision of trading*

Supervision of trading activities varies widely from firm to firm, but some generalizations can be made. Supervision is usually limited and general in nature. Many partners regard trading as a mysterious art—it is often said that most trading decisions depend upon intuition and a "feeling" for the market. Moreover, the speed of execution required of the trader makes his activities difficult to supervise.[47]

In the smaller firms, the trader may be a joint venturer with his partners, who tend to be more concerned about the status of the firm's trading account than the particular details of the trader's activities so long as they are profitable. In larger integrated firms it is frequently found that the partner in charge of the trading department and the traders under his supervision are separated both physically and organizationally from the partners conducting the retail and underwriting aspects of the business who are likely to be those with highest prestige and influence within the firm.

Almost all firms limit the inventory position which their traders may accumulate, or stated another way, the total amount of capital available to them for investment.[48] Some firms also limit positions which may be taken in particular securities, and many also require that a trader consult a partner before executing an order of substantial size. The degree to which traders are restricted generally depends upon the size of the firm and the trader's method of compensation. Traders who receive a straight commission invariably have greater leeway than traders who receive a salary, and traders in small firms tend to have more freedom than those in large firms. For example, a principal of M. L. Lee & Co., Inc., an underwriter of small equity issues, testified that his sole trader, who was compensated on a straight commission basis and who in 1961 earned over $170,000 for the firm, had "carte blanche" authority in all his trading activities. He further testified that, aside from the issues underwritten by the firm (in which

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[47] Broker-dealers are charged with the responsibility for supervising the activity of their employees. Failure to perform this duty can result in disciplinary action with sanctions including revocation of the firm's registration. The requirement to supervise is embodied in the rules of the NASD (art. III, sec. 27, Rules of Fair Practice), the NYSE (rule 405) and in the Exchange Act (see e.g., *In the Matter of Reynolds & Co.*, Securities Exchange Act release No. 6273 (May 25, 1960)). See also ch. III.B.

[48] Even this broad limitation, however, can be circumvented by traders who may resort to a practice known as "parking," in which one firm accumulates a long or short position on behalf of a trader in another firm. It is generally understood between the trader requesting "parking" of securities and the trader accepting it that the former will guarantee the latter against any loss.

"Parking" is not, however, a practice used exclusively by an employee against his firm's interests. Firms themselves may engage in the practice to circumvent the Commission's net capital rule or as a market manipulation device. Regardless of its purpose, the effect is that neither firm's books and records accurately reflect its position.

he required the trader to make a market), he did not know in which securities his trader was dealing. During the 2-day period, for example, the trader had transactions in about 40,000 shares of Universal Electronics Laboratories, Inc., stock at prices ranging from 8 to 12⅞—an issue with only 75,000 shares in its total floating supply. His employer claimed he had never heard of the security.[49]

Many firms require that initiation or termination of marketmaking activities for a particular security be approved by a responsible partner, but this requirement is by no means universally followed even among the largest wholesale dealer firms. As a general rule firms exercise little detailed supervision over the size of the spreads quoted by traders or the firmness of their markets.

The limited attention given to supervision in one large trading firm was illustrated by the following testimony of a nontrading partner, one of two responsible for supervising traders, and of a trader in the firm:

Q. You have experience in trading?
A. [the partner] No; none whatsoever, so I can speak freely on this subject.
Q. You have supervised traders for some time?
A. In a very broad sense; yes.

* * * * * * *

Q. * * * [D]o you [the trader] receive supervision from anyone other than [the partner]?
A. Yes, the partner of the trading department [the supervising partner not present].
Q. Does that partner trade himself?
A. Yes.
Q. He trades, I think you said before, some 50 stocks, approximately?
A. That's right.

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Q. How many traders are there altogether?
A. Twelve.

b. The interdealer network

(1) *Communication systems*

In the absence of a central trading floor or other means for bringing the orders of buyers and sellers together and generally disseminating quotations and reports of transactions, communications in the over-the-counter markets are made bilaterally between individual broker-dealers. Communication is necessary to permit a broker-dealer acting for itself or for a customer to execute an order with a market maker and to permit market makers to communicate with each other. The type of communications system used affects not only the speed and ease of transmission of information, but also the types and qualities of markets, and the manner of execution of customers' orders and the costs of doing business.[50]

The development and improvement of communications systems since World War II have made possible a proliferation of links between broker-dealers in the over-the-counter markets, with enormous impact

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[49] For a discussion of trading in this security immediately after its initial distribution to the public, see ch. IV.B.
[50] See pt. D.2, below.

on organization, trading practices, and the growth of the markets.[51] In the "old days," one of the major tasks was to locate a market—a task often performed by mail. Now, with improved communications systems, markets for most securities can be located almost instantaneously and transactions consummated within a matter of seconds. A member of the board of governors of the NASD recently stated:

> * * * [C]ommunications have so vastly improved that no matter where you are in this country, you can always, without spending a nickel, check somebody's market.

Virtually every city with a brokerage firm has at least one rapid line of communication to a New York firm. Some broker-dealers have stated that this development has led toward the centralization of trading activities in New York. On the other hand, others believe that the proliferation of lines to New York has made possible the development of primary trading centers in other areas, since broker-dealers not having rapid lines of communication to areas outside New York can now be quickly reached by going through a New York firm which has direct lines to other cities.

Communications systems in the over-the-counter markets are technical and complex, and the arrangements between broker-dealers for using such systems are varied and ingenious. A description of the more important systems follows.

(a) *Direct telephone lines.*—Direct telephone lines are simply direct connections between two parties in the same or another city. One party may call the other merely by operating a switch or lifting up the receiver. One firm with a direct telephone line between New York and San Francisco estimated its cost at $3,500 per month.

(b) *Automatic call distributors.*—One of the most important improvements in telephone communication between broker-dealers is the automatic call distributor. This device is somewhat similar to the private telephone exchange board but requires no central operator. Each trader within a firm has at his trading desk a board (or "turret") with a large number of keys representing direct telephone lines to other firms or institutional customers. By this means a trader making a market is able to handle a large number of incoming and outgoing calls, to receive and give quotations, and to complete transactions with minimum delay.

(c) *Open-end telephone lines.*—Some firms make use of open-end telephone lines into other cities. These are private telephone wires leased on a monthly basis which terminate in the telephone company office in another city so that connections can be made with any firm in that city.

(d) *TWX.*—Another method of communication is by teletype. A firm having a teletype (TWX) in its office can receive and send

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[51] As early as 1909, one observer of the securities markets noted the effect of a communications system upon over-the-counter trading:

"Present conditions are but the natural evolution and development of the business. Twenty years ago the bond business was in the hands of about one-fifth of the number of houses now engaged in it, and at that was conducted on much less progressive lines than at present. A house had bonds to sell in those days, and sold them in a careful, leisurely manner. Its broker got an order and went out to "see what he could do." The modern system of a grapevine of telephones between hundreds of small, busy houses, each one with half a dozen active young fellows out scouring the "Street" for a chance to pick up a sixteenth or a thirty-second—such conditions were absolutely unknown. In many outside bonds, nowadays the trading between houses over the telephones makes a much more active market than in some of the bonds usually considered active on the Exchange." Banker's Magazine, vol. 79 (1909), p. 925.

printed messages to other subscribing broker-dealers. Many broker-dealers in the United States subscribe to this service. Unlike a private wire system, which links only certain offices on the wire, TWX can be used to send long-distance messages to any subscribers regardless of their geographical location. This system enables a broker-dealer in a small city to communicate on a private basis with a broker-dealer in another city in order to obtain a quotation or execute a transaction. A broker-dealer wishing to "check" markets for a customer may have an arrangement whereby he calls a particular broker-dealer in a financial center who in turn checks the market, perhaps executes the transaction, and reports back.

(e) *Private wires.*—Leased private wires (teleprinters) are used by firms to link their main offices with branches and with the offices of other firms. Teleprinters, like TWX, are language printers which have supplanted the Morse code keys which were common in brokerage offices in former years. Many large broker-dealers lease several of these private wires.

(2) *Correspondent systems*

Firms on either end of an intercity private wire or direct telephone connection are commonly referred to as correspondents of one another. Generally, a New York firm provides the nexus for a correspondent system. While a correspondent arrangement may involve various services and facilities, this discussion relates to correspondents providing wholesale dealer services to one another.[52]

A typical correspondent relationship in the over-the-counter wholesale markets operates as follows: Assume that a west coast broker-dealer has a direct wire to a wholesale dealer in New York. A customer of a third broker-dealer on the west coast may wish to purchase a security in which the New York dealer is making a market.[53] Rather than make a long-distance call, the customer's broker may ask the west coast firm for a quotation from the latter's New York correspondent. The west coast firm immediately obtains the quotation from its correspondent and advises the customer's broker, which then has a short time to decide whether or not to execute on it. If it does, the west coast firm executes the order and "gives up" the name of the customer's broker to the New York firm. The services will be performed usually without charge to the customer's broker, which will receive its confirmation from the New York dealer. The west coast firm will be compensated for its services by the New York wholesale dealer. The transmitting correspondent usually receives a service fee of 2 to 5 cents per share from the market maker in such transactions.

The foregoing has some important variations. It there is substantial interest in a particular security on the west coast, the correspondent may appear in the Pacific Coast edition of the sheets to attract inquiries from west coast broker-dealers. The west coast correspondent's name is advertised, though the New York firm makes the market and consummates the transaction. The correspondent appears

[52] A New York correspondent may have extensive clearance facilities, a large research department and a communication system linking the firm to over-the-counter trading departments in New York and other financial centers. An out-of-town correspondent may use its New York correspondent for the execution and clearance of NYSE transactions, quotations, and execution of transactions in over-the-counter securities, research materials, and other services.

[53] The customer's broker will ordinarily determine the fact that a New York dealer is making a market in a security by checking the sheets.

in the sheets without any indication that its appearance is on behalf of another firm.[54] Payment for the appearance in the sheets is usually made by the firm making the market and not by the firm whose name appears.[55] In some cases both correspondents may appear in the same edition of the sheets though the market is made by only one firm.[56]

Under some correspondent arrangements, the correspondent appearing for a wholesale dealer may have limited authority to make a "firm market" for 100 shares in a particular security. When an inquiring broker-dealer asks for a quotation, the correspondent gives the quotation previously left with it and executes the order immediately, without obtaining approval from the market maker. It then advises the market maker that the latter has bought or sold 100 shares. The market maker may at any time give its correspondent a new price which will remain "firm" until changed. This is known as "laying a market." Some firms have as many as a hundred markets made for them by other broker-dealers in various cities. The correspondent in effect has the same authority as an assistant trader executing from the quotation board in the main office of the firm.

One New York firm interviewed by the study was organized in 1961 primarily for the purpose of serving out-of-town correspondents. The firm has two principal correspondents, one in San Francisco and one in Chicago. The communication with each of these firms is by means of a private open telephone line.[57] The firm makes only two markets of its own but appears in the sheets in 275 securities in which it quotes markets for its correspondents.[58] Some of these markets are firm for 100 shares and the rest require checking before execution. Seventy-five percent of the firm's business is done for its correspondents and is handled on a give-up basis with the firm receiving a fee ranging between 3 and 5 cents per share for each give-up execution. The firm employs five traders and has about 60 direct lines to other New York firms of which only about five are ordinarily competitors of the firm's correspondents. The purpose of the arrangement is to permit the San Francisco and Chicago firms to "tap" the New York market for securities in which they make markets, by having an easily accessible and inexpensive method of communication.

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[54] In this connection one west coast firm advised its salesmen in an internal memorandum as follows:

"Many persons not familiar with the proper use of the National Quotation Daily sheets request quotations on stocks from dealers who show up having an interest, when in reality their name appears showing this interest for a correspondent or someone with whom they are connected by private wire. Thus, the time wasted in asking for the quotation for the 'secondary' dealer can be quite a problem. Specifically, quite a few Eastern brokers appear in the quotation sheets as having an interest in stocks which are largely in this market, and where the 'fundamental' or 'primary' market is actually made. Being quite specific—Bank of America shown in the sheets as having a market made by Scherck Richter & Co., in St. Louis, when it is actually made for J. Barth & Co., in Los Angeles and San Francisco. The same illustration could be repeated many times."

[55] The cost of the wire is usually shared. In many instances there is no payment for the execution. Instead, there is an arrangement whereby A performs a correspondent function for B and vice versa and no cash compensation passes between them. In other instances, if more business flows into A than into B, then A might pay the cost of the wire rather than sharing it with B. These are all matters for negotiation between correspondents.

[56] It is more usual for a New York wholesale dealer to appear in the sheets for its correspondents than vice versa because New York firms may not be familiar with the names of out-of-town firms in other correspondent systems. Out-of-town firms, however, generally know which local correspondent to call when they see a New York dealer in the sheets.

[57] The lines between the firm and its correspondents represent the only direct connection which those correspondents have with a New York firm.

[58] The correspondents also appear in the sheets on these securities, and on a number of them appear in the same (Eastern) section of the sheets. See sec. 3, below.

When firm markets are left with others, the market maker must check its markets and constantly transmit changed quotations to its correspondents because the last price given permits the correspondent to execute orders at that price. In view of the effort required to communicate constantly with correspondents to whom they have given firm markets, certain firms do not permit firm markets to be made for them by others. On the other hand, one wholesale dealer has stated that it lays firm markets and takes the risk of keeping its correspondents current on price changes since the existence of a firm market permits faster execution and gives it a competitive advantage over other wholesalers who require that their correspondents check with them before execution.

During the market break of May 1962 many wholesale dealers felt that they could not keep current with expected volume. Consequently many advised their correspondents that until further notice their markets would not be firm. In certain firms, especially those which did not usually lay firm markets over their wires, traders were sufficiently alarmed that they did not post quotations on their trading boards. This made it difficult for correspondents and other incoming inquirers to obtain quotations, for every quotation had to be obtained directly from the trader, whose turrets in many cases were overloaded.[59]

Another variation of the correspondent system is the so-called "loop" wire which connects a number of firms on the same teletype. A wire from an east coast firm to a west coast firm also may reach north and south to other broker-dealers. Each time a correspondent requests a quotation from a market maker, other broker-dealers on the wire may see the information.[60] Besides being relatively inexpensive, the "loop" wire also permits a firm laying markets in identical securities in several cities to change its quotations rapidly. The existence of a "loop" wire may also serve to stimulate activity in a particular security by reason of the fact that all broker-dealers on the loop become aware of buying or selling interests transmitted over the wire.

(3) *Other interdealer arrangements*

The joint trading account is another type of marketmaking arrangement between dealers who may or may not be correspondents of each other. The joint account has been defined as an "agreement between two or more firms to share in the purchase, sale or ownership of securities with equal or proportionate risk and financial participation." [61] In some joint accounts, each participating dealer may execute for their combined interest, and either or both may appear in the sheets. The authority of each dealer to execute transactions for the joint account may be limited to a certain number of shares. The fact that two or more firms making markets in a security are in a joint account is not disclosed in the sheets or to other firms. Therefore what appear to be two or more quotations in different names may actually represent a single quotation and what appears to be a competitive market for a security may, in fact, be a single market.[62]

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[59] See sec. 2.d(2), below.

[60] Firms with "loop" wires have understandings that none of them will approach the initiating firm for the purpose of consummating the transaction. However, one firm has stated that one reason that it does not have "loop" wires is that it cannot trust others who may intervene and communicate with inquiring firms.

[61] "Handbook on Over-the-Counter Trading," NASD, 1960, p. 16.

[62] See sec. 2.c(1), below.

2. CHARACTERISTICS OF WHOLESALE MARKETS

a. Commencement and termination of wholesale trading

Broker-dealers have complete freedom to commence or terminate making an over-the-counter market for any security, including any security listed on an exchange, for any reason and regardless of their relationship to the issue or the issuer.[63] Unlike the exchange specialist, the over-the-counter market maker is not required to be registered in the security in which he intends to make a market.[64]

There are several possible motives for making a market. Probably of greatest significance, particularly for nonintegrated firms, is the desire of the dealer simply to profit from expected activity of broker-dealers engaged in executing buy or sell orders for public customers. Firms primarily engaged in wholesale trading nearly always advertise their markets in the sheets on a daily basis. They hope to—and ordinarily do—make trades by having other broker-dealers execute at their bid and offer prices. Although the over-the-counter market is sometimes called a negotiation market of bargainers, several prominent wholesale dealers have indicated that most standard-size transactions with other broker-dealers take place at the wholesale dealer's bid or offer and not between them.[65] A trader for such a wholesale dealer expects activity to come from retail houses; when that activity falls off, he may lose interest and discontinue trading. The trader hopes that retail houses which have buy and sell orders for the security will execute them with him and permit him to make a profit of 1/8's and 1/4's on high volume. This type of trading—referred to as trading stocks "as numbers"—was described in this way by one trader:

> * * * I will trade any security. Mostly the size of the issue. What I think will trade most actively. This interests me mostly because then I can turn over more volume on the issue. That is the important factor in trading. Now, any stock to me is just a vehicle. I have no statistical department. I mail no literature to anybody. I have never written up a security. * * * I just make a market all day long.

Many firms which make markets solely on the basis of activity may have little information concerning the issuer's financial condition. They have no research or statistical departments, do not subscribe to investment or counseling services, employ no retail salesmen, and concentrate on quoting prices in response to incoming orders.[66] The retail activity by other broker-dealers may be prompted by market letters, publicity campaigns, special selling efforts, favorable or adverse information or other stimuli. Such activity normally will cause

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[63] There is one important exception to this statement. Broker-dealers who are members of exchanges may be required to obtain exchange approval in order to trade off-board in listed securities. See NYSE rule 393. Under the rules of the NYSE, if the transaction involves any of certain guaranteed and preferred stocks, exchange approval is not required. See NYSE rule 394.

[64] See ch. VI. D.1 and D.3.b.

[65] An officer of New York Hanseatic Corp. has estimated that 50 percent of the firm's trading transactions take place at its quotations given during trading and that the percentage may be higher in active markets.

[66] However, there are exceptions. A trader from Troster, Singer & Co., a large wholesale dealer, for example, was described as follows:

"While Mickey [the trader] often trades stocks only as numbers, he also buys and sells them as shares in corporations whose history and outlook he studies intimately. 'Many traders trade stocks as numbers and nothing else,' says Mickey 'and this often proves profitable. They watch the stocks' short swings and bid them up or down on purely technical considerations without particularly caring whether the company itself is in the entertainment business * * * or part of the drug industry. * * * These fellows will probably catch more of the stock's day-to-day swings and win the battles", says Mickey, 'but I'll usually get the trends that are a little long term and win my share of the war.' " The Wall Street Journal, Oct. 31, 1957, p. 12.

competition among the wholesale dealers for customers' orders held by retail firms.

In buying and selling securities for their own accounts, market makers will acquire long or short positions in individual securities. Since the wholesale dealer usually expects to make its entire profit out of the spread, it usually attempts to keep inventories low in order to minimize the effects of price fluctuations. Most transactions are executed by market makers on an incoming basis, and only occasionally will a wholesale dealer initiate a transaction, since it would ordinarily mean purchasing at another dealer's offer or selling at another dealer's bid.[67] Accordingly, the size of inventories is ordinarily adjusted by the wholesaler changing his price—lowering his bid and offer if he is long and raising them if he is short, and awaiting calls from firms with retail customers.

Large wholesale dealers with extensive wire and correspondent systems may make markets because of retail activity among their correspondents. A wholesale dealer usually expects its correspondents to execute customer orders with it. Some large wholesale dealers may initiate retailing activity within their own correspondent systems. These firms sometimes prepare reports for distribution to their own traders and to their correspondents who may on the basis of these reports take positions in the stock for eventual sale to the public.[68] However, for most wholesale dealers with extensive wire connections, research and active merchandising is the exception rather than the rule.

Some firms may commence trading in a security in order to accumulate or dispose of a position. Under these circumstances, the firm has an interest on only one side of the market; that is, it may place a higher bid, to accumulate stock, or enter a lower offer, to dispose of stock, than its competitor's. Through advertising its changed quotation, the firm obtains inquiries from other dealers who wish to sell or buy the security. If it did not advertise its market, it would be required to initiate the inquiry and buy or sell the security from another market maker at the latter's inside offer or bid; that is, it would have to pay a higher price or receive a lower price than if it had advertised its market and bought or sold on the basis of incoming inquiries from other dealers.

A market may be made by a broker-dealer with a retail department in order to accumulate securities at its bid price prior to the commencement of a selling campaign for a particular security. It has been stated that average costs will be lower if a position is acquired prior to the dissemination of a market letter or initiation of a selling campaign. Since integrated firms may regard their wholesale trading activities as an adjunct to retailing, they often are less concerned about their competitive position in the wholesale market than pure wholesale dealers.[69] The integrated firm can raise its bid prices and initiate inquiries with the expectation of selling accumulated inventories to its own customers at higher prices.

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[67] Singer, Bean & Mackie, Inc., a large wholesale dealer, has indicated to the study that approximately 90 percent of its trades are the result of calls to it by other houses.

[68] The correspondents in this situation somewhat resemble the retail department of an integrated firm.

[69] See sec. 2.c dealing with markets made by integrated firms.

Some wholesale dealers may make markets on behalf of other broker-dealers. As described earlier, a dealer may make markets for its correspondent. In other situations, markets may be made at the request of other broker-dealers to facilitate a retail distribution, to qualify an issue for dissemination of retail quotations,[70] to create an impression of activity, to conceal the interest of a principal or to accumulate or dispose of positions. As in the case of correspondent relationships described above, if a firm makes a market on behalf of another firm and inserts quotations in the sheets, there is no indication in the sheets that its appearance is on behalf of another.[71]

Some firms may commence making a trading market upon the grant of cheap stock or options from underwriters and issuers. One of the practices disclosed in the study of new issues was the allotment by underwriters of "hot issues" at or below the public offering price to wholesale dealers upon their undertaking to assist in making an active after-market.[72] In some new issue offerings, allotments of issues in public demand were made at or below the public offering price by the underwriter to firms who might stimulate after-market activity both at the retail and trading level. Certain dealers were selected to handle the trading and others to generate retail interest. Wholesale dealers receiving allotments of new issues usually placed their shares in the firm trading account or in the accounts of insiders to be sold out in the course of trading activities at premium prices.

Some underwriters of new issues offered wholesale dealers, instead of an allocation of the issue, some other item of value. The partner in charge of the trading department of one large firm stated that underwriters had approached his firm and attempted to induce it to trade their issues in return for which the underwriters would reciprocate by channeling specified amounts of business to the firm. There are also indications that the solicitation of some trading houses was accompanied by informal guarantees against loss; in one case the underwriter placed customer purchase orders with a wholesale dealer at a substantial profit to the latter though the underwriter itself was making a market at the time.[73]

Some wholesale dealers apparently see nothing objectionable in accepting cheap stock or options as an inducement to make a trading market. For example, the senior partner of one large wholesale dealer in a lawsuit against a company for damages for failure to deliver options covering 15,000 shares of the company's stock testified as follows:

> [The company's president] said that they would need additional capital at some future time and that was his purpose in seeing us—to get the market going, so that he would be able to float an issue at some future time when the stock got up to, I remember the price of around $3 a share.
>
> * * * * * * *
>
> I turned around and I said, "Gentlemen"—and I was very explicit—I said, "We are not an underwriting house. We are not a financing house. We are a trading organization. I can only do one thing: Give you character and stability

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[70] See pt. D.4.a.
[71] See sec. 1.b, above, and sec. 3.a, below.
[72] See ch. IV.B.3.
[73] Another method utilized, particularly where it was expected that the issue would be "hot," was to select, as members of the selling group, firms with trading departments, with an implied or expressed understanding that these firms would trade the stock after the distribution was complete. This made it possible for such firms to use the trading function as a bargaining tool for the obtaining of an allocation of a premium issue for their customers.

in the market by virtue of the fact that we have wires all over the United States, plus over 150 stock exchange wires—direct wires."

* * * * * * *

Well, I did say, "And I wouldn't be interested in that unless I got ample consideration."

* * * * * * *

I said that if we went into this here, we would have to have some kind of compensation—remuneration—in order to go in there, because we are going in there laying our own money on the line, making a market for the stock; and we have to have a play with the stock.

In another case, which arose during the course of the Special Study, a small broker-dealer firm participating in the distribution of a large block of the common stock of a company called Diversified Funding, Inc., arranged for several firms, including a member firm of the New York Stock Exchange, to place fictitious quotations in the sheets while a retail selling campaign was in progress. A trader of the member firm testified that his firm purchased 500 shares of Diversified Funding from the underwriter below the current bid "to make it attractive for me to trade." The underwriter gave instructions that quotations (at increasing bids) be inserted in the sheets and purchased stock acquired by the member firm at a markup of one-eighth to that firm.[74]

The allotment of "hot issues," cheap stock, options or other things of value to wholesale dealers to induce them to make a market may give a deceptive appearance of activity in a stock and may encourage such firms to "condition" the market in order to effect a distribution of shares held by them and by others. In its worst form, occurring particularly among speculative new issues underwritten by marginal firms, the wholesale dealer may act as part of a "pool operation" in which members of the pool distribute a block of stock withheld from a public offering or received as underwriters' compensation. The firm creates the illusion of active trading in such shares by entering fictitious quotations in the sheets at increasingly higher bids, and serves in some cases as the conduit through which shares held by pool members are distributed to retail firms and thence out to the public at premium prices.[75]

Just as a wholesale dealer may have varied motives for commencing trading in a security, his decision to terminate such trading may be influenced by a number of factors. The wholesale dealer may feel no responsibility to continue a trading market for a security, as illustrated by the following testimony:

Q. * * * [When] someone like your firm pulls out of the sheets, [do] you think that the market becomes less orderly and becomes less fair a market? * * *

A. I appreciate the compliment that I might be a determining factor. I doubt that very much. Frankly, what happens to the market or activity, whatever it is, when I decide not to trade any more is of no consequence to me.

* * * * * * *

Q. * * * [Y]our files show that [of the] 11 companies you filed your questionnaires on [you] are no longer in the sheets [in any of them] * * *.

* * * * * * *

Do you think that there would be or should be any rules or regulations which would restrict the ease with which firms like yourself could go in and out of the market, particularly out of the market?

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[74] An officer of the member firm indicated that the appearance of a member firm in the sheets for Diversified Funding attracted "primary calls" from other member firms who preferred to deal with a member firm rather than a nonmember firm.

[75] See, e.g., the description of the Geochron distribution in ch. IV.B.3.c.

A. When we decide to trade in a stock we do it of our own volition. We make markets, bid and asked, with many determining factors surrounding them which include an inventory either on the long or the short side. And as long as we elect to trade in a situation, for whatever reason, whether it be a new issue or an old issue—the only expression I can find for it is we put our money on the line, so to speak, and I feel we should be privileged to stop trading it whenever we feel like it.

Q. What do you think your duty is to the general public, if any?

A. I don't believe I have a duty to the general public.

This is not to say that there are not important inhibitions against abandonment of marketmaking activities in particular securities. If trading a security offers the opportunity for profit, it usually attracts and retains trading interest. Another consideration is the fact that wholesale dealers rely upon other broker-dealers for business; these other broker-dealers are regarded as customers. If a firm discontinues trading in a security in which its customers have an interest, it may adversely affect its relations with them. In a large measure the success of the market maker depends on making markets and quoting prices which are fair and attractive to his customers as compared to prices quoted by his competitors, and continuity of his markets may be required because of competition for customers.[76] As the representative of one large wholesale dealer firm explained it:

Now we have our overhead to worry about plus the position that we have in the security. For instance, a wire house like Bache, will come in and give us a lot of business, and if we got a bid and we don't go along with them, we are killing the business for the future with that one firm. If we kill that we would kill what we are working for.

* * * * * * *

I mentioned Bache because that was one firm in particular. [Our firm] was in there making a market. After it happened [Eisenhower heart attack] we lost a lot of money that day. We stood up in the market and our position went up. Fortunately, the next day we got out pretty good. For instance, we made a market good for 100 shares, and in some instances the stock was down a point or a point and a half and we still stood up for 100 shares to make this customer's firm look good to the customer, but we did that just to try to keep an orderly market. That is what we have to do for the future of our business. That has been a big function of ours. That is what I said before, that there are a lot of people in the business that don't understand the business, a lot of new firms that don't understand the primary function of the over-the-counter broker.[77]

Another important consideration in continuing to maintain a trading market, particularly among firms with retail customers, arises out of an assumed obligation to customers who have purchased the security from the firm, usually in an underwriting, and who might be deprived of a market if the firm discontinued its marketmaking activities. This kind of responsibility sometimes called "sponsorship" has been described elsewhere in this report and will be considered later

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[76] On the other hand, competition, when it becomes intense, may have the opposite effect. For example, one market maker testified:

"A. If there is too much competition and I can't make any money, I am going to drop out of the stock.

"Q. If it got too competitive you might drop it?

"A. That is right. We try to make the best market, but we are not going to make the best market on every stock at all times.

"Q. So that if you got too much competition you would have to drop it?

"A. We would drop it."

See sec. b(2), below.

[77] The same firm, however, concluded:

"Q. Do you think you have any obligation or duty with respect to your own profitmaking activities to that customer of, say, Merrill Lynch who is buying through Merrill Lynch?

"A. None whatsoever.

"Q. You expect that selling broker who comes to you, or the buying broker to act for his customer?

"A. That is right. That is what he is getting his commission for."

in this chapter in connection with the discussion of the integrated firm.[78]

However, not all retail firms may feel a responsibility to "sponsor" the market for an underwritten stock. When retail interest begins to wane, many smaller underwriters of speculative issues may feel no obligation to continue to make a trading market. For example, during and after the new issue phenomenon of 1959–61 investors frequently complained that the market for small issues which they had purchased at premium prices had disappeared. Of the 923 unseasoned common stock issues offered to the public through underwriters in 1961, there was no trading market in September 1962 for at least 6 percent of the registered issues and 25 percent of the regulation A issues.[79] Investors who purchased these issues in the expectation that their investment would have reasonable liquidity would thus have difficulty in finding markets in which they could sell their securities.

The decision to make a market or to discontinue making a market is not subject to any recognized standards or regulatory restraints in the over-the-counter markets other than the broad prohibitions against fraud and manipulation in the securities laws.[80] For example, as described above, some wholesale dealers consider it an acceptable business practice to receive allotments of "hot issues" at the public offering price, cheap stock or options as an inducement to make a trading market for a security. The NASD has not addressed itself to the propriety of this practice from the point of view of integrity of the trading markets, although in a 1960 decision it did treat the allotment of a "hot issue" to wholesale dealers as a violation of its "free-riding and withholding" policy.[81] Without official NASD expression of general standards or guidelines in this area, wholesale dealers have been largely free to treat the matter of commencing trading markets on this kind of motivation as being left to their discretion in light of their own business standards.[82]

With respect to the termination of trading, the NASD has taken the position that its members may terminate trading for any reason whatever and without any conditions being imposed upon such ter-

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[78] See sec. 2.c., below, and also ch. IV.B.3 and ch. IX.B.5.

[79] It should be pointed out that no attempt was made to determine whether any of the issuers of the securities that ceased to have trading markets had become inactive, liquidated, dissolved, or bankrupt during the period covered. See ch. IV, tables IV–20 and IV–35. (About 90 percent of the stocks for which there were quotations in September 1962, as shown in such tables, were underwritten issues.

[80] See Securities Exchange Act release No. 6097 (Oct. 23, 1959) for a description of circumstances under which the practice of allotting portions of public offerings to wholesale dealers may violate the securities laws.

[81] In 1960 the NASD instituted proceedings against the managing underwriter, the two co-underwriters, and four broker-dealer firms receiving allotments of 19,500 shares, in a 150,000-share offering of Telemeter Magnetics, Inc., common stock at the public offering price of $5.50 per share. These allotments were made in order to induce the broker-dealer firms to make a trading market for the stock. Each of these firms either placed its allotment in "insider" accounts where it was immediately available for firm trading activity or directly in firm trading accounts. Most of these allotments were sold out within a few weeks of the effective date at more than double the offering price.

In the NASD proceeding, the managing underwriter stated that it made the allotments to insure orderliness in the after-market and to prevent the market from being "artificially influenced by a lack of supply on the offered side," since the firm anticipated that demand would exceed supply in the after-market. Nevertheless, the NASD fined each firm $500 for depriving public investors of the opportunity to purchase the allotted shares at the public offering price, in violation of the "free-riding and withholding" policy. The study's examination of new issues in ch. IV revealed that the practices discussed in the *Telemeter Magnetics* case were still prevalent in 1961. See ch. IV.B.3.

[82] In the exchange markets, specialists are prohibited from holding options in securities in which they make markets on the ground that the holding of an option may influence the specialist's trading activity in a manner inconsistent with his obligation to maintain a fair and orderly market. See NYSE rule 105; see also "The Securities Markets," Twentieth Century Fund, 1935, pp. 447 et seq.

mination. For example, when an investor complained to the NASD that a registered representative at the time of sale had promised that his firm would continue making a market in a security, and the firm had thereafter discontinued making a market, a district committee of the NASD dismissed the complaint. In its decision, the committee stated:

It is the committee's opinion that broker-dealers may change their minds concerning insertion of markets in National Quotation Bureau sheets or the "making a market" in any particular security. The fact that a member is making a principal market in a particular security and lists a quotation for that security with a professional quotation service today and his salesman makes such a statement does not mean the member must continue "making a market" if he decides otherwise. Also, it would be a hardship and impractical to require members to give notice to their clients every time the decision was made to withdraw from making a principal market in a security.

b. Conduct of wholesale trading

(1) *Quotations of wholesale dealers*

(a) *Basis for quotations.*—Because of the decentralized nature of the over-the-counter markets and the lack of central reporting of orders and executions, the wholesale dealer has limited information concerning actual or potential buying power or selling pressure upon which to base the price that he quotes. Such information as he does have may have to come from a number of sources.

One of the primary sources for the trader of information about buying and selling interests may be his own retail department, correspondents, or other firms with retail customers.[83] On the basis of his assessment of information about retail activity, the trader can make an educated guess as to the extent of retail demand and supply for a security. However, a particular market maker's knowledge of the state of the total market is comparatively limited because buying and selling interest for a security is not concentrated in a single place.

A trader may also gain insights as to the market situation from the trading process itself. Through the constant stream of communications over the interdealer network, experienced traders can obtain a "feel" for the market in a security. A representative of one large wholesale trading firm described information about retail activity as "something similar to a specialist's book." Friendly traders, as described below, may exchange information about the sources and extent of buying or selling interest in a security.[84] The process of negotiation between traders may also elicit useful information about market conditions.[85]

Another source of information is the limit orders which a wholesale dealer receives from other broker-dealers or retail customers of the firm. (The limit order is a firm offer to buy or sell a stated amount of

[83] See the discussion in ch. IV.B.3.b, of the particular problems in connection with assessing retail demand and supply in the immediate after-market for a new issue.

[84] See subsec. (2), below.

[85] A trader in one large trading firm gave the following example of how the trading process provides useful information as to buying and selling interests:

"* * * if I would make a market, let us say, I would just take an arbitrary thing, let us say, 5¼–5¾ for a possibility, as an example.

"I say I have an even position and somebody would come and bid me, for example, 5½ for this stock. I would say, 'No, I have no desire to sell the stock at 5½.' I would reoffer at 5¾, but, meanwhile, I still know in my mind that there is a 5½ bid for the security. So, at the moment, my 5¼ bid should be pretty good, not realizing the fact that he might possibly execute his order.

"These things, we just do not know. We have to take the chance, and this makes my bid much better, knowing there is a higher bid for the security away from me."

securities at a stated price usually away from the current market.)[86] Some firms will not accept such orders; others will accept them but will not protect them, i.e., will not guarantee their execution even if the market reaches the stated price. Where protection is given, the criterion is usually the firm's own market. Some firms will accept limit orders but will retain them only under certain conditions, such as the specified price remaining not more than 20 percent away from the current market price. Unlike the limit orders on the exchange specialist's book, limit orders held by wholesale dealers are relatively scarce and thus seldom provide any reliable measure of the public interest in a security or guide to market trends.[87] In any event, even to the extent that a wholesale dealer holds limit orders, his knowledge of the potential market is limited because there may be other competing market makers holding other such orders.

It is important for the wholesale dealer to keep abreast of quotations of competitors so that he will not be "off his market." Without a central marketplace where limit and market orders for a security are concentrated, the wholesale dealer will normally communicate with competing market makers to insure that his quotations are in line with those of his competitors. However, a wholesale dealer cannot be sure that a competitor will give him a true picture of the market. In dealing with competitors dealers often widen the spread in their quotations since they are usually not eager to do business with them.[88] Generally, they feel that whatever the competitor has to gain by doing business with them, they must lose. A partner of one trading firm testified:

> To put * * * it very simply, if you trade with a competitive house as opposed to trading with a retail house who has initiated the order, instinctively there are times that we will not trade with the competitive house, based on the fact that we are not looking to put anybody else in business, if I may use that expression.

For this reason a wholesale dealer may request a third firm, who is not a competitor, to obtain a quotation for him.[89]

Automation, with its possibilities for the collection, processing, and dissemination of information about buying and selling interests in the over-the-counter markets, could have a far-reaching impact upon the manner in which wholesale dealers arrive at quotations. The possible effects of automation upon this aspect of the operation of the wholesale markets are considered in part E of this chapter.

(b) *Publication of quotations.*—By inserting quotations in the sheets, wholesale dealers advertise their buying or selling interests in securities. As described below, the sheets are the primary medium for the dissemination of wholesale quotations among professionals.[90] Although not every appearance in the sheets represents the same type

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[86] See ch. VI.B for a discussion of limit orders in the exchange markets.

[87] It should be pointed out that, in the absence of any system for publishing prices of consummated over-the-counter transactions, a customer has no reliable method of ascertaining whether his limit order should have been executed.

[88] Traders always request an inquirer to identify himself before a quotation will be furnished.

[89] It is interesting to note that in the markets for Government securities brokers are sometimes used by dealers to obtain quotations from other dealers. Brokers performing this service are sometimes referred to as "lieutenants." By employing a "lieutenant," a dealer hopes that his competitors may think that the broker is seeking a quotation for a nondealer. "Lieutenants" are apparently used when a dealer wishes to dispose of a position. See "A Study of the Dealer Market for Federal Government Securities," Joint Economic Committee, 86th Cong., 2d sess., 1960, p. 21.

[90] See the detailed discussion of the sheets in sec. 3, below.

of interest, as discussed below, there is a direct correlation between the number of wholesale dealers inserting two-way quotations and the volume in a security (app. VII–A, tables 4 and 4a).

A dealer may appear in the sheets on both sides of the market, or on one side only, or may advertise only its name without any indication of price. It may be identified in the sheets only on the side of the market in which it wishes to transact business or it may advertise a side of the market in which it does not wish to do business in order to conceal its interest. Even though it has a more or less continuous interest as market maker, it does not necessarily advertise that interest regularly.[91] In the absence of any system for differentiating quotations of a continuous market maker from those of other dealers, a person using the sheets cannot ascertain from them whether a dealer is interested in both buying and selling, whether he is acting as a correspondent, or whether a dealer's two-way quotations reflect a continuous market of appreciable depth or permanence. In an individual case, particularly where there is not a substantial number of two-way quotations, it is difficult even for the professional to determine what kind of professional participation is represented, because of wide divergencies among dealers in respect of available capital, inventory positions, and concepts of responsibility in making markets.

As indicated, the advertising of a dealer interest may not be continuous, particularly among inactive securities. To provide an illustration of the sporadic quality of dealer advertising in the sheets, the study took a sample of 300 common stocks appearing in the sheets over a 2-week period[92] and then sought to measure the frequency of the appearance of dealer interest in these stocks during that period.

Of the 300 stocks with apparent dealer interest listed during the period, 251 appeared on each of the 10 days studied. Thus, approximately 16 percent of the securities did not have sufficient dealer interest to be quoted on each of the 10 days. In many other securities dealer interest was minimal. Of the 273 securities in the sample quoted on a single day at the middle of the period covered (October 31, 1961), 161 (or 59 percent) had more than 2 dealers entering quotations of any type, 48 (or 18 percent) had 2 dealers and 64 (or 23 percent) had only 1 dealer. Of the 64 securities in the sample which had only 1 dealer entering any type of quotation on the single day, 26 were two-way quotations (bid and asked), 23 were one way only (bid or asked) and 15 had no price quotation at all (blank or "OW" [offer wanted] or "BW" [bid wanted] or a combination thereof). In the group of 48 securities having 2 dealers entering any type of quotation, 26 securities had both dealers appearing with two-way quotations and 22 securities had a mixture of two-way quotations, one-way quotations, and no quotations at all.

On the same day (October 31, 1961) there were 1,100 separate insertions for the 273 securities quoted. Eight hundred and forty-four of these were two-way quotations and 137 were one-way quotations; 119 dealers appeared with no fixed price quotation. Though there was a fairly high concentration of two-way insertions compared to the total number of quotations, approximately 35 percent of the two-way quotations were concentrated in 27 securities (10 percent of the sample)

[91] The frequency of appearance depends, among other things, on the dealer's willingness to incur the expense of insertion of quotations.

[92] The first 300 issuers whose names were listed in the Eastern edition of the sheets from Oct. 24 to Nov. 6, 1961, were chosen for study (excluding all listed companies, preferred stocks, warrants, units, closed-end investment trusts, stubs and securities which were first publicly distributed during the period).

and approximately 62 percent of the two-way quotations were concentrated in 63 securities (23 percent of the sample).

Thus, for a substantial number of over-the-counter securities, there is limited advertised dealer trading interest. Moreover, dealers making continuous firm trading markets in a security may be indistinguishable in the sheets from those having an interest on only one side of the market or just an occasional interest.[93]

(c) *Firmness of quotations.*—Prices quoted to another broker-dealer are supposed to be "firm" unless otherwise specified. This means that the dealer supplying the quotation is expected to be ready to buy or sell at the prices quoted in an amount equal to the normal unit of trading in that security (usually 100 shares). The quotation given in response to an inquiry may be qualified by an indication that it is "subjects" (i.e., not firm), "small" (i.e., less than 100 shares), "workout" (i.e., the trader will act essentially as broker and attempt to find interest on the other side), "coming to me" (i.e., the market quoted by a trader is not his own, but is being made by another trader), or a number of other terms indicating that the quoting dealer is not making a firm market.[94]

Quotations of wholesale dealers which appear to be firm may turn out to be illusory. A trader giving a firm quotation on the telephone or over the wire may subsequently qualify his quotation when an inquiring dealer attempts to execute on it. The practice is known as "backing away" from a quotation. The giving of a quotation that is not firm and not so identified is usually for the purpose of creating a misleading impression of price or of determining the inquirer's interest.[95] Wholesale dealers may also back away from quotations placed in the daily quotation sheets, which are supposed to be firm when placed—usually the day before the sheets are received by subscribers.[96]

The NASD files, Commission experience and comments of members of the industry make it clear that such activity is not uncommon. Several over-the-counter broker-dealers interviewed by the study indicated that "backing away" occurred with disturbing frequency, particularly among smaller and poorly capitalized broker-dealers making markets in speculative new issues. However, formal complaints by dealers to the NASD are few in number, apparently because of a reluctance to "turn in" a fellow dealer because unreliable dealers in many cases soon become known to the wholesale trading community.[97]

Moreover, there were numerous complaints to the Commission and the NASD from investors in speculative new issues, during the new

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[93] The NASD has stated that it is an unethical trading practice to advertise a two-way market when a wholesale dealer has an interest on only one side of the market or has just an occasional interest. "Over-the-Counter Trading Handbook," p. 3.

[94] See "Over-the-Counter Trading Handbook" for a description of the various terms indicating a "subject" market.

[95] "Nothing riles a professional trader quite so much as to show his hand by offering to trade with someone, thinking he has been given a firm trading market in which to buy or sell 100 shares of stock for instances, only to be told that the prices quoted to him do not represent a *firm* trading market at all, but, on the contrary, were intended to represent merely a quotation for information purposes." [Emphasis in original.] Id. at 4.

[96] See sec. 3.a(5), below, for a discussion of the insertion of fictitious quotations in the sheets to facilitate illegal distributions and manipulate prices.

[97] The lack of a firm market may not be discovered because the quotation is obtained only for information of a potential retail customer and no attempt is made to execute on it.

issue phenomenon of 1959–61, who attempted to sell their stock in the after-market and were informed by their brokers that dealers making markets would not purchase their stock or would purchase it only at a substantial discount from the quoted bid price. For example, one investor who stated that he had purchased 100 shares of Porce-Cote Research & Development Corp. common stock in the original underwriting at 5 attempted to sell his share through his own broker who was not connected with the underwriting. His broker gave him a quotation of 6¼—6½ obtained from the underwriter. When the investor indicated through his broker that he wished to sell, the underwriter dropped its bid to 5¼ "to keep free riders out." Another investor attempted to sell shares of Transistor Specialties, Inc., and was informed by his broker that, although four broker-dealers were appearing in the sheets with bid and asked prices, none was willing to purchase his shares.

By quoting ostensibly firm markets over the telephone or wire dealers represent that a unit of trading can actually be bought or sold at the prices quoted. Upon the basis of these quotations, professionals check competing markets and prices and make their trading decisions. Broker-dealers also obtain these quotations in connection with their retail activities, so that investment decisions of customers and the quality of executions for customers may depend on them. In these and other respects, backing away from quotations impairs a basic mechanism on which orderly operation of over-the-counter markets depends.[98]

The practice of "backing away" is presumably in violation of the NASD "Rules of Fair Practice" which require that all quotations be "bona fide." [99] However, the NASD apparently has not developed a regulatory program to deal with the problem. It has treated the matter as one of "misunderstanding" resulting from "careless phrasing," but it has not defined specific obligations binding on members. [100] Although the NASD "Rules of Fair Practice" require that a nominal quotation be so labeled, officials of the NASD and of the National Quotation Bureau, the publisher of the sheets, were unable to recall a single instance in which the sheets carried, or were asked to carry, quotations designated as "nominal." Nevertheless, the practice of "backing away" from published quotations as well as wire or telephone quotations appears to persist in sufficient degree to be of concern.

The Commission has general rulemaking power with respect to fictitious quotations under section 15(c)(2) of the Exchange Act, but no rules have been adopted under this provision.[101] The legislative his-

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[98] As described below, quotations in the sheets also serve as the basis for NASD regulation of markups and for its retail quotation system. See pt. D.4, below.

[99] NASD "Rules of Fair Practice," art. III, sec. 5, and "Interpretations, Policies, and Explanations, Manipulative and Deceptive Quotations," NASD Manual, G–54.

[100] See "Over-the-Counter Trading Handbook," p. 4.

[101] Sec. 15(c)(2) of the Exchange Act reads as follows:

"(2) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation. The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious."

tory indicates that "backing away" was one of the problems at which the provision was directed.[102]

(2) *Competition and diversity among dealers*

One of the unique characteristics of the over-the-counter markets is the presence of numerous wholesale dealers making markets for securities.[103] The effects of competition among wholesale dealers and the diversity of their purposes, expectations, and resources upon spreads in quotations and prices, where several dealers have an active interest in a particular security, is explored in this section.

Competition among dealers tends to narrow the spread between their individual bids and offers, particularly in stocks that sell in the medium and upper price ranges (table VII–3).[104] For example, in table VII–3, of the four stocks priced from $20.01 to $35 which had a spread of less than 2½ percent, none had fewer than five quoting dealers; but for the three stocks in that price category with spreads of over 7½ percent, none was quoted by more than four dealers. The table also shows that the size of individual dealer spreads may be related to the price of the stock as well as the number of dealers listed. Of 54 stocks priced between $.01 and $3, 27 or one-half had spreads of 30 percent or more and 6 had spreads of 50 percent or more. Moreover, spreads in these securities tend to remain wide regardless of the number of wholesale dealers. Of the 12 stocks in the sample priced from $.01 to $3 having 7 or more dealers inserting quotations, 10 had an interdealer spread of 10 percent or more. On the other hand, in the 20 stocks priced over $10 having 7 or more dealers inserting quotations, only 1 had a spread of 10 percent or more.

In quoting securities with limited activity, market makers widen their spreads because of the doubt that they will be able to dispose of shares accumulated in the course of marketmaking. This is particularly true, as noted above, in low-priced speculative securities in which there is little continuing public interest. For example, table VII–4 demonstrates that, for securities with low volume, the average spread between purchases and sales tends to widen. In 19 of 30 securities with total sales less than $10,000, the average sale price was more than 4 percent above the average purchase price. On the other hand, of 50 securities with total values of sales over $20,000 in only 2 did the average sale price exceed the average purchase price by 4 percent or more.

Similarly, the average spread between purchases and sales tends to narrow in securities with significant professional participation. For example, in securities with 9 or more market makers, only 3 securities

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[102] The principal witness for the Commission at the hearings on this provision gave the following example of fictitious quotations:

"Well, we find this situation not infrequently. Quotations are published by a dealer which are not genuine at all. He won't buy, he won't sell, or, perhaps, he sends out generally a quotation that he will buy 10 shares of stock if they are offered to him. He will send out a quotation which bears no relation to the real market. The real market may be 40. He may send out a quotation far from that market."

Hearings on S. 3255 and H.R. 9634 before the House Committee on Interstate and Foreign Commerce, and H. Rept. 2307, 75th Cong., 3d sess., p. 17 (1938). See also hearings on S. 3255, "Regulation of Over-the-Counter Markets," before the Senate Committee on Banking and Currency, and S. Rept. 1455.

[103] See the discussion in ch. VI.D.3 of the declining importance of competing specialists in the exchange markets.

[104] The sample is described in subsec. 2.b(1)(b), above. The 212 stocks consisted of all stocks in the sample appearing in the Eastern Section of the sheets on Oct. 31, 1961, and having at least 1 dealer quoting a 2-way market.

of 28 had spreads between average purchase prices and average sale prices in excess of 3 percent (table VII–5).[105]

Whatever may be the prevailing spread in quotations of individual dealers for a given security, their diverse purposes, expectations, and resources may serve to narrow the overall market. For example, wholesale markets made by three different dealers with the following respective quotations:

Bid	*Offer*
49	50
49¼	50¼
48¾	49¾

would permit sales at prices as high as 49¼ and purchases as low as 49¾. Thus, although no individual dealer's spread is less than one point, the spread between the best bid and best offer is only one-half point. The greater the number of dealers making a market the greater the chance for diversity, which will reflect itself in a narrowing of the difference between the highest bid and best offer.

The effects of diversity are indicated by an analysis of the spreads between the highest bids and lowest offers in wholesale quotations for the stocks in the 200 stock sample having at least 1 dealer quoting a 2-way market.[106] Table VII–6 indicates that the greater the number of market makers, the narrower the difference between the best bid and offer. Of the 42 stocks in the sample with only 1 to 2 dealers quoting 2-way markets,[107] 18 had spreads in their best bid and offer quotations of 10 percent or more and another 19 had spreads of 4 percent or more. At the other extreme, 20 stocks in the sample had over 10 dealers quoting 2-way markets and of these 20 stocks 15 had spreads between best bids and offers of less than 2 percent and 8 had spreads of less than 1 percent.

Actual prices of consummated interdealer transactions, as well as quotations, reflect the results of diversity. Table VII–7 shows the average prices of purchases and sales of market makers with other dealers in 9 stocks which traded on January 18, 1962, selected from the 200 stock sample. These securities were among those with the greatest professional participation of the 200-stock sample on January 18, 1962, based on the number of dealers entering 2-way quotations in the sheets. Although the stocks were actively traded and the total range in purchase and sale prices was relatively narrow, the table shows significant diversity in average costs of purchases among different market makers, and likewise significant diversity in average selling prices among different market makers.[108]

The foregoing analysis points up two important facts about interdealer quotations: First, the size of the interdealer spreads and the

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[105] For a detailed analysis by stocks of the range of prices of all market makers' purchases from other broker-dealers and of all market makers' sales to other broker-dealers for a sample of 78 securities on Jan. 18, 1962, see table VII–25.

[106] 163 stocks in the 200 stock sample had at least 1 dealer quoting a 2-way market on Jan. 18, 1962.

[107] Unless otherwise noted, the number of dealers referred to here and elsewhere in this chapter pertains to the number of dealers for each stock in the Eastern, Western, or Pacific Stock Sections of the National Quotation Service, depending upon the location of the principal market for the stock.

[108] Table VII–7 also illustrates that transactions by market makers on both sides of the market may be concentrated in a fraction of the dealers entering 2-way quotations. This concentration may be the result of a number of factors: Some of the ostensible market makers may have been correspondents for other firms; some firms may have more advanced systems of communication which enable them to obtain a greater percentage of orders than others who have the same quoted market; and others may have been unwilling to execute at competitive prices.

extent of interdealer competition are extremely relevant to the public customer in evaluating the liquidity of his investment in a security. Large spreads mean that a customer may lose a substantial portion of his investment immediately upon his purchase. Yet the size of wholesale spreads and the number of wholesale dealers is not ordinarily disclosed to the investor, who may purchase in the unfounded expectation that his investment has reasonable liquidity. Second, the analysis shows the importance of checking competing markets to obtain the benefits of diversity.[109] If a broker-dealer fails to check markets, the advantages of diversity may be denied to his customers. The existence of an active competitive market does not insure that the random selection of a wholesale dealer will result in the best possible execution since the diversity among market makers will cause them to have different bids and offers. Indeed, repeated execution with the same dealer without checking usually enables the market maker to guess whether the broker is a buyer or seller and, knowing that the broker will not check prices, to quote his market accordingly.

While competition appears to narrow the spreads both between bids and offers and prices of purchases and sales in active securities, various factors tend to limit its effectiveness in certain respects in the wholesale markets. One such factor is the employment of noncompetitive practices by traders. Some of these practices arise out of friendliness between traders. Friendly cooperation may involve warning other traders of the approach of buying or selling interests. For example, a trader indicated how he might be advised of selling interest:

> * * * I have not received a call in a stock in 5 minutes. * * * The last I heard, my market was 10 to ½. So, an unfriendly wire comes in, and he said, "What is your market?" I say, "10 to ½." He says, "I will offer you 500 shares at 10." I say, "I will buy 100 shares at 10." He says, "Thanks."
>
> He goes off the wire, I immediately check an outside wire of a firm who is my competitor, and ask him. He then tells me it is 9¾ to 10¼. He says, "There is a sell order. Watch out."
>
> I was off my market. He may not tell me about the sell order, but I know that he has already bought stock at 10. Therefore, he is dropping his bid. He is lowering his bid price. I go along with the same price that he is making.

Another trader described how his friend might learn of buying interest:

> Yes; if the market * * * is 20½ to 1, but * * * in New York * * * a very substantial buyer * * * decides they are going to buy 20,000 or 50,000 shares of this stock for an account, the market is no longer 20½ to 1. You may think it is and you are sitting there and if he is going to take all that stock, the market is at least 21 to ½.
>
> Now, if a competitor of yours gets the first call * * * and he makes the market, 20½ to 1, the man says he wants 5,000, he sells him 100 [the competitor] knows that the market is going to change, so he may call * * * the next fellow, 20½ to 1, and the next fellow would be, let's say somebody friendly to us, and he takes him, that is, buys 100 shares at 20½ to 1, to get his 100 back even, because he now knows the market is 21 to ½. My friend may call me and say watch out for so and so, he just knocked me off for 21 so when he calls, I tell him 21 to ½.

Traders may "hold hands" with one another:

> * * * [F]or instance, I might be making a market on a stock 8¼–8½. I call somebody else and he says he is 8⅝–8⅞. I say I think he is a little high, you

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[109] This is without regard to the possibility that the executing broker-dealer may be able to negotiate a better price than even the best quoted bid or offer. It appears, however, that in many of the situations in which such negotiation is successful the executing broker-dealer is acting for another professional or an institution. See pt. D.2.b, below.

had better get down, because I am a quarter to a half. I just bought stock at three-eighths.

If that is what you mean, I won't do that to everybody, somebody who is a friend, I will; somebody else I will say, you got it at five-eighths.

Q. And you will hit him with it?

A. Yes. * * *

Friendly accommodation may even take the form of not making markets as a favor to another firm:

* * * [Firm X] went short a great deal of stock, and he [the trader at Firm X] asked me not to make a market on it, not to make a price in the sheets so he could try to cover, which is what I did for a few days.

* * * * * * *

They asked me not to make a market, so they could cover some shorts.[110]

One large firm described the practice of "hand holding" as varying "from a little pat to a very strong handclasp." In its extreme form ostensible competitors may share profits and losses in a joint account which is not disclosed.[111] In this connection, an official of one large wholesale dealer firm cautiously commented:

A. * * * [J]oint accounts or holding hands are funny things. People guess at them a lot and don't really know for sure because that is considered a legitimate business practice. It has been historic for as long as I know in the street to conduct your business or for some people to conduct their business that way.

When I look at [Firm X] and [Firm Y] in the sheets, * * * I wouldn't know whether they are working together or not. I might subsequently find out by the pattern of trading and action or have a pretty shrewd guess.

Q. Does [your firm] hold hands with other trading firms on occasion?

A. We have a few.

Q. Have you a joint account with other firms, too?

A. Yes.

* * * * * * *

Q. Would you give us an example * * * what actual stock [you] had a joint account or held hands with another trading firm.

A. This information could get out to our competitors, to our competitive disadvantage.

Q. Off the record.

The study did not seek to determine the prevalence of these noncompetitive practices in the wholesale markets. However, the permissive attitude of some wholesale dealers toward them suggests that competition in these markets may at times be impaired, resulting in an appearance of competition that may not always accord with reality. Practices have come to be tolerated which are inconsistent with the frequent emphasis on the competitive nature of the wholesale markets.[112]

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[110] One trader indicated that friendliness may arise out of special contacts:

"Well, it is certain people that you get to know through the years and you meet people and you meet them at better parties and the trader parties and you have a drink with them and so forth. You get friendly with them.

"Other people you just do not like and if you can, we do what we call—what we term knock them off. We do it with great relish and it is done to us, too."

[111] See sec. 1.b(3), above.

[112] One wholesale dealer, for exampe, described the competitive nature of the interdealer markets in this way:

"One of the fundamental principles of government relation of American industry and commerce is *insuring competition*. And it works. Just insure that prices and market conditions are determined in competition and regulation is automatic.

"The specialist system on the exchanges concentrates trading in stocks in the hands of one firm, many times a single individual, located in one place, whereas the over-the-counter system spreads the trading out over the entire country over a good many firms whose financial responsibility in total far exceeds that of the specialist firm.

"Although the over-the-counter dealers (many of whom are Exchange members) could not as a group be any more honest than anybody else—they don't need to be to protect the public, because *competition* keeps them honest." [Emphasis in original.]

A different kind of limitation on the effectiveness of competition in over-the-counter markets is that for securities of limited activity there may be only one or two market makers. This type of situation, which is of considerable importance in the total over-the-counter category, is separately discussed below.[113]

c. The integrated firm

The integrated firm combines wholesaling and retailing activities. Its trading activities may be primarily an adjunct of its retailing activities [114] although in certain securities the integrated firm may conduct its trading activities like the wholesale dealer. As described earlier, the integrated firm may use its trading department to accumulate inventories for retailing to its customers. Often it trades or "sponsors" a security because of an underwriting relationship to the issuer. In some securities, the integrated firm may effect a high percentage of the dealer transactions in the issue and in the case of inactive issues it may be the sole or dominant market maker. The integrated firm in its trading activities may have different relationships to different securities depending upon such factors as the size of the trading department, the number of its customers holding the security, the retail interest of its customers and its relationship to the issuer.[115]

It would appear that the trading activities of the integrated firm have become of increasing importance in the wholesale markets. This fact is attributable, in part, to the large number of new issues offered publicly in recent years, in which the managing underwriter has often become the principal market maker for the issue. The following discussion of the integrated firm should therefore be considered in conjunction with the description of the underwriting of new issues in chapter IV.B.

(1) *Conduct of trading activities*

The relationship between retail and wholesale departments in integrated firms varies considerably. At the one extreme, particularly in small firms, the same person may act as trader and as retail salesman.[116] At the other, there may be a complete separation so that retail salesmen are not permitted to deal with the firm's trading de-

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[113] See sec. c(3), below.

[114] The extent to which firms combine over-the-counter wholesale and retail activities can be seen in app. VII–A, table 20. Of the 1,200 firms indicating that their primary activity was over-the-counter retailing, 409 listed wholesale trading as their secondary activity. Similarly of the 352 firms listing wholesaling as their primary activity, retailing was the secondary activity of 227. See also table VII–2.

[115] And as mentioned above, the integrated firm may, of course, do a retail business in securities in which it is not a market maker at all.

[116] In the exchange markets, transactions of public customers are almost always handled on an agency basis. In addition where an exchange member has an interest in a security, a number of exchanges' rules are designed to place customers' interests ahead of those of exchange members dealing for their own account. See, e.g., NYSE rules 91 and 92. There are not similar rules in the over-the-counter markets.

A senior partner of Troster, Singer & Co., one of the largest wholesale dealer firms, made this comment on combining trading and retailing activity in the same personnel:

"We have found one thing to be true in our own organization: that it is almost impossible to be a serviceman and a trader at the same time. A serviceman will call up an institution and say that there are 10 bonds available or 500 shares, or he will keep a prospective customer informed as to the trend of a market in certain securities. If, in addition to servicing he also has the responsibility of making markets in other securities, he will be pressed for time. For, while he is making the call to advise that a certain stock is moving, someone else will ask for a quote on another stock. He will have to give up his first call for the moment, and get his mind on his own trading. It is the constant interruption of ideas, of trying to make a profit for yourself and at the same time keeping someone informed on the course of the market that is difficult. The two just do not jibe. They are always at cross purposes, and as soon as you get into one, I advise dropping the other." "Wall Street Explains Its Operations," New York Institute of Finance (1951), p. 52.

partment. In some integrated firms the trading department is regarded as an individual profitmaking entity and its inventory policies are governed by the same considerations that exist in the case of the wholesale house.[117] However, even in such cases, there are certain important differences between wholesale firms and integrated firms relating to the conduct of their trading activities.

The integrated firm is closer to the retail market and often is better able to judge retail buying and selling interest. It can interest its customers through its merchandising activities and in so doing generate trading activity. Whereas the wholesale trading firm may have to raise quotations to cover a short position and lower them to dispose of a long position, the integrated firm may be able to cover or dispose of trading positions through its own customers without changing its quotations. A representative of one integrated firm testified in this connection as follows:

Q. Now just assume that you acquire a long position and the market is thin and it is declining, or at least it is not going up. Do you dispose of the security at times through the solicitation of your retail customers?

A. Yes; we do.

Q. Is it fair to say that one of the most significant ways of getting rid of—I don't mean that with any detrimental implication, but limiting your long position is soliciting your retail customers to buy the stock in the after-market?

A. That is correct. It is a question of bringing buyers and sellers together, that is right.[118]

In a similar vein, a representative of another integrated firm commented:

I think we always have to be prepared to reduce the long position through our own retail department. We might or might not have to do it, but generally speaking I think that it would be done mostly when we take a position that we do liquidate it through our own retail department.

* * * * * * *

I think that goes back to what was said this morning, that we would not take this long position unless we were prepared to recommend the security to our customers.

The nonintegrated firm does not have a retail department through which to sell inventories. As a trader of one such firm testified:

Q. Do you have any retail customers?

A. No, sir. I would say it would be around one-half of 1 percent. For instance, people in the family and a few friends that bother us occasionally. We definitely discourage anybody coming to us.

Q. You can make a fair and orderly market without the use of retail customers?

A. We do.

Q. When you have a long position you either get stuck or you have to get rid of it slowly in the street. Is that correct?

A. That is right.

Q. You can't make use of the retail department?

A. That is not our function. If we decided to drop the stock we would have to freeze the stock until some time that we felt we wanted to sell it.

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[117] When an integrated firm makes a sale out of inventory to a public customer, the trader will usually "bill" the retail department for the sale at the trader's asked price, and the retail department will add to that price a "markup" in order to arrive at the retail price to the customer. The salesman's compensation is usually a percentage of the markup. See ch. III.B. The pricing practices of the integrated firm are further discussed in pt. D.4.b, below.

[118] The use of a retail department to cover short positions is less common. However, during the new issue phenomenon of 1959–61, firms participating in the distribution of "hot issues" who later made markets in such issues frequently placed allotments with persons from whom shares could be readily repurchased to cover short positions in firm trading accounts.

However, large wholesale dealers may, to some extent, benefit from the retail interest of their correspondents:

Q. If you have a long position which you regard as an unduly long position, to what extent would you utilize the retail department in order to distribute that stock?

A. May I answer that? We have no retail departments. * * *

* * * * * * *

Q. Would you ever rely on your correspondent network to stimulate interest in a security?

A. Might; yes, sure.

* * * * * * *

We regularly produce material from our research department for the benefit of our correspondents around the country.[119]

The significance of the combination of retail and trading activities may be looked at in another way: In a market made by firms trading only on an interdealer basis, selling interest is transmitted directly to the market, and normally tends to affect the price because the seller either sells at another's bid or lowers his own offer in order to dispose of unwanted inventory. Under such circumstances buyers will gravitate to the lowest offer and the desire to sell will be reflected in a lower market price. However, an integrated firm that wishes to sell inventory in the over-the-counter markets has a further choice—it may use its sales organization to recommend the stock to public customers who may have no knowledge of the relative prices of other wholesale dealers, the position of the soliciting broker-dealer or the reason for the recommendation. Sales to retail customers therefore may be made with less pressure on overall prices. This technique of placing over-the-counter securities "outside" the wholesale markets is similar to the method by which most large-scale distributions take place. Underwriters place securities, not into the trading markets, but rather away from them with numerous individual investors so that selling pressure will not be felt in the market.[120] The integrated firm can use the same technique and for the same reasons. Indeed, it should be recognized that one important advantage of the over-the-counter markets is that they permit the distribution or redistribution of large blocks of securities to investors "away from" the interdealer trading market and without placing temporary stress on such market.

(2) *The managing underwriter in the after-market and sponsorship*

There are two major areas in which the trading and underwriting activities of the integrated firm may interact. The first involves the trading activities of the integrated firm in the immediate after-market for an underwritten issue; the second relates to the responsibility, called "sponsorship," that an integrated firm may feel to provide a continuous trading market for an unwritten issue. The following section discusses the trading activities of the integrated firm in each of these areas.

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119 Another large wholesale firm stated in an advertisement:

"How does Troster, Singer widen interest in local securities traded most actively by its correspondent firms? By good merchandising. This brings us back to the frenetic activity of the trading room; the traders widen interest by getting on the phone and talking to other dealers on the network. Also, the firm's research department gets to work investigating the locally popular securities to see if they warrant national interest; if they do, a report is prepared and sent to correspondents." (Investment Dealers Digest, p. 41 (Apr. 24, 1961).

120 See the discussion of exchange distributions in ch. IV.C.2.

(a) *The after-market.*—In the immediate after-market for an underwritten issue, the managing underwriter may absorb large amounts of stock in the course of its trading activities.[121] These activities are frequently conducted for the purpose of "stabilizing" or making "orderly" the over-the-counter market for a security in fulfillment of the managing underwriter's professed duty to the issuer, the other underwriters and the purchasers in the original offering. Shares acquired by the managing underwriter are then redistributed to its own customers or to other broker-dealers—a process which in an exaggerated degree parallels the activities of the integrated market maker described above.

One large managing underwriter making substantial purchases in the after-market for an underwritten issue described its responsibilities in this way:

Q. On March 9, Marache, Stroud, Becker, Casper Rogers, Vilas and Hickey, Saxton, Warner Jennings, Singer Bean, and A. P. Montgomery * * * appear, * * * can you give us an explanation why it was necessary for [your firm] to make a fair and orderly market?

A. We believe we have the responsibility to the underwriters and the people who purchase the stock through the underwriters and the issuing company * * * to make a market or attempt to make an orderly market.

Q. Do you think the market being made by the people on this list, which includes some of the largest houses, was disorderly?

* * * * * * *

A. The primary reason, as we have stated, was the responsibility to the customers of all underwriters, to the underwriters, to the company issuing, the company selling to the shareholders; if we market profitably, it is all to the good.

* * * * * * *

Q. It dropped in price 4½ points in about a 25-day period. * * * Why did [your firm] feel it was necessary to buy the securities [on balance] when the market was going down?

A. We don't think it affected the market price. We bought at the bid market.

* * * * * * *

Q. * * * We were discussing the $44,000 long position of your trading account as of October 31. Is it fair to say that your long position was caused by the drop in [X stock] from the price of 22½ down to 15 per share?

A. There were more sellers than buyers.* * * We simply move with the quotations, perhaps making a better bid than some people. We are not just a 100-share bidder.

Another important underwriting firm expressed similar views:

Q. Let us assume that * * * the stock drops below the offering price. What is [your firm's] policy with respect to what they do in that kind of situation?

* * * * * * *

A. If we feel that we can be constructive, it is not necessarily because it has gone below the issue price—it may have been a very handsome premium and it may have declined, which would indicate they are selling—but if we feel that our trading functions could help in inducing orderliness into the market, we might very well then undertake a trading operation in that stock.

* * * * * * *

* * * We might have a feeling we could strengthen that market by soaking up what supply might be around and getting it into different hands.

* * * * * * *

* * * We either retail it out through our retail department, or we will make a market between brokers.

Q. Which of the two procedures was followed most often?

A. I would say the former.

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[121] See also the discussion of the managing underwriter in the after-market for new issues in ch. IV.B.3.c.

Q. Retailed out to your customers?
A. Yes.
Q. Basically, the salesman would call up his own individual customers and say, "I would like to sell the stock to you?"
A. Bear in mind that, first of all, we won't take that long position unless we think the security is attractive and that we are willing to recommend it to our customers.

* * * * * * *

Q. But the situation would arise, in at least two of the three situations which you have described, in which the public, in aggregate, decided that it was not so attractive—and that is why you were forced to take the long position in the first place.
What you are saying is that [your firm] takes an opposite view?
A. We do in many instances. I suppose that is what makes buyers and sellers.

The fact that an underwriter may purchase shares on balance in a declining market, as a result of bidding somewhat higher than other wholesale dealers, not only tends to retard the decline but also assures the underwriter of control over the prices at which shares are redistributed to public customers. However, this is not to say that underwriters refuse to lower their bids in a declining market after an underwriting. Rather, they often will take more shares at a prevailing price and perhaps, if they are simultaneously soliciting retail customers, enter the market with a stronger bid than other market makers. In a sense, therefore, the purchases of its customers on redistribution, rather than the risk capital of the underwriter, may act as a stabilizing factor.

Some managing underwriters take a different view of their aftermarket obligations. A representative of one large integrated underwriter, for example, told the study that, while partners of the firm might purchase for their own account or accounts of their families issues which the firm had underwritten, the trading department would be unlikely to do so. Furthermore, the firm apparently does not dispose of positions acquired in the course of trading by sales to retail customers. A partner of another underwriter expressed somewhat similar views:

Q. Do you find that the market is disorderly when you, as managing underwriter, are not there in the sheets helping to maintain it?
A. No.
Q. Do you think that your customers are suffering because you are not in the sheets making a primary market in those issues?
A. We think not.

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Let's say that, instead of 1,500, I had 10,000 shares. Let's say that I am a little bit frantic about the position that I have, and I want to unload it. Well, this is something that [our firm] does not do.
Q. But in that situation the stock is lower than the offering price. So couldn't you justify it on that ground?
A. The answer to that would be that you can justify it on the basis of what I told you initially—that I think the stock is a good buy at 8½.
You could say that that would justify it if I had to support the stock by selling that stock out to a customer. But I still say to you that I think that I could be considered suspect as to what was my motive.
* * * I am an underwriter, and I am bringing to the public an issue. I am putting my name behind the issue. I am telling our customers and people generally that I think this is a good issue.
Now, having taken this position, if market conditions are unfavorable and I have to buy a lot of stock on a syndicate bid, and I now have a considerable position in this issue, I think that my position is much clearer, and my conscience is much clearer. If I really believe what I say about the issue, I think that all I

ought to do is get these people to buy the stock, not from me but in the open market. There can be no question then that I haven't helped myself to unload anything when I do this.

Why should I unload the stock on one of my customers? If the customer wants to buy it, he buys it the way that I bought it.

Now, at some later date, if this market rises * * * I may feed out stock in the open market, not to our customers but to those who have asked for it.

Q. In other words, all of your customers' orders during this period of time would be agency transactions?

A. Absolutely.

The after-market activities of Blyth & Co., Inc. ("Blyth") in the following case study help to illustrate some of the problems in this area. Blyth was the managing underwriter of an offering of 436,086 shares of Grosset & Dunlap, Inc. ("Grosset & Dunlap") at $29 per share offered on May 11, 1961.[122] Immediately following the distribution, the security rose from its offering price of 29 to 39, with certain customers on the offering date paying as much as 44. Blyth, however, was not making a market at this time since trading restrictions had not yet been terminated. The records submitted by reporting broker-dealers indicate that approximately 4,500 shares were purchased by 52 public customers on the first day of trading.

Until May 15 trading in the stock was concentrated in several firms that primarily bought from and sold to other broker-dealers who were executing customer buy and sell orders. On May 16, when the security had declined to 36, Blyth entered the trading market, purchasing approximately 10,000 shares and selling approximately 6,400 shares. According to Blyth, it was making a trading market hoping to profit on its spread. On the following day Blyth purchased and sold approximately 4,300 shares.

As Blyth's participation in the market increased, the participation of other wholesale dealers decreased. Within a few days after May 17, it was clear that the security was falling in price. Blyth stated that it did not let it "drop off * * * as quickly as we ordinarily would * * * because we were trying to curb it to some extent and make it orderly." By May 19, the security had fallen to 32 and by May 22 to 29, the original offering price. Between May 16 and 19, Blyth had substantially liquidated its long position primarily by filling a large institutional order which had been given to another broker-dealer for execution. During this period customer purchases of reporting broker-dealers fell off sharply.

On May 22, Blyth bought approximately 4,200 shares for the firm account and ended the day long approximately 3,700 shares. There was no significant buying power to assist in reducing its long position. On the next day, the firm purchased 10,000 shares and ended long almost 7,000 shares. On May 24, while the activities of other wholesale dealers were minimal, Blyth bought another 2,400 shares, almost all of which was adding to its long position. Blyth, in effect, had become the only market and, indeed, a depository for the positions held by other traders. On May 25, the firm bought almost 4,000 shares and ended the day with a 10,000-share position. The next day Blyth bought another 2,000 shares. By this time, all sales of Grosset & Dunlap were being absorbed by Blyth, there being practically no retail buying support for the stock. Blyth's long position was well in excess of $300,000. For

[122] Grosset & Dunlap, Inc., was 1 of the 22 new issues studied in ch. IV.B. For further details concerning the offering of this issue see app. IV.A.

the next few days the situation remained somewhat static, but on June 5 Blyth purchased another 2,000 shares, which increased its long position to 13,000 shares.

On June 7, Blyth reduced its long position by approximately 2,000 shares, not through its normal trading activity but rather mainly as a result of the firm's solicitation of customers, 31 of whom purchased over 1,500 shares, most at a price of 28¾. Representatives of Blyth testified that at this point, when the security was selling at or about the offering price, they were concerned about their long position and salesmen of the firm were told that they would be paid a larger than normal profit for sales of Grosset & Dunlap to retail customers.[123]

On June 8, Blyth sold 1,600 more shares, mostly at prices of 29, principally through the solicitation of customers, without, however, substantially changing its long position since the selling pressure by original distributees increased. On June 9, 20 customers of Blyth purchased 970 shares.

At or about this time, Blyth sold 10,000 shares to Morgan Guaranty Trust Co., 5,000 shares to One William Street Fund, and approximately 5,000 shares to 15 retail customers, with the result that the firm acquired a 10,000-share short position. When the firm went short, it withdrew the extra commission to salesmen, thus withdrawing the special inducement for sales of the stock.[124] During the week that followed, not one retail customer of Blyth purchased stock of Grosset & Dunlap. The selling pressure continued, however, enabling Blyth to cover its short position.

A representative of Blyth stated:

Q. So is it fair to say that even though you still considered the stock a good buy at the 28, 29 level because Blyth had a short position it wanted to cover——

A. Yes, that is what I wanted to bring out.

Q. It had to stop the active solicitation and recommendation to customers?

A. We felt that we had established our position so that we were now in a position to maintain a more orderly market. We didn't want to be short more than we had, than that, we thought that was a sufficient short, and that is the reason why we withdrew the profit [to salesmen]. We never stopped recommending the stock.

Q. But you knew that if there was no premium to the salesmen, that they weren't going to recommend it to their customers, and in fact, they would probably recommend some other stock where there was a premium to them?

A. That is precisely correct. And the salesman will usually work to sell something that he has got a profit in.

Q. Yes. Is it, then, really fair to say that at the point that you acquired your short position, you were more interested in making sure that the short position did not increase, because of buying by customers, than you were in recommending it to customers?

A. As I say, I feel sure, the way I recollect this, is that that was a sufficient short in our mind. As a matter of fact, we probably thought it might even be possibly a little dangerous, being short 10,000 shares, because we didn't expect the stock to keep going down, down, down. We thought there was a point where it would turn around.

Q. As a matter of fact, your belief that it might be dangerous was implemented by your taking away the premium to salesmen?

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[123] Blyth explained:

"* * * when it gets back down to issue price, it is there we commence to feel a little responsibility to our clients that we sold it to at 29, and to the issuer, plus the fact that we have originally thought this was worth $29 a share, and we haven't seen any reason to change our mind, at this point, and then we go out and retail it in order to reduce the position that is inordinately large."

See the discussion of salesman's compensation in relation to selling practices in ch. III.B.

[124] Blyth charged the cost of its trading operation in Grosset & Dunlap stock to its underwriting department since it did not regard its marketmaking activities as ordinary trading.